United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 16-1334 **September Term, 2017**

FILED ON: FEBRUARY 16, 2018

PALM CANYON X INVESTMENTS, LLC, AH INVESTMENT HOLDINGS, LLC, TAX MATTERS PARTNER,
APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE,
APPELLEE

On Appeal from the United States Tax Court

Before: ROGERS, MILLETT and WILKINS, *Circuit Judges*.

J U D G M E N T

This action was considered on the briefs of the parties. *See* FED. R. APP. P. 34(a)(2); D.C. CIR. R. 34(j). The court has afforded the matter full consideration and has determined that it does not warrant a published opinion. *See* D.C. CIR. R. 36(d). It is

ORDERED AND ADJUDGED that the judgment of the United States Tax Court be affirmed for the reasons stated in the memorandum accompanying this judgment.

Pursuant to D.C. Circuit Rule 36, this disposition will not be published. The Clerk is directed to withhold issuance of the mandate herein until seven days after resolution of any timely petition for rehearing or rehearing *en banc*. *See* FED. R. APP. P. 41(b); D.C. CIR. R. 41(a)(1).

PER CURIAM

FOR THE COURT:
Mark J. Langer, Clerk

BY: /s/ Ken Meadows
Deputy Clerk

MEMORANDUM

After exposing an illegitimate tax shelter scheme involving Palm Canyon X Investments, LLC, the Internal Revenue Service invalidated improper tax deductions stemming from the use of a sham partnership and imposed a mandatory 40% tax penalty for the gross misstatement of taxable income. The United States Tax Court upheld the invalidation of the deductions and imposition of the penalty, concluding that the taxpayer lacked reasonable cause for its gross underreporting. The only issue on appeal is whether the Tax Court properly rejected the taxpayer's reasonable-cause defense to the tax penalty.

Section 6662 of the Internal Revenue Code imposes a mandatory penalty for certain income tax underpayments. *See* 26 U.S.C. § 6662. The amount of the penalty depends on the magnitude of the understatement of income. As relevant here, if a taxpayer misstates its tax basis by more than 400%, the penalty amount will be equal to 40% of the underpayment. *See id*. § 6662(h)(1)–(2)(A)(i); *106 Ltd. v. Commissioner*, 684 F.3d 84, 89 (D.C. Cir. 2012); *see also American Boat Co. v. United States*, 583 F.3d 471, 480 (7th Cir. 2009).

A taxpayer can avoid such a penalty, however, if she proves that she had "reasonable cause" for the underpayment and "acted in good faith." 26 U.S.C. § 6664(c)(1); *see 106 Ltd.*, 684 F.3d at 89–90. "The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances." 26 C.F.R. § 1.6664-4(b).

One way of establishing the "reasonable cause" defense is for the taxpayer to demonstrate "reasonable" "reliance on the advice of a competent and independent professional advisor." *American Boat Co.*, 583 F.3d at 481; *see also United States v. Boyle*, 469 U.S. 241, 251 (1985). For the reliance to be considered reasonable, the advice the taxpayer received (1) must have been "based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances," 26 C.F.R. § 1.6664–4(c)(1)(i), and (2) cannot rest "on unreasonable factual or legal assumptions," including "a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true," *id*. § 1.6664–4(c)(1)(ii). And the reliance "itself [must] be *objectively* reasonable." *Stobie Creek Invs. v. United States,* 608 F.3d 1366, 1381 (Fed. Cir. 2010) (emphasis in original). *See 106 Ltd.*, 684 F.3d at 90.

Because the inquiry into reasonable reliance is objective, it "focus[es] * * * on what [the taxpayer] knew or should have known at the time he obtained the [advice]." *American Boat Co.*, 583 F.3d at 485. "[T]he taxpayer's education, sophistication and business experience" also factor into the reasonableness and good faith of the reliance. 26 C.F.R. § 1.6664–4(c)(1). That test precludes reliance on advice "from parties who actively promote or implement the transactions in question." *106 Ltd.*, 684 F.3d at 90 (quoting *Stobie Creek*, 608 F.3d at 1382); *see also Mortensen v. Commissioner*, 440 F.3d 375, 387 (6th Cir. 2006) ("In order for reliance on professional tax advice to be reasonable * * * the advice must generally be from a competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment.").

In the 1990s, several law and accounting firms marketed to wealthy individuals tax-avoidance schemes known as BOSS and, later, Son-of-BOSS tax shelters.[1] In simple terms, the Son-of-BOSS tax scheme transferred a taxpayer's assets that were, or would be, encumbered by significant liabilities to a partnership created for the purpose of generating tax benefits. That encumbrance would artificially inflate the taxpayer's basis in its partnership interest and, upon dissolution of the partnership, would give the taxpayer a write off for the artificial partnership losses. I.R.S. Notice 2000-44, 2000-2 C.B. 255–256 (2000).

Courts across the United States have long sustained IRS decisions invalidating tax deductions based on artificially inflated bases, like those underlying the BOSS and Son-of-BOSS schemes. *See, e.g.*, *ACM Partnership v. Commissioner*, 157 F.3d 231, 252 (3d Cir. 1998) ("Tax losses such as these * * * which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); *Scully v. United States*, 840 F.2d 478, 486 (7th Cir. 1988) (a loss must be a "genuine economic loss" to be deductible); *Shoenberg v. Commissioner*, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"); *see also* 26 C.F.R. § 1.165–1(b) ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

The BOSS and Son-of-BOSS schemes eventually became so pervasive and harmful to the public fisc that, in September 2000, the IRS issued a public notice declaring the sham partnership transactions that formed the basis of the Son-of-BOSS schemes to be abusive tax shelters. I.R.S. Notice 2000-44, at 255–256. The Notice also warned taxpayers that the use of such schemes could result in the imposition of stiff penalties. *Id*. Both before and, especially, in the wake of that Notice, courts have repeatedly sustained the imposition of penalties on those who employed BOSS or Son-of-BOSS tax shelters in misreporting their income. *See*, *e.g.*, *United States v. Woods*, 134 S. Ct. 557, 567–568 (2013); *106 Ltd.*, 684 F.3d at 86, 91–93 (acknowledging Notice 2000-44 in affirming tax court's determination that no reasonable cause existed). *Cf. American Boat Co.*, 583 F.3d at 486 (concluding that the taxpayer had reasonable cause for relying on professional advice concerning Son-of-BOSS shelter in 1998 because, in part, that reliance occurred before Notice 2000-44 and its attendant publicity brought the scheme to light).

Alan Hamel is the sole owner and shareholder of ThighMaster World Corporation. As relevant here, Hamel formed and was the sole owner of AH Investment Holdings, LLC. AH Investment, in turn, became a partner entity in, and the tax matters partner for, Palm Canyon X Investments, LLC, the sham partnership around which the Son-of-BOSS tax shelter scheme in this case was constructed.

Clifton Lamb is a Certified Public Accountant who advised Hamel on tax matters. In August 2001—nearly a year after the IRS Notice condemning Son-of-BOSS tax shelters issued—Lamb met with John Ivsan of the now-defunct law firm Cantley & Sedacca, LLP to explore "high end tax products for big losses." J.A. 429. Ivsan pitched him a Son-of-BOSS form of tax shelter. Lamb's first reaction was that the proposed tax benefits were "too good to be true." J.A. 502. At

[1] BOSS stands for "Bond and Options Sales Strategy." *See American Boat Co.*, 583 F.3d at 474. Son-of-BOSS tax shelters are variations on the original BOSS tax shelter design.

Hamel's direction, Lamb reviewed a generic tax opinion prepared by the law firm of Bryan Cave, LLP that provided support for the tax shelter.

Ken Barish, Hamel's tax attorney, also reviewed Bryan Cave's generic tax opinion at Hamel's instruction. Barish repeatedly expressed skepticism about the legitimacy of the proposed tax scheme. Barish and Lamb subsequently reviewed a second tax opinion prepared by Mark Kushner, an attorney at the law firm of Pryor Cashman, to whom they were referred by Cantley & Sedacca. Barish and Lamb advised Hamel that Kushner had provided "an aggressive tax opinion." J.A. 641–642.

Nonetheless, in October 2001, Hamel decided to go forward with the transaction and engaged the promoter firm, Cantley & Sedacca, to implement the tax shelter for a $325,000 fee. Hamel then, through Cantley & Sedacca and an affiliated broker-dealer Daniel Brooks, purported to form Palm Canyon as a partnership between AH Investment and a limited liability company owned by Brooks. Brooks, on behalf of Palm Canyon and with money Hamel advanced through Cantley & Sedacca, utilized foreign currency swaps to overstate by approximately $5 million AH Investment's asset basis in Palm Canyon. On December 7, 2001, Palm Canyon terminated its currency swaps and harvested the artificial losses. Eleven days later, AH Investment bought out Brooks' Palm Canyon interest, dissolving the Palm Canyon partnership and triggering the pass-through of a more than $5 million artificial loss to AH Investment.

Ultimately, as a result of that scheme, Palm Canyon misreported its capital contributions and assets on its tax return. AH Investment, for its part, used its distribution from Palm Canyon to wrongfully claim on its 2001 tax return an inflated basis in its Palm Canyon interest and more than $5 million in currency trading losses. Because AH Investment was a subsidiary of ThighMaster, ThighMaster in turn improperly reported a more than $5 million dollar loss attributable to the tax shelter on its corporate income tax return. Finally, ThighMaster allocated that loss to its sole shareholder, Hamel, who claimed it on the personal income tax return he filed jointly with his wife. At the end of the day, the tax shelter scheme reduced the Hamels' tax liability down from owing $1.5 million to owing nothing.

The IRS was not fooled. Declaring the tax shelter to be an unlawful Son-of-BOSS scheme, the IRS invalidated all of the claimed tax benefits and imposed a 40% tax penalty under 26 U.S.C. § 6662. *Palm Canyon X Inv., et. al. v. Commissioner*, 98 T.C.M. (CCH) 574, 2009 WL 4824326, at * 2 (Dec. 15, 2009).[2]

Palm Canyon challenged the IRS's decision in the United States Tax Court. That court sustained the adjustment and penalty both initially and on reconsideration, concluding that Palm Canyon was a sham partnership; its transactions lacked economic substance; and Section 6662's 40% gross valuation misstatement penalty properly applied to the resulting substantial underpayment of taxes.

We review the Tax Court's findings of fact and determination of the case-specific context and circumstances bearing on reasonable cause for clear error. Whether those facts and

[2] As noted, the IRS's assessment and the Tax Court's decision involved a rather complex chain of misreported income by Palm Canyon, AH Investment, ThighMaster World Corporation, and Hamel. For ease of reference, in discussing the objects of the IRS's action, we refer to them collectively as "Palm Canyon."

circumstances establish the elements of reasonable cause is reviewed *de novo. Boyle*, 469 U.S. at 249 n.8 ("Whether the elements that constitute 'reasonable cause' are present in a given situation is a question of fact, but what elements must be present to constitute 'reasonable cause' is a question of law."); *see 106 Ltd.*, 684 F.3d at 89 (citing and quoting *Boyle*).

Palm Canyon does not dispute that the tax scheme was unlawful. Palm Canyon argues only that Hamel reasonably relied on lawyers and tax advisors in deciding to go through with the scheme, and thus that the 40% penalty should not be applied. We find no error in the Tax Court's conclusion that the totality of relevant facts and circumstances foreclose a reasonable-cause defense to the tax penalty.

First, the claim of objective reasonableness must overcome the fact that IRS Notice 2000-44—which expressly warned taxpayers against the use of Son-of-BOSS tax shelters—had been a matter of public record for a year before the Palm Canyon scheme was put into motion. And importantly, the IRS Notice specifically identified as prohibited almost the exact Son-of-BOSS variation used by Palm Canyon. I.R.S. Notice 2000-44, at 255–256. That makes proof of reasonableness in this case an especially steep uphill battle. *See also Woods*, 134 S. Ct. at 567–568 (holding that a Son-of-BOSS scheme virtually identical to Palm Canyon constituted a "sham" transaction requiring application of the 40% penalty).

Second, Palm Canyon's reliance on advice given by Cantley & Sedacca, Ivsan, or Brooks is of no help. It is settled law that reliance on the professional advice of those one knows, or should know, to be promoters of a tax scheme is objectively unreasonable. *106 Ltd.*, 684 F.3d at 91–92; *Van Scoten v. Commissioner*, 439 F.3d 1243, 1253 (10th Cir. 2006).

Third, Lamb's advice provides no cover for this scheme. Lamb's role was largely limited to investigating the promoter's *bona fides*, not providing tax advice. Moreover, Lamb testified that, while he did not feel qualified to provide an opinion on the technical merits of the scheme, he believed the tax benefits were "too good to be true." Reliance on professional advice is not reasonable where "improbable tax advantages" signal "the [tax] shelter's illegitimacy." *106 Ltd.*, 684 F.3d at 93. Finally, Lamb explained that, when it came time to prepare Hamel's 2001 return, Lamb performed only "a cursory review of the completed [return]" because he "did [not] feel comfortable" with the transaction. J.A. 538–539.

Fourth, consultations with Barish offer no shield either. Quite the opposite: Barish had said he was "skeptical" of the transaction, based on his prior experiences with tax shelters, J.A. 631, and he "didn't have any substantive input as far as the [tax] opinion itself," J.A. 648. Given that Barish and Lamb both recognized that the proposed partnership strategy was a tax-avoidance scheme, the Tax Court did not err in concluding that they neither conducted a proper investigation of the transaction nor provided an independent opinion concerning its legitimacy on which Palm Canyon could reasonably rely. *Palm Canyon*, 98 T.C.M. (CCH) 574, 2009 WL 4824326, at * 38. Rather, they limited their due diligence to the scheme's players, not its substance, and relied on the opinions of its promoters. *Id.*

Fifth and finally, the tax opinions provided by Bryan Cave and Mark Kushner do not aid Palm Canyon. Treasury Regulations require, among other things, that professional advice be based on "all pertinent facts and circumstances" relating to the taxpayer before reliance can be

reasonable. 26 C.F.R. § 1.6664–4(c)(1)(i). The generic Bryan Cave opinion does not pass muster since "it was not prepared for Palm Canyon and did not necessarily focus on facts peculiar to it." *Palm Canyon*, 98 T.C.M. (CCH) 574, 2009 WL 4824326, at * 38. Indeed, the opinion itself cautioned that courts frequently disallow reliance on "an opinion of counsel" that is "not directed to the specific investor[.]" J.A. 104.

Kushner's opinion was doubly unreliable. To begin with, Kushner and his law firm were part of Cantley & Sedacca's tax-scheme promotion team, and it was Cantley & Sedacca that pointed Lamb to Mark Kushner. In addition, the express terms of the tax opinion required the taxpayer to submit a signed representations sheet to Pryor Cashman attesting that all relevant information had been provided before reliance could be justifiably placed upon any opinion rendered. Neither Hamel nor Lamb ever submitted a signed representations sheet. Worse still, Hamel failed to provide the law firm with documents detailing necessary and fundamental aspects of the scheme that may have had a material effect on its professional assessment.

In short, the Tax Court properly concluded that Palm Canyon's decision to proceed in the face of the IRS's express warning in Notice 2000-44 against such schemes—and in reliance only on advice provided by the tax shelter's promoters and their affiliates, other skeptical advisors, and ill-informed tax opinions—was neither reasonable nor taken in good faith. We accordingly affirm the Tax Court's decision upholding the IRS's invalidation of the tax deduction and imposition of an accuracy-related penalty.