

Part III - Administrative, Procedural, and Miscellaneous

Common Trust Fund Straddle Tax Shelter

Notice 2003-54

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers for the purpose of generating deductions. This notice alerts taxpayers and their representatives that the claimed tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

FACTS

The transaction involves the use of a common trust fund (CTF) that invests in economically offsetting gain and loss positions in foreign currencies and allocates the gains to one or more tax indifferent parties and the losses to another taxpayer. For example, in the transaction, a bank (Bank) forms a CTF. The CTF's plan provides for monthly valuation dates and for the computation of income and loss on a monthly basis. Two tax indifferent investors, through grantor trusts (Investors' Trusts), each invest money in the CTF. The CTF then invests the money in economically offsetting positions in foreign currencies, which become offsetting gain and loss positions as a result of market price movements. The CTF sells the gain position and allocates the gain proportionately to the Investors' Trusts.

The next month, an investor (Taxpayer) who desires a tax loss uses a grantor trust (Taxpayer's Trust) to invest in the CTF. Taxpayer's Trust makes a large investment for an 80 percent share of the CTF. Consequently, the shares of the CTF's portfolio owned by the Investors' Trusts are diminished to 10 percent each. The CTF then sells the loss position. For tax purposes, the loss is allocated proportionately among Taxpayer's Trust and Investors' Trusts. Taxpayer's Trust is allocated 80 percent of the tax loss and Investors' Trusts are each allocated 10 percent of the tax loss under the accounting rules provided in § 1.584-2(c)(2) of the Income Tax Regulations.

ANALYSIS

The transaction described in this notice has been designed to use economically offsetting positions, one or more tax indifferent parties, and the CTF accounting rules of § 584 of the Internal Revenue Code to allow Taxpayer to

claim a noneconomic loss. The Service intends to challenge the purported tax benefits from this transaction on a number of grounds.

The offsetting positions entered into by the CTF did not have any effect on the CTF's net economic position or non-tax objectives and did not serve any non-tax objectives of the CTF or afford it a reasonable prospect for profit. Therefore, the losses purportedly resulting from this transaction are not allowable. See *ACM Partnership v. Commissioner*, 157 F.3d 231, 260 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999). In addition, the Service may disallow the loss of an individual under § 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for profit. See *Smith v. Commissioner*, 78 T.C. 350 (1982) and *Fox v. Commissioner*, 82 T.C. 1001 (1984) (disallowing losses from straddle transactions). Further, the Service may, under appropriate circumstances, assert that the CTF does not meet the requirements of § 584, including the requirement that it be operated in conformity with the rules and regulations of the Comptroller of the Currency, as set forth in 12 C.F.R. § 9.18 (2003). In that event, the Service will recharacterize such a CTF as a partnership and reallocate the gains and losses in accordance with the economics of the transaction and the interests of the participants. See § 704(b). In addition, the Service may challenge the allowance of the loss deduction based on other statutory provisions, including § 988, and judicial doctrines.

Transactions that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. The transaction described in this notice and the transactions described in Notice 2002-50, 2002-28 I.R.B. 98 (Partnership Straddle Tax Shelter), and Notice 2002-65, 2002-41 I.R.B. 690 (Passthrough Entity Straddle Tax Shelter), are substantially similar transactions. For purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), a transaction will be considered the same as, or substantially similar to, the transaction described in this notice even if the gain and loss legs of the economically offsetting positions are triggered in separate taxable years, or a trust other than a grantor trust is used. Further, it should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2), transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111, or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2 and 301.6112-1).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transaction described in this notice or substantially similar transactions and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transaction or substantially similar transactions and who fail to do

so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions or, as applicable, on persons who participate in the reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662 and the return preparer penalty under § 6694.

The principal author of this notice is Tara P. Volungis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Volungis on (202) 622-3080 (not a toll-free call).