BORROWER BEWARE: RAMIFICATIONS OF THE COURT'S RECHARACTERIZATION OF A LOAN TRANSACTION

I. INTRODUCTION

"A common phenomenon in federal income taxation is the restructured transaction—a business arrangement that is classified differently by the IRS and the courts than by the private parties who entered into it."[1] That sentence may bear repeating, as its implications are great. A line of recent tax cases have set a disturbing precedent of both tax and circuit court approved re-characterizations of loan transactions.[2] That is to say, two parties may enter into an agreement that both characterize, classify, treat and in every way contemplate as a loan, and—come collection time—the IRS may step in and re-characterize that loan as a sale.[3] Courts have now sanctioned this IRS re-characterization, assessment of deficiency tax,\ and fixing of deficiency penalties on newly created gains from a sale that the taxpayer never formally entered into.[4] The taxpayer's documentation and treatment of the transaction all continue to evidence a non-recourse type loan agreement;[5] but courts, relying on shaky reasoning,[6] have approved the IRS characterization and deficiency assessments at the expense of the time honored tradition of effectuating parties' intent and preserving for them the benefit of the contracts they enter into.[7]

The transactions suffering from re-characterization are complex; this note does not attempt to gloss over that complexity

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1. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS, RESTRUCTURED BUSINESS TRANSACTIONS ¶ 4.4.1 (Warren, Gorham & Lamont, Inc.,9th ed. 2005), *available at* 1997 WL 439507 [hereinafter BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS].

2. *See id.*; *see also* Caroline Owens Van Wagoner, *Fitting a Square Peg in a Round Hole: Calloway v. Commissioner's Analytical Shortcomings*, 66 TAX LAWYER 273 (2012).

3. Robert W. Wood, *When "Loans" Are Taxed As Income*, FORBES.COM (Jan. 26, 2011), http://www.forbes.com/sites/robertwood/2011/09/26/when-loans-are-taxed-as-income.

4. *See, e.g.,* Landow v. Comm'r, 102 T.C.M. (CCH) 88 (2011); Calloway v. Comm'r, 691 F.3d 1315 (11th Cir. 2012); and Kurata v. Comm'r, 101 T.C.M. (CCH) 1291 (2011).

5. The Landow court spends pages outlining letters of credit, collateral, and loan agreement documentation. At no point during that painstaking recitation of the loan agreement does the court find fault with their accuracy. Landow v. Comm'r, 102 T.C.M. (CCH) 88 (2011).

6. *See* Owens Van Wagoner, s*upra* note 2 at 273 (criticizing the court's analytical approach in a loan-sale re-characterization case as its "analytical approach unnecessarily clouds jurisprudence and creates uncertainty for practitioners").

7. RESTATEMENT (SECOND) OF CONTRACTS § 201 cmt. c (1981)(emphasis added) ("Subsection (1) makes it clear that the primary search is for a common meaning of the parties, not a meaning imposed on them by the law. . . . *The objective of interpretation in the general law of contracts is to carry out the understanding of the parties rather than to impose obligations on them contrary to their understanding*: "the courts do not make a contract for the parties." Ordinarily, therefore, the mutual understanding of the parties prevails . . .").

or fault the IRS for careful auditing and creative tax assessments.[8] Indeed, as creative planners find new ways to structure business transactions to achieve favorable tax treatment, the IRS necessarily must adapt.

This note attempts to focus on the troubling lack of guidance provided by the courts in light of both taxpayer and tax assessor creativity, especially regarding the non recourse loan that when construed in a certain light may bear resemblance to a sale. The *Landow v. Commissioner* case presents the classic re-characterization event.[9] The Landow court used a practically identical line of reasoning in its previous loan re-characterization cases.[10] Consistency is usually laudable, but reasoning that fails to provide proper guidance for future business transactions cannot be praised merely because the court continues to repeat it.

This note consists of four parts. Part one examines the body of law that regards the differentiation between a loan and a sale for income tax purposes. Part two looks at the distinct tax treatment of loan and sale transactions. Part three then reviews the application of these principles, and the tax court's treatment of IRS loan re-characterization by exploring the Landow decision in detail. Part four presents some possible ramifications of the Landow decision and others like it, contemplating its effect on the way practitioner's structure transactions and finally concludes with the hope that Landow's appeal may be met with better judicial reasoning and consequently more certainty for practitioners and taxpayers.

II. HISTORY

> "When a transaction is restructured, the legal relationships between the parties to the transaction are not changed by its altered tax aspects. The parties continue to be bound by the contract as written—which determines where legal ownership resides, what payments must be made and when, and other nontax rights and duties . . . whether a transaction is "restructured," "reclassified,"

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8. On its website the IRS acknowledges this complexity and proves that even tax collectors can have a sense of humor. Yes, IRS.GOV dedicates an entire page to quirky quotes by famous figures including physicist Albert Einstein's admission that "[t]he hardest thing in the world to understand is the income tax." *Tax Quotes*, IRS.GOV, http://www.irs.gov/uac/Tax-Quotes (last visited Sept. 2015).

9. *Landow,* 102 T.C.M. (CCH) 88.

10. *See generally, id.;* Kurata v. Comm'r, 101 T.C.M. (CCH) 1291 (2011); and Schlachte v. U.S., No. C 07–6446 PJH, 2008 WL 3977901 (N.D. Cal. Aug. 26, 2008).

> "recast," or "realigned," the result is a different set of tax results from those that the parties contemplated."[11]

In certain cases the court deems it necessary to disregard the intent of the parties to a transaction and change the characterization of a business transaction from a loan to a sale.[12] As Bittker notes, such recasting by a court does not modify the relative rights and obligations of the parties under the agreement.[13] Courts tend to justify this restructuring on a substance over form basis.[14] The general argument is predicated on the idea that determining tax treatment based on the economic reality and substance of a transaction is more accurate than taking into account its bargained for form.[15]

Over the years the courts have developed a benefits and burdens test to aid in determining the "substance" of a transaction and thus its tax treatment.[16] In establishing whether a transaction "transferred the benefits and burdens of property ownership from one party to another," the court purports to reveal the true nature and substance of the transaction.[17] Thus, "[a] recurring theme in restructure transactions is identifying the true owner of property. Ownership of property is important in determining whether a taxpayer has made a sale or exchange of property. . . . [and] whether a taxpayer is eligible for various tax allowances that follow ownership of property."[18]

The often cited *Grodt & McKay* Court focused their examination on eight factors thought to be decisive of whether the full benefits and burdens of property ownership passed from

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11. BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.1.

12. *See, e.g.*, Landow, 102 T.C.M. (CCH) 88.

13. BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.1.

14. *See* Owens Van Wagoner, *supra* note 2, at 275.

15. *See* Pac. Coast Music Jobbers, Inc. v. Comm'r, 55 T.C. 866, 874 (1971) (explaining that "If it is found from all the facts and surrounding circumstances that the . . . agreement transfers substantially all the accouterments of ownership, the transaction will be treated as a sale *even though the parties intended the legal title should not pass* until later")(emphasis added).

16. *See* Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1236-37 (1981) (posing an early iteration of the now commonly cited factors weighed in a benefits and burdens analysis).

17. *See id.* at 1236-37. *See also* Owens Van Wagoner, *supra* note 2, at 274 (criticizing the use of a test "designed to determine ownership of tangible property [as it] introduces irrelevant and inapplicable factors to the analysis. Such a broad, inexact test is unhelpful to practitioners who structure and advise on the tax treatment of transactions involving securities. The courts could have applied a more precise benefits and burdens test, clarifying the law and reducing practitioner confusion").

18. BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.1(A).

one party to another, meeting the definition of a sale.[19] Those factors are best summarized as follows: (1) whether legal title passes, (2) how the parties treat the transaction, (3) whether an equity interest was acquired in the property, (4) whether the contract creates a present obligation on the seller to execute and to deliver a deed and a present obligation on the purchaser to make payments, (5) whether the right of possession is vested in the purchaser, (6) which party pays the property taxes, (7) which party bears the risk of loss or damage to the property, and (8) which party receives the profits from the operation and sale of the property.[20]

Transactions involving securities require special considerations. Both the IRS and the courts generally evaluate a transaction involving fungible securities through application of a "benefits and burdens test that focuses on the unique characteristics of stock."[21]

The court in Dunne v. Commissioner fashioned various factors that are relevant to securities transactions generally and the Landow loan specifically: (1) the right to sell the stock,(2) the right to receive dividends, and (3) the opportunity for gain and the risk of loss in the value of the shares.[22] The *Dunne* court further stated that "[t]o determine when beneficial ownership has passed from one person to another, a court generally must determine at what point the transferee acquires more attributes of ownership than the transferor."[23]

These principles for determining the passage of ownership, of course, are of great relevance to the Landow case, and others like it,[24] where the IRS has re-characterized a loan to a sale based on an identification of the transaction's sale-like "substance".

Put another way, the Service claims to have identified the

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19. *See Grodt & McKay Realty, Inc.*, at 1236-37. It is worth noting that the *Grodt & McKay* court had before them a transaction involving cattle, and thus geared the multifactor test towards determining the nature of a transaction involving fungible, tangible personal property. *Id.*

20. Owens Van Wagoner, *supra* note 2, at 275.

21. *Id.* at 274-75.

22. Dunne v. Commissioner, 95 T.C.M. (CCH) 1236, 1242 (2008) (citing Ragghianti v. Commissioner, 71 T.C. 346, 349 (1978), *aff'd.,* 652 F.2d 65 (9th Cir.1981))(stating that "[i]t is well settled that beneficial ownership, not legal title, determines stock ownership for Federal income tax purposes"). *See also* Owens Van Wagoner, *supra* note 2 for an application of the *Dunne* factors to a Derivium loan situation.

23. *Dunne* 95 T.C.M. (CCH) 1242 (citing *Ragghianti*, 71 T.C. at 349)).

24. *See, e.g.,* Schlachte v. U.S., No. C 07–6446 PJH, 2008 WL 3977901, at *1 (N.D. Cal. Aug. 26,2008); Shao v Comm'r, 100 T.C.M. (CCH) 182 (2010); Calloway v. Comm'r, 691 F.3d 1315 (11th Cir. 2012); Kurata v. Comm'r, 101 T.C.M. (CCH) 1291 (2011); and Raifman v. Comm'r, 104 T.C.M. (CCH) 165 (2012).

true owner[25] of the security by re-casting the loan as a sale, evidenced by full transfer of all the "benefits and burdens" inherent in ownership of the property in question. The implication is that the IRS has evaluated the purported loan according to one of the established tests to determine that the attributes of ownership have passed from the borrower to the lender.[26]

Securities, as stated above, do usually require a special lens. Section 1058 of the Internal Revenue Code displays Congress' attempt to codify a "safe harbor" for securities lending transactions.[27] Congress incorporated "[t]he general principles of the benefits and burdens test" into section 1058.[28] Section 1058 is, in part, a reaction to an influential 1926 case, *Provost v. United States*, where the Supreme Court recognized a securities loan as a taxable disposition of the loaned security.[29] The Internal Revenue Service later realized that securities loans are particularly able to promote liquidity and facilitate market transactions.[30]

Due to these attractive qualities or capabilities, the Internal Revenue Service implemented a non-recognition policy for these loans.[31] I.R.C. section 1058, enacted in 1978, codified the Internal Revenue Service's practice of non-recognition treatment for securities loans.[32] "Section 1058 provides that no gain or loss is recognized on either the lender's transfer of securities to the borrower or the borrower's subsequent return of identical securities to the lender."[33] The lending agreement must meet the three requirements outlined in section 1058(b) in order for the securities lender to receive non-recognition treatment.[34]

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25. BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.1.

26. This evaluation at times is through securities specific lens as in *Dunne. Dunne*, 95 T.C.M. (CCH) 1236.

27. Owens Van Wagoner, *supra* note 2, at 276.

28. *Id.*

29. Provost v. United States, 269 U.S. 443, 456-57 (1926).

30. *See* Mark Leeds, *A Riff On Cliff: Calloway and* Anschutz *Expand Tax Ownership Authorities from Debt to Equities*, 64 TAX LAW 657, 692 (2011); *see also* Owens Van Wagoner, *supra* note 2, at 276.

31. *See* Leeds, *supra* note 30, at 692; *see also* Owens Van Wagoner, *supra* note 2, at 276.

32. The code provides that as a "[g]eneral rule [i]n the case of a taxpayer who transfers securities . . . pursuant to an agreement which meets the requirements of subsection (b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer." I.R.C. § 1058 (a)(2012).

33. Owens Van Wagoner, *supra* note 2, at 277 (Citing I.R.C. § 1058(b)).

34. I.R.C. § 1058(b) ("In order to meet the requirements of this subsection, an

Section 1058 is instrumental in forming the basis for courts' treatment of the sale versus loan issue. This is due in part to the one taxpayer's use of 1058 as a defense in the *Calloway* case[35], but more importantly because it connects the treatment of fungible securities in the tax code to valid loan forms, and court made tests for determining when a security is owned by a particular party (rather than simply on loan to him, or serving as collateral for a loan).[36]

III. TAX TREATMENTS

Full appreciation of the substance over form[37] rationale for recasting a loan as a sale necessarily regards the different tax treatments of distinct loan types and other dispositions of property. This part provides a brief overview of traditional loan and sale forms and their tax respective tax treatment, as well a quick examination of the importance of the election.

A. *Tax Treatment of Loans*

When a taxpayer borrows money they are not required to include the loan proceeds in their taxable income, as they have

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agreement shall—(1) provide for the return to the transferor of securities identical to the securities transferred;(2) require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;(3) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and(4) meet such other requirements as the Secretary may by regulation prescribe.").

35. Leeds, *supra* note 30, at 673 (detailing the *Calloway* case where the taxpayer sought to defend the non taxability of the 90% stock loan by arguing that the loan was analogous to nontaxable securities lending arrangements). Leeds points out that the *Calloway* Court noted one common thread in each of these authorities: The lender had the right to terminate the stock or securities loan on demand. *Id.* "[T]he ability to terminate the transaction on demand ensured that the taxpayer retained the ability to benefit from the appreciation in the stock. In the case of the 90% stock loan, however, the taxpayer did not have the ability during the three-year loan term to terminate the transaction. . . Accordingly, the court rejected the taxpayer's claim that the 90% stock loan should be considered to be a nontaxable stock loan under the securities lending authorities." *Id.*

36. I.R.S. Tech. Adv. Mem. 2006-04-033 (Jan. 27, 2006) (explaining that "[s]ection 1058 clearly envisions that the 'lender' retain a significant amount of risk of loss and opportunity for gain on the subject property" as well as the ability (at any time) to recoup possession of the property. Congress wanted to ensure that a taxpayer receiving non-recognition treatment under section 1058 retain some ownership characteristics or qualities over the subject shares, despite the fact that a share lending transaction generally results in transfer of ownership of the shares.").

37. *See, e.g.,* Samueli v. Comm'r, 661 F.3d 399, 412 (9th Cir. 2011); and I.R.S. Tech. Adv. Mem. 2006-04-033 (Oct. 20, 2005) ("provisions that result in the exclusion (or non-recognition) of income must be narrowly construed and the substance rather than form take control for tax purposes.").

incurred an equal obligation to repay the lender later.[38] If that loan obligation is later canceled, the taxpayer may be required to include the amount of the canceled debt in gross income.[39] Often, inclusion will turn on whether the original debt that was later canceled was classified as nonrecourse or recourse borrowing.

1. Non Recourse Debt

"A nonrecourse obligation—that is, a secured debt instrument that may be satisfied only out of the security, and not by recourse to other assets of the debtor—may qualify as valid indebtedness for federal tax purposes."[40] So, debts fully secured by collateral generally remove personal responsibility for repayment from the borrower. Debt identified as nonrecourse is satisfied by the surrender of the secured property (collateral) regardless of its fair market value (FMV) at the time of surrender and the borrower is not liable for any remaining deficiency.[41]

This form of lending is often used in business transactions,[42] as nonrecourse transactions serve to limit the borrower's accountability to the value of the posted collateral. The commercial reality of securing a collateral interest in publicly traded securities often requires that the owner of the security (the borrower) relinquish title to the assets.[43] "It is common in transactions treated as pledges of such assets, and in garden-variety brokerage accounts, for the title to be transferred to the borrower or brokerage firm."[44]

It is worth noting that the absence of liability on the part of the borrower, and the transfer of title should not bear on whether or not the transaction is considered a loan.[45] As one commentator on the restructure issue, Leeds, has noted: "[t]he

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38. *Tax Topics-431-Cancelled Debt*, IRS.GOV, http://www.irs.gov/taxtopics/tc431.html (last visited Dec. 30, 2013).

39. *Id.*; I.R.C. § 61(a)(12) (2012) (defining gross income by those items taxpayers must include and specifying "[i]ncome from discharge of indebtedness.").

40. 1 MERTENS LAW OF FED. INCOME TAX'N § 7:18 (Database updated Jan. 2014).

41. *Courseware Link & Learn Taxes Glossary*, IRS.GOV, http://apps.irs.gov/app/vita/content/36/36_02_020.jsp?level=advanced#mainmenu (last visited Jan. 2014). The IRS glossary continues: "[i]f property subject to non-recourse debt is abandoned, foreclosed upon, subject of a short sale, or repossessed by the lender, the circumstances will be treated as a sale of the property by the taxpayer." *Id.*

42. *See* Durkin v. Commissioner, 872 F.2d 1271, 1276-77 (7th Cir. 1989) (confirming that "nonrecourse debt is commonly used in bona fide commercial transactions with genuine business purposes.").

43. Leeds, *supra* note 30, at 668-69.

44. *Id.*

45. No court has successfully applied one of the various multi-factor tests based on borrowed funds classified as nonrecourse. They have, or course, tried. *See, e.g.,* Anschutz Co. v. Commissioner, 135 T.C. 78, 99 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011).

court correctly noted that the nonrecourse nature of the loan transferred all risk of loss below the repayment amount to Derivium, as the lender. This fact, however, is present in every nonrecourse secured loan."[46]

2. Recourse Debt

Where nonrecourse debt relieves all responsibility to repay a loan, recourse debt resides at the opposite end of the spectrum. Recourse debt allows a lender to pursue any of the borrower's non-exempt assets in satisfaction of the debt, until it is fully satisfied.[47] When a taxpayer's commitment to make payments is rooted in a recourse debt obligation, that taxpayer cannot walk away without liability, and the obligation to repay is construed as "real" by courts looking to sniff out sham transactions.[48] However, as regards both recourse and nonrecourse debt, "[u]nder *Frank Lyon*,[49] the court may not ignore transactions that have economic substance even if the motive for the transaction is to avoid taxes."[50]

B. *Tax Treatment of Sales*

Section 1001(c) of the Internal Revenue Code requires that a taxpayer recognize the gain or loss from a disposition of property by sale unless a specific non-recognition I.R.C. provision applies.[51]

Except if otherwise provided for in applicable sections of the Internal Revenue Code, gain or loss realized from the exchange of property for cash, or from the exchange of property for other property that differs materially (in kind or quantity), is treated as taxable income or sustained loss.[52] For tax purposes, to arrive

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46. Leeds, *supra* note 30, at 670.

47. *Courseware Link & Learn Taxes Glossary*, IRS.GOV, http://apps.irs.gov/app/vita/content/36/36_02_020.jsp?level=advanced#mainmenu (last visited Jan. 2014).

48. BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.3.

49. Frank Lyon, Co. v. United States, 435 U.S. 561, 583-83 (1978) (holding that "where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties").

50. BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.3 (citing *Frank Lyon, Co.* 435 U.S. 561).

51. I.R.C. § 1001(c) (2012) ("Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.").

52. Treas. Reg. § 1.1001-1(a) (as amended in 2012).

at the amount realized from such a sale, exchange, or other disposition of property a taxpayer must calculate the sum of cash received plus the fair market value of any property (other than cash) received.[53] The fair market value of property is a question of fact, but only in rare or extraordinary circumstances will property be deemed to have no fair market value, or one that is too difficult to discern.[54]

Generally, taxpayers us a method of computing gain or loss from a sale as prescribed by section 1001(a)-(d).[55] The 1001 formula contemplates that from the amount realized by the sale (or exchange) the taxpayer shall withdraw an amount sufficient to restore the adjusted basis[56] prescribed by section 1011[57] and the regulations promulgated for that section (i.e., "the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis").[58] The amount that remains after the adjusted basis has been returned to the taxpayer represents the realized or taxable gain.[59] If the amount realized by the sale or exchange transaction is not sufficient to return the adjusted basis of the property, the taxpayer has sustained a loss.[60] The loss the taxpayer will claim is limited to the difference between the adjusted basis and the amount realized.[61] It is worth noting that the taxpayer's basis may be different depending upon whether they need to compute gain or loss.[62]

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53. *Id.*

54. *Id.*

55. *Id.*

56. Adjusted basis is calculated by beginning with an asset's original cost basis, and then making adjustments (up or down) for purchasing costs, title fees, depreciations or amortizations claimed, etc. . . I.R.C. § 1011 (2012).

57. *Id.* "Basis is generally the amount of your capital investment in a property for tax purposes. Use your basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale, exchange or other disposition of the property." I.R.S., PUBLICATION 551: BASIS OF ASSETS (Rev. Dec. 2014), *available at* http://www.irs.gov/publications/p551/index.html.

58. Treas. Reg. § 1.1001-1(a).

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* The regulation further explains that "[f]or example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of that section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property, the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust)." *Id.*

C. *The Election, and It's Import When Contemplating a Transaction*

Given the very distinct tax treatments of funds received from a loan as compared to those received upon sale or exchange, it becomes very clear that a taxpayer and his counter party make an important and meaningful election when they agree to engage in a loan instead of a sale.[63] If a taxpayer intended to sell or exchange property, they would enter into some such agreement with full knowledge of the tax consequences that attach to it. Further, if a taxpayer intends to borrow money and is willing to post collateral or remain personally liable for the debt's satisfaction, he does so knowing that the transaction does not create a taxable event regarding income.[64]

On advice of a consultant, Landow made the important choice to borrow funds on a nonrecourse basis and use FRNs as collateral.[65] As the preceding part describes, Landow entered this transaction and planned his behavior rooted in the understanding that a loan is a loan and not a sale, carrying specific tax consequences.

IV. THE LANDOW CASE

This part details the history and facts surrounding the Landow Transaction, including background information regarding Mr. Landow's counterparty, Derivium Capital.[66] Then, a discussion of the court's reasoning and holding is followed by a

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63. As made clear by notes 40 through 64, *supra*, loans are not realized income at the time of lending (as the taxpayer's wealth has not technically changed in amount given his obligation to repay), even though collateral may be posted in exchange for that loan, but a sale constitutes almost immediately recognizable income. See *supra* notes 40-64 and accompanying text.

64. *See* MERTENS, *supra* note 40.

65. Landow v. Comm'r, 102 T.C.M. (CCH) 88 (2011).

66. Stipulated Permanent Injunction, U.S. v. Cathcart, No. C 07-4762 PJH at *2 (N.D. Cal. Nov. 23, 2009). Prior to the I.R.S. assessment of deficiency and penalties against Mr. Landow, among others, a Federal District Court in California granted an injunction against Derivium Capital's owner. *Id.* The D.O.J. prepared the order which read in pertinent part:

> "C. Pursuant to I.R.C. § § 7402(a) and 7408, Cathcart is enjoined and restrained from, directly or indirectly, by use of any means or instrumentalities:
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> 1. Organizing, promoting, marketing, selling, or implementing the "90% Loan" program that is the subject of the complaint herein;
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> 2.Organizing, promoting, marketing, selling, or implementing any program, plan or arrangement similar to the 90% Loan program that purports to enable customers to receive valuable consideration in exchange for stocks and other securities that are transferred or pledged by those customers, without the need to pay tax on any gains because the transaction is characterized as a loan rather than a sale." *Id.*

few brief thoughts on the state of Mr. Landow's appeal.

A. *Background and Legal Questions*

1. Landow

The 2011 Tax Court decision requiring Landow to recognize gain on the Derivium loan transaction, described in greater detail below, resulted from the taxpayer's petition challenging an IRS notice of deficiency for Landow's 2005,2006, and 2007 returns.[67] Landow, owner of a successful medical services company in New York,[68] decided to diversify his portfolio and simultaneously reward "employees of N.Y. Medical through the establishment of an employee stock ownership plan (ESOP)".[69] Sometime around 2000, Landow established a seller financed type ESOP[70] and engaged consultation services to help the ESOP finance the purchase of stock from NY Medical/Landow.[71]

Landow intended to use section 1042 of the Internal Revenue Code[72] to defer the gain of that purchase, complying with the statutory requirement to use qualified replacement property in the leveraged transaction.[73] This lead to the creation of the Floating Rate Note portfolio (FRN or FRN portfolio) that became collateral for the Derivium Capital loan transaction.[74]

The Tax court detailed Landow's attempt a "zero cost borrowing" through traditional lenders such as Citibank and

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67. *Landow*, 102 T.C.M. (CCH) 88, at * 1.

68. Landow organized the corporation, N.Y. Medical, in 1994 utilizing the state of Delaware's business friendly laws. *Id.* at 1. While NY Medical, Inc. has been embroiled in this dispute with the IRS, Landow (a medical doctor) has gone on to found another company, Vein Care of New York. *Visual CV, Jonathan Landow*, VISUALCV.COM, http://www.visualcv.com/jonathanlandow (last visited Jan. 7, 2014).

69. *Landow*, 102 T.C.M. (CCH) 88 at *1.

70. A seller financed employee stock purchase program generally follows three basic steps: (1) shareholders sell their stock to the ESOP trust in exchange for a note to be repaid over a term of years (the company guarantees the loan), (2) the company makes cash contributions to the ESOP to coincide with the debt service required under the loan. These contributions are fully deductible for federal income tax purposes to the company, (3) the ESOP trust, in turn, uses the cash contributions to pay the selling stockholders according to the terms of the note between the ESOP trustee and the selling stockholders. Scott D. Miller, *The ESOP Exit Strategy*, THE JOURNAL OF ACCOUNTANCY (March 2010), http://www.journalofaccountancy.com/issues/2010/mar/20092046.htm.

71. *Id.*

72. I.R.C. § 1042(b) (2012) ("Requirements to qualify for non-recognition.—A sale of qualified securities meets the requirements of this subsection if—(1) Sale to employee organizations.—The qualified securities are sold to—(A) an employee stock ownership plan (as defined in section 4975(e)(7)), or (B) an eligible worker-owned cooperative.").

73. Landow v. Comm'r, 102 T.C.M. (CCH) 88, *1 (2011).

74. *Id.* at *5. *See also* Appendix A.

Morgan Stanley.[75] Landow's consultant introduced him to the idea of Derivium Capital in order to achieve the lending results he sought.[76] It is the Derivium loan that the IRS has re-characterized, and therefore that loan, not the more traditional previous lines of credit are the focus of this article.

Interestingly, the Landow court seems willing to recognize that this particular taxpayer did indeed believe he had bargained for and entered into a loan agreement. The language used to describe Landow's negotiation with Derivium[77] and the eventual agreement between the two parties evidences that acknowledgement by the court.[78]

Landow primarily argued that the transaction retained all loan characteristics and should never have been treated as a sale.[79] As detailed below, the court moved through other cases involving Derivium loans, and finally drew a line connecting Landow to Calloway, Kurata, and Shao cases.[80] The court claimed consistency by treating Landow as the others despite actual differences in their cases.[81] The most important part of Landow's defense lay in proving loan characterization as accurate, however, his alternative argument, should the court find that the transaction constituted a sale, rested on either section 1042 or 1033 of the Internal Revenue Code.[82] Involuntary conversion, section 1033,[83] operates where the code makes special

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75. *Landow*, 102 T.C.M. (CCH) 88 at *5-6.

76. *Id.* at *6.

77. *Id.* at *7. Landow showed concerns over certain terms and requested changes to the standard master loan agreement language, both regarding early repayment of the loan (allowing it!) and contingency planning in the case of lender bankruptcy. *See id.*; *see also* Appendix C.

78. *Landow*, 102 T.C.M. (CCH) 88 at *7. "In each of those documents, Derivium proposed to lend Mr. Landow on a nonrecourse basis 90 percent of the face value of the FRN to which the document pertained at a net interest rate calculated by reference to either the one-month London interbank offered rate or the three-month London interbank offered rate and taking into account interest paid on that FRN. Each of the proposed loan term sheets proposed prohibiting (1) Derivium from calling before maturity the loan to which each such sheet pertained unless Mr. Landow was in default on that loan and (2) Mr. Landow from prepaying before maturity the principal of that loan. The respective proposed loan term sheets set forth the terms of the proposed loans as ranging from 27 to 38 years and required annual net interest payments on those loans (i.e., the respective amounts, if any, that Mr. Landow was to pay after taking into account the respective interest payments under the FRNs) that ranged from $1,207.50 to $15,098.72 depending on the respective face values of the FRNs." *Id.* at *6.

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *See* I.R.C. § 1033 (2012); 47A C.J.S. Internal Revenue § 121 (explaining that this *is to be liberally construed to achieve its purpose.*") An involuntary conversion may be the result of the destruction of the property in whole or in part, its theft, seizure, requisition,

provision for the non-recognition of gain . . . in the case of so-called "involuntary conversions" under certain specified circumstances."[84] This is a relief provision enacted to allow a taxpayer to replace property involuntarily converted without paying the tax incident to other exchanges of property.[85] Recognition of gain from that transaction is merely deferred until the sale of the replacement property.[86] The court also rejected this argument given language in the Master Loan agreement allowing Derivium to sell the collateral.[87] Section 1042 is explaining in a previous part of this comment, and unfortunately for Landow, also rejected by the court.[88]

Derivium, in all its infamy, played an integral role in the court's decision-making process, therefore that company and its practices and legal troubles are detailed below.

2. Derivium

Derivium's 90% stock loan program consisted of loaning customers 90% of the value of their stock on a nonrecourse basis.[89] Although customers granted Derivium the right to sell their stock, Derivium never told its clients when the stock was actually sold and instead led clients to believe that it still held the collateral stock, or evaded questions regarding the securities' disposition.[90] At the end of the loan term, clients could pay their balance and Derivium would return the stock, or clients could

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or condemnation, or even the threat or imminence of its requisition or condemnation. The conversion may be into similar property, money, or dissimilar property. I.R.C. § 1033(a). "If the conversion is into similar property or property related in service or use, no gain is recognized regardless of when the disposition of the converted property took place or whether or not the taxpayer elects to have the gain recognized."). *Id.*

84. 47A C.J.S. *Internal Revenue* § 121 (2012).

85. *Id.*

86. *Id.* Importantly, the basis of replacement property is the same as the property converted, decreased by the amount of money received not expended for replacement and increased in the amount of any gain or decreased in the amount of any loss recognized on the conversion. *Id.*

87. *See* appendix C.

88. Landow v. Comm'r, 102 T.C.M. (CCH) 88 (2011).

89. *See, e.g.,* Harbor Bancorp & Subsidiaries v. Comm'r, 115 F.3d 722, 729 (9th Cir.1997) (holding that it is axiomatic that tax law follows substance and not form).

90. The tax court understood Landow's concerns regarding a possible sale of his collateral as evidenced by reference to his attorney's letter to Derivium stating: "you have been the subject of a recent article in Forbes magazine, as has Derivium Capital LLC and Bancroft Ventures Ltd (IOM). My client, Dr. Landow, is concerned about the custody and control of his securities [the FRN portfolio] . . . As you know he negotiated a contract different from that proposed to others, and he has every expectation that you will return his securities to him. The sentence in the Forbes article that you sold the stock is therefore extremely disturbing." *Landow*, 102 T.C.M. (CCH) 88 at *13 . This is further evidenced by the court's statement that Landow was indeed unaware of Derivium's almost immediate sale of the FNR portfolio collateral. *Id.* at *10.

surrender the stock to Derivium to satisfy their debt.[91] While Derivium undoubtedly engaged in sham transactions designed to deceive both its customers and the Internal Revenue Service, its customers believed they had executed a valid loan replete with all the traditional characteristics of a loan.[92]

The California District Court that heard the complaint against Derivium agreed with the I.R.S, holding that as a matter of law, the transactions between Derivium and its clients were, at their core, not loans.[93]

That court reasoned through *Grodt & McKay*[94] by applying the multi-factor test to determine the point at which the burdens and benefits of ownership are transferred for purposes of qualifying a transaction as a sale.[95] Perhaps more on point, the court then worked through *Welch v. Commissioner*,[96] which aids in examining the factors necessary to determine whether a transaction constitutes a bona fide loan. That case law analysis led the court to feel "compel[ed]" to conclude that the transactions in question constituted the sale of securities, not bona fide loan transactions.[97]

B. *The Reasoning Lent to Landow*

The Landow court made heavy use of the Calloway case to arrive at their decision.[98] There are numerous distinctions in the cases' fact patterns that may warrant wholly separate treatment, thus giving practitioners better guidance, but the Court rested its reasons on Calloway.[99] For that reason, the following section details the Calloway case.

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91. *See* Owens Van Wagoner, *supra* note 2, at 278-79. Owens Van Wagoner explores the aftermath of a Derivium loan for taxpayer Calloway. *Id. Calloway* was the first in a line of cases prosecuted against taxpayers who engaged in transactions with Derivium, and Owens Van Wagoner posits that the taxpayers' good faith and honest intent did little to persuade a court already colored by Derivium's decidedly tax avoiding behavior. *Id.*

92. *See* Appendix C-D for Landow's specific agreement and payment schedule.

93. United States v. Cathcart, C 07-4762 PJH, 2009 WL 3103652 (N.D. Cal. Sept. 22, 2009).

94. Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1236-37 (1981).

95. As mentioned above in note 19 *supra*, the court that conceptualized the *Grodt & McKay* factors did so in the context of transactions involving fungible tangible property. The particular property at issue there being cattle. *Supra* note 19 and accompanying text. Many scholars find that beyond the obvious distinctions, cattle and securities differ in their tangibility, as well.

96. *Welch v. Comm'r,* 204 F.3d 1228, 1230 (9th Cir.2000).

97. United States v. Cathcart, C 07-4762 PJH, 2009 WL 3103652 (N.D. Cal. Sept. 22, 2009).

98. Landow v. Comm'r, 102 T.C.M. (CCH) 88,* 15 (2011).

99. *Id.*

1. The Calloway Case

In 2001, Calloway engaged in a loan transaction with Derivium on a non-recourse type basis.[100] As was common with Derivium agreements, Calloway transferred shares of "IBM common stock to Derivium as collateral for a loan of 90% of the value of the shares."[101] By the terms of the purported loan agreement, Derivium had the right to unload the securities without notice and to retain any proceeds from such a sale.[102]

Interest accrued at a rate of 10.50% per annum[103], yet Calloway could not make loan payments until it reached maturity in three years time.[104] The loan had no margin requirements apart from the initial collateral and could not be terminated prior to maturity.[105] Calloway was to receive 90% of the stock's value rather than 80% after paying capital gains tax, thus the transaction made good economic sense as a taxpayer.[106]

However, Derivium turned around and sold the collateral (Calloway's shares) just one day after having received them.[107] Derivium never informed Calloway of the sale but rather told him that they had taken action to had "hedge" his stock.[108] Derivium used the "hedged value" to determine the loan amount and then sent the proceeds to the taxpayer.[109] Calloway did not report the receipt of $93,586.23 on his 2001 tax return.[110]

Shortly before the parties to the Landow case filed their respective opening briefs, the court decided Calloway's case.[111] They held, on the basis of the facts, as presented above, that the

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100. Calloway v. Comm'r, 135 T.C. 26, 26-28 (2010); Calloway v. Comm'r, 691 F.3d 1315 (11th Cir. 2012).

101. *Calloway v. Comm'r,* 135 T.C. 30.

102. *Id.* at 29. While this provision is uncommon to most collateralized loan agreements, in and of itself, it should not have prevented taxpayer Calloway from retaining the characterization of the transaction in the loan category. BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.1.

103. This figure is well above the average for the 2010 year as reported by the treasury. *See Interest Rates & Prices,2010 Treasury Direct*, TREASURYDIRECT.GOV, http://www.treasurydirect.gov/govt/rates/pd/avg/2010/2010_12.htm.

104. *Calloway v. Comm'r,* 135 T.C. 29.

105. *Id.*

106. *Id.*

107. *Id.* at 30.

108. *Id.* at 31. The right to sell the stock was not in question, as the master loan agreement provided Derivium with that capability. Rather, the issue that the court failed to highlight is that Calloway had not contemplated the immediate sale of the collateral, and continued to believe that the securities were held in a manner consistent with loan characterization. *See* Owens Van Wagoner, *supra* note 2, at 281-282.

109. *Calloway v. Comm'r,* 135 T.C. 31.

110. *Id.*

111. Landow v. Comm'r, 102 T.C.M. (CCH) 88,* 15 (2011).

transaction between the taxpayer (Calloway) and Derivium constituted the taxpayer's sale of those securities, and not a loan for 90 percent of the value of the securities portfolio.[112]

The court reasoned that "[p]etitioners are correct that none of the above-listed facts were present in *Calloway v. Commissioner*. However, those facts were present in *Shao*, and *Kurata* two cases in which we held that *Calloway* was controlling and that the respective transactions at issue in those cases"[113] constituted sales of securities by the respective taxpayers, and not loans to those taxpayers.[114]

The two cases the court relied on to confirm their consistency regarding this issue are briefly explained below.

2. The Shao Case

In *Shao v. Commissioner,* the court found no evidence that the taxpayer engaged in the transaction for the purpose of monetizing her securities and avoid paying tax on the proceeds.[115] In fact, the taxpayer in *Shao* entered into the Derivium transaction at issue in that case as a way to substitute a margin account that she had held with a financial institution.[116] The taxpayer in *Shao* characterized her transaction as a loan or lending agreement at all times. The taxpayer in *Shao* did not "voluntarily surrender" her securities portfolio at the end of her purported loan term. The portfolio that she had transferred to Derivium as collateral for that supposed loan remained collateral in her treatment, and not a voluntary surrender.[117]

While the taxpayer in *Shao,* as any other nonrecourse borrower, had the right to "walk away" from the professed loan at the conclusion of the three-year term the loan, she elected to pay a weighty renewal fee, and thereby extend the term of the loan.[118] Despite this distinct fact circumstance, the court held in *Shao* that the *Calloway* decision controlled, and therefore the Derivium transaction at issue in *Shao* constituted a sale of the securities ("collateral") by the taxpayer, and not a loan to the taxpayer by Derivium.[119]

112. *Id.* at *16.
113. *Id.*
114. *Id.*
115. Landow v. Comm'r, 102 T.C.M. (CCH) 88,* 16-17; *see also* Shao v Comm'r, 100 T.C.M. (CCH) 182 (2010).
116. Landow, 102 T.C.M. (CCH) 88, at *16-17.
117. *Id.*
118. Shao v Comm'r, 100 T.C.M. (CCH) 182 (2010).
119. *Landow*, 102 T.C.M. (CCH) 88, at *17.

3. The Kurata Case

In *Kurata v. Commissioner* the court also found no evidence that the taxpayers engaged with Derivium for the purpose of monetizing their securities while avoiding taxation of the proceeds.[120] The taxpayers in *Kurata* treated the transaction as a loan throughout the entire term of that "loan." Importantly, there the taxpayers reported gain from the sale of the securities that had served as collateral when they chose to surrender those securities at the conclusion of the three-year term.[121] Despite these distinct fact circumstances, the court held in *Kurata* that *Calloway* still controlled, and therefore the Derivium transaction at issue in *Kurata* always constituted a sale of securities by the taxpayers, and was never a loan to the taxpayers by Derivium.[122]

Landow pointed out certain other facts that he believed made the Derivium transaction in his case materially distinguishable from the Derivium transaction at issue in *Calloway,* including the following: "(1) Mr. Landow retained the ability to prepay the loan principal under the Derivium transaction documents and (2) those documents provided that the FRN portfolio continued to be an asset of Mr. Landow."[123] As recounted below, the court rejected these differences as immaterial, out of hand.

C. *Outcome and State of Appeal*

The substance over form doctrine, upon which the government relied, further supports the conclusion that, in looking beyond the actual language of the Master Loan Agreement to the totality of the undisputed facts, the substance of the transaction between the parties constitutes a sale, and not a bona fide loan.[124] The Landow court essentially trotted out this same line from California: the substance was a sale regardless of documentation, intent, bargain, and obligation to repay.[125]

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120. *Id.*; *see also* Kurata v. Comm'r, 101 T.C.M. (CCH) 1291 (2011).

121. *Kurata*, 101 T.C.M. (CCH) 1291.

122. *Id.*

123. *Landow*, 102 T.C.M. (CCH) *17.

124. United States v. Cathcart, C 07-4762 PJH, 2009 WL 3103652 (N.D. Cal. Sept. 22, 2009).

125. *Landow*, 102 T.C.M. (CCH)* 17 ("Based upon our examination of the entire record before us, we find that the Derivium transaction at issue here is not materially distinguishable from the Derivium transaction at issue in *Calloway v. Commissioner, supra*. On that record, we further find that *Calloway* is controlling in these cases. On the record before us, we find that the Derivium transaction constitutes a sale by Mr. Landow of the FRN portfolio to Bancroft, and not a loan by Bancroft to Mr. Landow that was collateralized by that portfolio.").

Many of Landow's points of distinction were valid and worthy of more than a cursory glance, or an, "oh, but we must" given that other, somewhat similar, cases were decided resting upon Calloway.[126]

V. RAMIFICATIONS & CONCLUSION

In *Calloway*, the Tax Court and Eleventh Circuit invoked an unsuitable analytical structure to reach the result that the 90 percent loan was a taxable disposition;[127] the court then relied on that same inappropriate logic for later cases.[128] The court employed a benefits and burdens test originally designed for tangible, non-fungible property that frankly does not work for transactions involving intangible, fungible, corporate stock or others securities.[129]

Furthermore, the *Calloway* opinion was decided against the backdrop of a government investigation of Derivium and the Tax Court's other Derivium decisions.[130] The I.R.S. had successfully litigated two promoter suits against Derivium principals, and that company was in the midst of bankruptcy proceedings when the Tax Court received *Calloway*. This background likely influenced the decision to bestow sale disposition treatment.[131]

A more precise test, tailored to the specific attributes of securities, would provide better guidance for practitioners trying to advice clients regarding the tax treatment of a complicated transaction.[132] Clearly the tax consequences influence the election of transaction structure. So, the courts should have born this in mind and relied on previous Tax Court jurisprudence and I.R.S. guidance to outline the most important factors in stock ownership. While it is possible that an understanding of Derivium's history and the differences between the 90 percent loan and other securities transactions illuminates why the transaction is a sale in some cases,[133] it does not necessarily

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126. *Id.*; *see also* Leeds, *supra* note 30 (criticizing the *Calloway* court for shaky reasoning).

127. Calloway v. Comm'r, 691 F.3d 1315 (11th Cir. 2012). *See* Owens Van Wagoner, *supra* note 2, at 273.

128. *See generally Landow*, 102 T.C.M. (CCH) 88; Shao v Comm'r, 100 T.C.M. (CCH) 182 (2010); Kurata v. Comm'r, 101 T.C.M. (CCH) 1291 (2011).

129. *See* Leeds, *supra* note 30; *see also* Owens Van Wagoner, *supra* note 2.

130. Owens Van Wagoner, *supra* note 2.

131. *Id.*

132. *Id.*, *see also* Leeds, *supra* note 30 (lamenting the lack of specific direction from the courts for parties engaging in loan transactions involving securities).

133. Owen Van Wagoner believes the Calloway transaction was undoubtedly a loan, but does not look at any later cases involving distinct fact patterns. Owens Van Wagoner,

follow that all cases involving a company of that nature (or that company specifically) merit identical treatment.[134]

Following one's own advice: The *Landow* court fixated on consistency among all cases with a loan of a similar shade, and in doing so fell victim to upholding form over substance—precisely the error they claim to correct by re-characterizing Landow's transaction.[135] Unfortunately for Landow and practitioners, this leaves little guidance for later transactions. The *Calloway* court, and due to its rigid adherence to faulty logic disseminated in early cases disguised as "consistency"[136], the *Landow* court, pinned loan to sale conversion decisions on Derivium alone.[137] What will happen now that this company is not able to offer its service,[138] but practitioners still need to structure transactions in their clients' favor?

Those professional have little direction and no clearly tailored test from the courts to light their way.[139] We know only that a loan from Derivium, no matter how the taxpayer renegotiates and transforms its terms, will always be treated as a sale, because that's how the *Calloway* court did it. But what of other lenders, what specific substance requirements must taxpayers meet when using securities (or other similar property) as collateral for a loan? These questions remain unanswered. We can only hope that Landow's appeal will garner greater judicial reasoning and a readily applicable test or list of factors to guide future transactions.[140] Until then, borrowers using securities must beware—the tax consequences associated with their

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supra note 2.

134. *See generally* Leeds, *supra* note 30; and Robert W. Wood, *When "Loans" Are Taxed As Income*, FORBES.COM (Jan. 26, 2011), http://www.forbes.com/sites/robertwood/2011/09/26/when-loans-are-taxed-as-income.

135. *See* BITTKER, RESTRUCTURED BUSINESS TRANSACTIONS, *supra* note 1, at ¶ 4.4.1.

136. Landow v. Comm'r, 102 T.C.M. (CCH) 88, (2011)("Unfortunately, harmony is not guaranteed even in this situation; since each taxpayer has the burden of proof in his own case, one might fail to convince the judge that a witness is telling the truth, while the other might simultaneously fail to prove by the requisite standard that the same witness is mistaken. The prospect of inconsistent findings at the trial level is increased if one case is tried in the Tax Court and the other in a federal district court.").

137. *Id.*

138. A Federal District Court in California granted an injunction against Derivium Capital's owner.

Stipulated Permanent Injunction at 2, U.S. v. Cathcart, No. C 07-4762 PJH (N.D. Cal. Nov. 23, 2009).

139. None of the courts dealing with these loan re characterization cases have crafted a specific test. They have used the *Grodt & McKay* test, which as explained is inappropriate, and have ignored the *Dunne* test, which could be refined for such a purpose. *See* Leeds, *supra* note 30, for his discussion of 4 factors from Dunne that are very applicable to the securities collateral situation.

140. Landow's appeal, in the 2nd circuit, is yet to commence.

transactions may not match their form.

L. K. Napoli

APPENDIX A: FLOATING RATE PORTFOLIO[141]

Content and Purchase Date

Date of Purchase	**Principal Amount (USD)**	**Date of Maturity**	**Issuing Company or Corporation**
11.2.2000	3,094,000	08.15.2050	Proctor & Gamble
11.2.2000	3,000,000	12.27.2039	E.I. Dupont
6.20.2001	3,000,000	12.27.2040	Merck & Co.
9.17.2001	3,000,000	06.21.2051	United Parcel Service
11.13.2001	1,500,000	12.21.2041	Minnesota Mining
11.29.2001	1,156,000	12.21.2041	Minnesota Mining
11.29.2001	250,000	10.9.2041	E.I. Dupont

141. Landow v. Comm'r, 102 T.C.M. (CCH) 88 (2011).

APPENDIX B: IRS ASSESSED DEFICIENCIES AND PENALTIES[142]

Year	Deficiency	Additional Tax Under §6651(a)(1)	Accuracy-Related Penalty Under § 6662(a)
2003	$4,318,104.00	$ —	$863,620.80
2004	$749.00	$ —	$ —
2005	$93,009.45	$3,962.00	$18,601.89
2006	$89,040.00	$ —	$17,808.00
2007	$211,976.00	$16,300.70	$42,395.20

142. Landow v. Comm'r, 102 T.C.M. (CCH) 88,*1 (2011).

APPENDIX C: MASTER LOAN AGREEMENT DERIVIUM-LANDOW[143]

3. FUNDING OF LOAN

The contemplated Loan(s) will be funded according to the terms identified in one or more term sheets, which will be labeled as Schedule A, individually numbered and signed by both parties, and, on signing, considered a part of and merged into this Master Agreement. The Client understands that by transferring securities as collateral to DC and under the terms of the Agreement, the Client gives DC and/or its assigns, the right, without requirement of notice to or consent of the Client, to assign, transfer, pledge, repledge, hypothecate, rehypothecate, lend, encumber, short sell, and/or sell outright some or all of the securities during the period covered by the loan. The Client understands that DC and/or its assigns have the right to receive and retain the benefits from any such transactions and that the Client is not entitled to these benefits during the term of a loan. The Client agrees to assist the relevant entities in completing all requisite documents that may be necessary to accomplish such transfers.

4. RETURN OF CLIENT COLLATERAL

DC agrees to return, at the end of the loan term, the same collateral (or cash equivalent if the Client's collateral securities have reached their maturity date or the collateral has been called by the issuer), as set out and defined in Schedule(s) A attached hereto, upon the Client satisfying in full all outstanding loan balances, including all outstanding net interest payments due, if any, and/or all late payment penalties due, if any.

5. REGISTRATION AND SUBCUSTODIANS

DC may place the Client Assets i) with any domestic or foreign depository or clearing corporation or system that provides handling, clearing or safekeeping services; ii) with the issuer of a security in non-certificate form; iii) with any domestic or foreign bank or depository as subcustodian; and DC will pay the fees and expenses of the foregoing entities.

Each of the Derivium schedules A provided in pertinent part:

3. Anticipated Loan Amount: 90% of the face value* * *

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143. The tax court reproduced pertinent portions of the loan agreement entered into in the text of the opinion. Landow v. Comm'r, 102 T.C.M. (CCH) 88,*10 (2011).

4. Interest Rate: Loan interest rate (LIR) will be indexed to [1 or] 3 month [as the case may be] $US LIBOR ("LIBOR")

5. Interest Payments: Interest on the collateral will be received by the Lender and applied against interest due on the Loan, with the result that net interest due per dollar on the Loan will be determined by the . . . Annual Net Interest Rate Formula . . . . The . . . formula reduces to the Annual Net Interest Payment/ Loan Amount. . . .

6. Late Payment Penalty: A late fee of 5% of the Quarterly Net Interest Payment due will be assessed for any Net Interest Payment past due by 30 days or more and will be payable within 60 days of the Net Interest Payment due date.

7. Default: Borrower will be considered in default if any Quarterly Net Interest Payment or late payment penalty is past due by 90 days or more.

10. Prepayment: Except as provided for in Paragraph 14, prepayment of the Loan can be made on any date which is a fiveyear anniversary date of this Loan, provided DC is noticed of this election at least one year prior to a five- year anniversary date and a pre-payment fee of 6.0% of the Loan amount has been paid to DC or the Lender at the time of said election.

11. Margin Requirement: None, beyond initial collateral.

12. Non–Callable: Loan cannot be called by Lender before maturity as long as Borrower is not considered in Default. If Borrower is in Default, the Loan may be called by Lender at Lender's discretion.

13. Non–Recourse: Non-recourse to Borrower, recourse against the Collateral only.

14. Creditor Claims: DC and the Lender acknowledge that the Collateral is the asset of the Client and is not subject to the claims of any creditors of DC or the Lender. Should any creditor of DC or the Lender contest the ownership of the Collateral in any court or similar proceeding, DC shall provide immediate notice to the Client and Client shall have the right to prepay the Loan (without any fee) and recover the Collateral provided that the benefit of any transaction entered into by DC or the Lender shall be held by the Client for DC's or the Lender's benefit and such benefit shall be the only compensation due to DC or the Lender.

Schedule D

The Client understands that by transferring securities as collateral to DC and under the terms of the Agreement, the Client gives DC the right, without notice to the Client, to transfer, pledge, repledge, hypothecate, rehypothecate, lend, short sell, and/or sell outright some or all of the securities during the period covered by the loan. The Client understands that DC has the right to receive and retain the benefits from any such transactions and that the Client is not entitled to these benefits during the term of a loan. On repayment of a loan in full by the Client, including all outstanding net interest payments due, if any, and/or all late payment payment [sic] penalties due, if any, DC has the obligation to return to the Client the same collateral (or cash equivalent if the Client's collateral securities have reached their maturity date or the collateral has been called by the issuer), as set out and defined in Schedule(s) A attached hereto.

APPENDIX D: LOAN INTEREST PAYMENT SCHEDULE[144]

Schedule no.	**Loan Term (in years)**	**Annual Net Interest Payment**
A-1	28	$921.25
A-2	28	$9,480.00
A-3	36	$11,055.00
A-4	37	$9,480.00
A-5	38	$9,322.56
A-6	27	$11,556.09

144. As reprinted by the Tax Court. Landow v. Comm'r, 102 T.C.M. (CCH) 88,*9 (2011).