Assigned - Wherry

UNITED STATES TAX COURT

PA

WASHINGTON, DC 20217

DERRINGER TRADING, LLC, JETSTREAM BUSINESS LIMITED, TAX MATTERS PARTNER, ET AL	)	
Petitioners	)	Docket No. 20872-07, 6268-08.
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

ORDER

On July 25, 2007, respondent sent Notices of Final Partnership Administrative Adjustment (FPAAs), relating to tax years ended December 31, 2003, and December 31, 2004, respectively, to Derringer Trading LLC (Derringer) and its tax matters partner, Jetstream Business Limited (Jetstream). On September 13, 2007, Derringer timely petitioned the Court seeking redetermination of the adjustment to partnership items set forth in the FPAAs. On November 26, 2007, Leila Verde Fund LLC (Leila Verde), a putative partner of Derringer during the years at issue, filed a Notice of Election to Participate with the Court.

On December 28, 2016, the Court filed Respondent's Motion for Summary Judgment. On January 11, 2017, the Court filed Petitioner's Opposition to Respondent's Motion for Summary Judgment. On January 27, 2017, the Court filed Leila Verde's Participant's Opposition to Respondent's Motion for Summary Judgment.

Respondent's motion requests summary adjudication in his favor under Rule 121.[1] In support of his motion, respondent argues that our opinion in Superior Trading, LLC v. Commissioner, 137 T.C. 70 (2011), supplemented by T.C. Memo. 2012-110, aff'd, 728 F.3d 676 (7th Cir. 2013) governs the resolution of this case.

Comparing the transactions in this case to the transactions in Superior Trading, respondent concludes that in every material aspect, the two sets of transactions are identical. Therefore, respondent argues that for the same reasons we advanced in Superior Trading, we should grant summary judgment in his favor in this case.

Petitioner does not make any specific allegations challenging respondent's argument that this case is governed by Superior Trading. Leila Verde does not counter respondent's argument at all; instead, it claims that there is no evidence to prove Leila Verde was ever a partner of Derringer. That claim, even if true, would not affect our review of respondent's adjustments to the partnership items of Derringer determined in the FPAAs.

Background

The following facts are derived from the parties' pleadings and motion papers, including the exhibits attached thereto. See Rule 121(b). In addition, we take judicial notice of the findings of fact set out in Superior Trading, 137 T.C. at 73-79, under Rule 201 of the Federal Rule of Evidence. We note that our decision in Superior Trading is now final within the meaning of section 7481.

We found the following facts in Superior Trading relevant, and we recite them here for context. Warwick Trading LLC (Warwick) was a limited liability company organized on December 17, 2001, under the laws of the State of Illinois by Mr. John E. Rogers (Mr. Rogers). On May 7, 2003, Warwick entered into a so-called contribution agreement with Lojas Arapua, S.A. (Arapua), a Brazilian retailer, under which Arapua transferred certain Brazilian consumer receivables (Arapua receivables) to Warwick in exchange for a 99% interest in Warwick.

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code in effect at the relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

Superior Trading, 137 T.C. at 73. Shortly after transferring its receivables, Arapua was redeemed out of its partnership interest in Warwick. Id. at 77.

At different times during the latter half of 2003, Warwick, in turn, claimed to have contributed varying portions of the Arapua receivables it acquired in exchange for a 99% membership interest in a number of different limited liability companies (trading companies). Id. at 73-74. Individual U.S. investors acquired membership interests in these trading companies through yet another set of limited liability companies (holding companies). Id. at 74. To accomplish this, Warwick contributed virtually all of its membership interests in each given trading company to the corresponding holding company. Id. These trading companies then sold, exchanged, or otherwise liquidated the Arapua receivables for the receivables' fair market value, which was a small fraction of their face value. Id. at 78.

Asserting that they had inherited carryover bases in the Arapua receivables under section 723, the trading companies then claimed deductions in the amount of the excess of those bases over the receivables' fair market value. Id. As a result, during 2003 and 2004, each of the trading companies wrote off almost the entire basis in its share of the Arapua receivables, claiming the resulting deductions. Id. at 74.

The Commissioner issued FPAAs to Warwick and the trading companies, disallowing the trading companies' claimed deductions for both 2003 and 2004. Id. In Superior Trading, we consolidated and decided the partnership-level cases of 14 trading companies, along with Warwick. Id. at 71. During the years at issue there, Jetstream, a company originally formed under the laws of the British Virgin Islands, was the managing member of Warwick, each of the 14 trading companies, and the various holding companies. Id. at 74. Mr. Rogers was the ultimate sole owner and only director of Jetstream for those years. Id. at 92.

Following a trial, we disallowed the claimed deductions of each of the 14 trading companies, and sustained the Commissioner's FPAAs at issue in Superior Trading. See Superior Trading, LLC v. Commissioner, 137 T.C. at 81-92. We did so on several grounds: absence of a bona fide partnership and contribution, disguised sale of property to a partnership, and the step transaction doctrine. See 137 T.C. at 81-92.

This case features yet another trading company, Derringer, which was involved in the same series of transactions described above between Warwick and

Arapua. Derringer was a limited liability company organized under the laws of the State of Illinois by Mr. Rogers on December 19, 2003. By an agreement dated the same day, Warwick purported to contribute a portion of the Arapua receivables to Derringer, in exchange for a 99% membership interest in Derringer. On December 22, 2003, Warwick transferred all but 1% of its interest in Derringer to Leila Verde, in exchange for a 99% interest in Leila Verde. According to respondent, on the same day, Warwick sold its 99% interest in Leila Verde to Patricia Hartigan, an individual U.S. investor residing in Massachusetts during the years at issue.

During 2003 and 2004, Derringer claimed a total of $3,395,762 in business bad debt and other deductions. The business bad debt deductions, amounting to $3,395,000, related to Derringer's share of the Arapua receivables that it had received from Warwick. For each of the two years at issue, Jetstream was the managing member of both Warwick and Derringer.

Respondent issued FPAAs to Derringer for 2003 and 2004, disallowing the deductions relating to the Arapua receivables, and asserting a 40% accuracy-related penalty for gross valuation misstatement under section 6662(h). Alternatively, respondent asserts a 20% accuracy-related penalty for any one of three reasons: substantial valuation misstatement under section 6662(e), negligence or disregard under sections 6662(b)(1), and substantial underpayment under sections 6662(b)(2).

Discussion

The purpose of summary judgment is to expedite litigation and avoid unnecessary and time-consuming trials. Fla. Peach Corp. v. Commissioner, 90 T.C. 678, 681 (1988). The Court may grant summary judgment when there is no genuine dispute as to any material fact and a decision may be rendered as a matter of law. Rule 121(b); Sundstrand Corp. v. Commissioner, 98 T.C. 518, 520 (1992), aff'd, 17 F.3d 965 (7th Cir. 1994). The burden of proving this rests on the moving party. Bond v. Commissioner, 100 T.C. 32, 36 (1993). But where the moving party makes and properly supports a motion for summary judgment, "an adverse party may not rest upon the mere allegations or denials of such party's pleading". Rule 121(d). Instead, he must set forth specific facts, by affidavit or otherwise, showing that there is a genuine dispute for trial. Id.

Petitioner argues that "[r]espondent's motion is not supported by affidavit and is merely allegation of counsel." That is clearly not the case. Respondent's motion is supported by a declaration from respondent's counsel, along with exhibits, setting forth "such facts as would be admissible" at trial. Rule 121(d). Petitioner, on the other hand, appears to "rest upon * * * mere allegations or denials" of respondent's assertions. Id.

In light of respondent's motion, his supporting declaration and exhibits, the deemed admission by petitioner of the undenied affirmative allegations of respondent's answer, and petitioner's response to the summary judgment motion, which alleges no colorable dispute as to any material fact, we conclude that this case may be adjudicated summarily.

We further agree with respondent that the structure of the transactions at issue in this case is identical in all material aspects to the structure of transactions at issue in Superior Trading. We discuss below the commonality between this case and Superior Trading, and its implications for the adjustments to the partnership items of Derringer determined in the FPAAs.

I. Deductions Relating to the Arapua Receivables

First, in Superior Trading, we held that Arapua never formed a bona fide partnership with Jetstream and Warwick, nor did Arapua ever make a bona fide contribution of the Arapua receivables to Warwick. Superior Trading, LLC v. Commissioner, 137 T.C. at 81-82. We found that Jetstream and Arapua did not intend to join together as partners in the conduct of a business. Instead, Jetstream looked to the Arapua receivables for their built-in loss, while Arapua wanted to derive cash from them. See id. In short, the so-called partnership formed between Arapua and Jetstream was not a bona fide partnership; it lacked a common intent to collectively pursue a joint business. Id.

Furthermore, the contribution made by Arapua was not a bona fide contribution, because Arapua had never considered itself a partner in a joint enterprise with Jetstream. Everything indicated that Arapua simply wanted cash from the transfer of the receivables. Id. at 82.

This case, while involving a different trading company than the 14 trading companies at issue in Superior Trading, involves the same transactions among Arapua, Jetstream, and Warwick that we analyzed in Superior Trading. Petitioner

does not adduce any evidence challenging our conclusion in Superior Trading that Arapua neither formed a bona fide partnership with Jetstream nor made a bona fide contribution of receivables to Warwick. Therefore, there is no genuine dispute as to those material facts, and we reiterate that conclusion here.

As an alternative holding in Superior Trading, we concluded that because Arapua received cash for its interest in Warwick within a year after entering into the contribution agreement, the contribution may be recharacterized as a disguised sale under section 707(a)(2)(B). Id. at 83. Under section 1.707–3(c), Income Tax Regs., if a partner transfers property to a partnership and within two years thereafter, the partnership transfers money or other consideration to that partner, the partner's transfer is presumed to be a sale of the property to the partnership. We held in Superior Trading that because no evidence was provided to rebut that presumption, the transactions between Arapua and Warwick constituted a sale under section 707(a)(2)(B). Id.

In this case, petitioner has adduced no evidence nor presented any argument to justify reconsidering the conclusion the Court reached in Superior Trading. Therefore, there is no genuine dispute as to those material facts, and we reiterate that the transactions between Arapua and Warwick constituted a sale rather than a contribution.

Finally, in Superior Trading, we invoked the step transaction doctrine, as a result of which we collapsed the many steps in the series of transactions between Arapua, Jetstream, Warwick. See Superior Trading, LLC v. Commissioner, 137 T.C. at 88-91. We held that the transactions between Arapua and Warwick could certainly meet the "end result test," which focuses on the parties' subjective intent at the time of structuring the transaction. Id. at 89. We arrived at this conclusion by pointing out that it was undisputed that tax benefits were the inducement for individual U.S. investors to participate in the scheme, and obtaining those tax benefits required "the carefully choreographed entry and exit of Arapua from the outset." Id. at 89-90. We concluded therefore that there must have been a pre-arranged plan to reap those tax benefits. Id. at 90.

Moreover, we held in Superior Trading that the transactions between Arapua and Warwick could also pass the "interdependence test" for invoking the step transaction doctrine. Id. This test focuses on whether the intervening steps are so interdependent that the legal relationships created by one step would have been fruitless without completion of the later series of steps. Id. We concluded

from the facts in Superior Trading that an outright sale of the Arapua receivables, rather than a contribution of the Arapua receivables, would have been just as effective in transferring title and facilitating their subsequent servicing. Therefore, we held that Arapua's entry to and exit from Warwick served no economic or business purpose other than obtaining tax benefits. Id.

Because both tests were satisfied, either of which could independently invoke the step transaction doctrine, we proceeded to collapse the series of transactions into just one: the sale of the Arapua receivables to Warwick. Id. Petitioner adduces no new evidence regarding the transactions between Arapua and Warwick. Therefore, there is no genuine dispute as to any material facts that would cause us to reconsider our decision to invoke the step transaction doctrine in Superior Trading.

In sum, we concluded in Superior Trading that three independent reasons, viz, no bona fide partnership and contribution, disguised sale, and the step transaction doctrine, lead us to the same result: Warwick's basis in the Arapua receivables should be a cost basis rather than a carryover basis. Superior Trading, LLC v. Commissioner, 137 T.C. at 90.

In affirming Superior Trading, the Court of Appeals for the Seventh Circuit independently determined that, after considering all of the many transactional steps in light of our findings of fact, Mr. Rogers' entire investment scheme constituted a "sham." Superior Trading v. Commissioner, 728 F.3d 676, 681 (7th Cir. 2013). The Court of Appeals held that the purported contribution of receivables should be treated as "a sale by Arapua of its receivables to the shelter investors," according those receivables a cost basis. Id.

Neither Warwick nor any of the trading companies whose cases we decided in Superior Trading was able to substantiate the amount of payments Warwick made to Arapua for the receivables. 137 T.C. at 90-91. Therefore, we imputed a zero cost basis to those receivables in the hands of Warwick, and consequently, a zero cost basis in the hands of each of the trading companies at issue there. Id. at 91.

In this case, petitioner too fails to adduce any evidence to substantiate Warwick's payments for the Arapua receivables. Consequently, there is no genuine dispute as to any of the material facts about petitioner's cost basis in the

Arapua receivables, which should therefore be zero as well. We will accordingly grant respondent's motion for summary judgment with respect to the determinations in the FPAAs disallowing Derringer's claimed deductions relating to the Arapua receivables.

II. Accuracy-Related Penalties

As noted above, the FPAAs also determine accuracy-related penalties under section 6662, which include the 40% gross valuation misstatement penalty under section 6662(h). If we were to find that Warwick and Derringer acted with reasonable cause and in good faith, we would not sustain an accuracy-related penalty. Sec. 6664(c)(1). We make this determination at the partnership level, taking into account the state of mind of the general partner. See New Millennium Trading, LLC v. Commissioner, 131 T.C. 275 (2008). Therefore, Mr. Roger's subjective intent is the focus here, since he was the sole ultimate owner and the only director of Jetstream, which was the managing member of both Warwick and Derringer. Accord Superior Trading, LLC v. Commissioner, 137 T.C. at 92.

In Superior Trading, we found that "[t]here ha[d] been no showing of reasonable cause or good faith on [Mr.] Rogers' part in conceptualizing, designing, and executing the transactions." Id. In this case too, petitioner has not adduced any evidence of reasonable cause or good faith on Rogers' part. Because we upheld the penalties at issue in Superior Trading, we could conceivably reach the same conclusion in this case because again there is no genuine dispute as to those material facts.

But since we decided Superior Trading, the Court has issued its opinion in Graev v. Commissioner, 147 T.C. __, __ (slip op. at 12) (Nov. 30, 2016), interpreting section 6751(b)(1), which requires, as a prerequisite for sustaining the assessment of an accuracy-related penalty, the personal written approval of the immediate supervisor of the individual who had made "the initial determination of assessment." Graev is appealable to the Court of Appeals for the Second Circuit, which has held that the Graev dissent rather than the majority "got it right." Chai v. Commissioner, 851 F.3d 190, 216 (2d Cir. 2017), aff'g in part, rev'g in part T.C. Memo. 2015-42. The Graev dissent, which the Second Circuit endorsed, would require in this case that written supervisory approval of the penalties determined in the FPAAs should have been obtained "prior to the initiation of Tax Court proceedings." Chai v. Commissioner, 851 F.3d at 216; see also Graev v. Commissioner, 147 T.C. at __, slip op. at 29.

Respondent's counsel has orally represented to the Court that if this case were to go to trial, respondent will be able to introduce evidence meeting the Graev dissent's standard for complying with section 6751(b)(1). Respondent has not yet adduced any such evidence in the declaration and exhibits supporting his motion for summary judgment, nor has he otherwise carried his burden of proof under the Second Circuit's decision in Chai. In this respect, we note, however, that under our Court's precedent, as set out in Graev, any such burden is still to arise because the penalties at issue have not yet been assessed. Graev v. Commissioner, 147 T.C. at __, slip op. at 10. Thus, consideration of section 6751(b)(1) would be premature here. We also note that absent a stipulation to the contrary, appeal of this case would not appear to lie with the Court of Appeals for the Second Circuit. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir.).

Regardless, to afford respondent an opportunity to establish that he can in fact satisfy the Graev dissent's requirement for sustaining the penalties determined in the FPAAs, we will deny respondent's motion for summary judgment with respect to those penalties. We encourage the parties to stipulate to the authenticity of whatever documents respondent may be able to produce in this regard, and submit the penalties issue to the Court under Rule 122. Upon due consideration and for the reasons stated above, it is

ORDERED that Respondent's Motion for Summary Judgment in docket No. 20872-07 is granted in part, and the adjustments to the partnership items determined in the FPAAs of July 25, 2007, with the exception of the accuracy-related penalties under section 6662 asserted therein, be and are hereby sustained. It is further

ORDERED that respondent's Motion for Summary Judgment in docket No. 20872-07 is denied with respect to the accuracy-related penalties under section 6662 determined in the FPAAs of July 25, 2007. It is further.

ORDERED that respondent's Motion for Summary Judgment in docket No. 6268-08 is held in abeyance.

(Signed) Robert A. Wherry
Judge

Dated: Washington, D.C.
July 26, 2017