Bought Law

In 1991, Donald Trump bought a tax opinion from Wilkie Farr, a New York law firm, that allowed him to avoid tax on roughly a billion dollars of income. In the closing days of Trump's Presidential campaign, the opinion was leaked.[1] Willkie Farr was supposed to have had a bit better than a one-in-five chance of success for its theory if contested,[2] but Willkie Farr was its own judge and jury on the chances. Willkie Farr could also get more business if it became generally known that it was willing to shade its opinions in clients' favor. There was very little down side risk.

Plausibly Willkie Farr got carried away with itself, and the theory had less than a one-in-five chance of success before a capable court. The theory behind the Willkie Farr opinion is pretty flakey. It had neither the literal wording of the statute nor any court case on its side. The theory was terrible as a matter of tax policy. The theory allowed Trump to keep a billion dollars of fake tax loses to shelter a billion dollars' worth of luxury consumption from tax when nothing was lost as a matter of economic substance.

Willkie Farr's opinion was also not trying to determine what the law was. The "law" is best defined as how a court would rule if it knew all the facts and saw the issues. The document was conceived of as a legal brief advocating for a client. Willkie Farr was not called on to give opinion that Trump would prevail if challenged and did not. Consistent with the technical standards governing the Willkie Farr opinion, the IRS could have had a 79 percent chance of success in litigation. Given both the pressure on Willkie Farr to go low, and the flimsiness of the theory, the easy conclusion at a pretty high level of confidence is that Trump would have lost if capably challenged.

Nonetheless the document, while not law, still worked, and was worth every cent of its cost, because it resulted in Trump not paying tax. The opinion freed Trump from penalty if wrong because he had relied on "advice of counsel." The IRS for reasons that are deeply flawed, very human, and deeply embedded in the system apparently did not challenge the theory nor prevail in court as it should have. Rudolph Giuliani has described Trump as a tax "genius" taking advantage of "a perfectly legal application.[3] The position was not "legal," defining "legal" in terms of confidence a court will uphold it. Trump's accountant, moreover, has leaked that Trump was clueless and indifferent on tax issues.[4]

Trump claimed tax losses of $916 million.[5] Trump though his partnerships borrowed $3.4 billion from various banks to buy assets including Trump Taj Mahal and other casinos in Atlantic

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[1] http://www.nytimes.com/interactive/2016/10/31/us/politics/trump-tax-letters.html?_r=0

[2] Reg. section 1.6662-4(d)(2); IRS, ''Report on Civil Tax Penalties by Executive Task Force,'' Commissioner's Penalty Study (1989) (20 percent).

[3] http://www.latimes.com/nation/politics/trailguide/la-na-trailguide-updates-giuliani-calls-trump-an-absolute-1475422952-htmlstory.html

[4] Benjamin Wallace-Wells, *The New York Tale of Donald Trump's Accountant*, THE NEW YORKER, Oct 8, 2016 http://www.newyorker.com/news/benjamin-wallace-wells/the-new-york-tale-of-donald-trumps-accountant

[5] http://www.nytimes.com/interactive/2016/10/01/us/politics/donald-trump-taxes.htmlhttp://www.nytimes.com/interactive/2016/10/01/us/politics/donald-trump-taxes.html

City.[6] The businesses lost serious money under Trump's control, almost immediately. If we treat the bank debt as if they were costs, then Trump plausibly had the billion dollars of operating losses that passed through to him for tax: By 1992, Trump had a net worth estimated at negative $1.4 billion.[7] In 1991, banks holding his notes contributed them to the Trump partnership in exchange for a lesser stated debt and a partnership interest.[8] The combined value of partnership interest and lesser debt reflected the losses that the banks had suffered so far by lending to Trump. Trump's tax losses survived as net operating loss carryforwards to be reported on his 1995 return,[9] because he treated the bank debt as part of his cost upfront, but inconsistently did not correct his accounting when the debt turned out not to be paid.

The grand framework of tax presumes that obligations to pay bank debts are costs equivalent to cash, on the commercially reasonable assumption that banks protect themselves by demanding repayment. When the debt is not paid, however, the debt is not a cost and the tax system takes away the deductions when the debt is not paid. Nonpayment is an event inconsistent with the original deductions. Sometimes the cancellation of the debt produces immediate ordinary income, sometimes we reduce tax net operating losses and sometimes we reduce basis and future deduction.[10] The combined remedies for cancellation of debt were intended by Congress to be a water-tight system. Trump relied on a kind of goofy accounting generating fake billion dollar tax losses without a rationale or legitimacy, by treating the debt as cost even after default proved it was not a cost.

Willkie Farr's legal theory on behalf of Trump was that the bank's exchange of depleted-value debt for an interest in Trump's partnership in 1991 was tax exempt, and also did not reduce his prior deductions or take away his net operating losses. By exchanging the debt for partnership interest, the bank did not discharge the debt, the argument goes, but merely took back partnership equity for partnership.[11]

The exchange of debt for equity theory works internally, however, only to the extent of the depleted value of the debt. An exchange means equal value is given and taken on both sides. If the debt is being settled for 10 cents on the dollar, the 90 cents is cancelled and it is not exchanged for anything. An exclusion for "exchanges" does not cover the 90 cents of debt that disappears.

The Trump theory has another deep problem. The is no support in the statutory language: There is no common law exemption in Congress's statute for partnership exchanges.

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[6] Perte Grant and Alexandra Berson, *Trump and His Debt: A Narrow Escape,* WALL ST. J., Jan. 4, 2016.
[7] Larry Light and Joseph Weber, *Donald's Trump Card,* BLOOMBERG (March 22, 1992).
[8] http://www.nytimes.com/interactive/2016/10/31/us/politics/trump-tax-letters.html?_r=0
[9] http://www.nytimes.com/interactive/2016/10/01/us/politics/donald-trump-taxes.htmlhttp://www.nytimes.com/interactive/2016/10/01/us/politics/donald-trump-taxes.html
[10] IRC section 108(b).
[11] James B. Sowell, Partnership Workouts: Is It That Time Again? 42 BNA TAX MANAGEMENT MEM. 414 (Sept. 10, 2010); Richard M. Lipton, Planning for Noncorporate Debt Workouts Outside of Bankruptcy, 70 Taxes 275, 297 (1992); Henry Ahrens, "Partnership Equity for Debt Transactions as an Exception to the Realization and Recognition of Cancellation of Indebtedness Income: Fact or Fiction?," 93 TAX NOTES TODAY 171-68 (Aug. 17, 1993)

Even beyond any technical arguments, the losses have no economic substance. Trump did not have a billion dollar of cash to put into the game, and without cash in the game, he had no losses when all was settled. Losses without economic substance are taken away by the courts when the courts can see them. A transaction that is "devoid of economic substance ... *simply is not recognized* for federal taxation purposes."[12] To quote Judge Posner's wonderful phrase, Trump's losses do not "impinge on the world."[13] The courts take away fake billion dollar tax losses, on the merits, even when the technical case for the accounting is a lot stronger than the Trump theory has.[14] The abusiveness of debt in cost basis when it is not a cost in the end is too great, for a well briefed court to uphold it.

What happened, after Trump reported his tax without the cancellation of indebtedness remedies is not publically known. If the IRS had served its duty to God and Country it would have challenged the position and prevailed in court. A court case would have produced a public record. Perhaps the IRS did not see or did not perceive how flakey the Trump theory was. America should have the best and brightest as agents and lawyers to protect our Uncle Sam from tax predators like Trump, but perhaps here they failed. Taxpayers camouflage their bad positions, or bluster and fake and demoralize the IRS even when they have no merit to their claim. If Trump in fact saved a tax on a billion of luxury consumption because of this theory, then injustice triumphed.

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[12] ACM Partnership v. Commissioner, 157 F.3d 231, 245-46 (1998) (emphasis added).

[13] Yosha v. Commissioner, 861 F.2d 494, 496, 499 (7th Cir. 1988)

[14] *See, e.g.,* Southgate Master Fund LLC v. United States, 659 F.3d 466 (5th Cir. 2011) (Patrick Higginbotham, J.) (billion loss suffered by Bank of China partner on bad loans could not be taken by American partners, notwithstanding literal compliance with regulations allowing partner to step into shoes of Chinese partner when they buy out the Chinese partner).