IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF TEXAS
AUSTIN DIVISION

J. WINSTON AND SHERI S. KRAUSE Plaintiff, v. UNITED STATES OF AMERICA, Defendant.	)))))))))	CIVIL NO. 08-CA-865 SS

UNITED STATES OF AMERICA'S
STATEMENT OF UNDISPUTED FACTS
IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT

Pursuant to Local Rule CV-7(c), the United States submits this Statement of Undisputed Facts in Support of its Motion for Summary Judgment.

UNDISPUTED FACTS

The undisputed facts pertinent to this matter are as follows:

INTRODUCTION

1. The Plaintiff in this matter, J. Winston Krause ("Krause") utilized a tax shelter transaction in 2002 to generate a substantial ordinary loss which he deducted on his 2002 Federal income tax (Form 1040) return. *See* Gov. Ex. 1, J. Winston & Sheri S. Krause 2002 Form 1040; *see also* Gov. Ex. 12, Deposition of J. Winston Krause, dated September 30, 2009 ("Krause Dep."), p. 21, l. 7.

2. The general type of tax shelter used in this case is known as a "Son of BOSS" tax shelter – it used partnership interests and offsetting foreign currency options to artificially create high basis in property which was used to generate an equally large amount of artificial tax loss to offset taxable income. Gov. Ex. 12, Krause Dep., p. 21, ll. 9-14. The Son of BOSS shelter was

identified by the Internal Revenue Service in 2000 as an "abusive" transaction. *See* IRS Notice 2000-44, 2000-2 C.B. 255.[1] Krause's shelter was a modified form of the abusive transaction described in IRS Notice 2000-44.

Krause's Educational and Employment Background

3. Krause graduated from the University of Texas at Austin in 1977, receiving his Bachelor of Business Administration in Accounting. *See* Gov. Ex. 12, Krause Dep., p. 9, ll. 12-14, 23. Krause went to law school at Southern Methodist University, receiving his J.D. in 1982. *Id.*, p. 9, ll. 15-18. Krause was admitted to the Texas Bar in 1982, and he is a certified public accountant. *Id.*, p. 13, l. 22.

4. During law school and after graduation, Krause worked for Arthur Andersen & Company in both their audit and tax departments. *Id.*, p. 10, ll. 3, 13. While at Arthur Andersen,

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[1] IRS Notice 2000-44, a courtesy copy of which is included in the Appendix, describes the tax shelter as follows:

> In another variation, a taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might purchase call options for a cost of $1,000X and simultaneously write offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than $1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.
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> Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options ($1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero. On the disposition of the partnership interest, the taxpayer claims a tax loss ($1,000X in this example), even though the taxpayer has incurred no corresponding economic loss.

Krause prepared tax returns, and was involved in estate planning and various tax research projects. *Id.*, p. 11, ll. 20-22. He also worked for General American Oil Company, where he prepared and reviewed leases and did title work. *Id.*, p. 11, l. 15. Following his employment at General American Oil, Krause went to Deering Massey Company, a company that represented professional athletes, real estate syndications and did sporting event promotion. *Id.*, p. 12, ll. 13-16. At Deering Massey, Krause reviewed player contracts, worked on various tax compliance issues, and reviewed private placement memorandums. *Id.*, p. 12, l. 18 – p. 13, l. 1. Krause also became familiar with the securities laws in effect at that time through his work at Deering Massey . *Id.* p. 13, ll. 2-4. After Deering Massey, Krause worked for a law firm called Chapman and Buford, which subsequently became Weeks and Buford and then Buford & Krause. *Id.*, p. 13, l. 5 – p. 15, l. 23. While at these firms, Krause characterized himself as a "business lawyer" who also" worked on tax cases." *Id.*, p. 13, ll. 12-13. Krause opened his own firm, KALP, in 1993. *Id.*, p. 15, ll. 21-23.

5. Krause is authorized to practice before the United States Tax Court, the United States Supreme Court, the U.S. Court of Appeals for the Fifth Circuit, the U.S. District Court for the Western District of Texas, and U.S. Court of Federal Claims. *Id.*, p. 18, ll. 1-13.

6. Krause is Board Certified by the Texas Board of Legal Specialization in (i) Tax Law, and (ii) Estate Planning and Probate Law. *Id.*, p. 18, ll. 17-19.

7. Krause was recently appointed to serve on the Texas Lottery Commission by Governor Rick Perry. *Id.*, p. 16, l. 22.

8. Currently, Krause's primary practice areas include "tax affected corporate work, tax affected partnership work, regular old plain corporate, some contracts, [and] a little bit of real estate." *Id.*, p. 16, ll. 8-10. Krause's primary focus is in the tax area. *Id.*, p. 16, l. 18.

Implementation of the Tax Shelter at Issue in This Matter

Like many tax shelters, this transaction was complex in detail but simple in principle. *Kornman & Associates Inc. v. United States*, 527 F.3d 443, 447 (5th Cir. 2008), *citing Cemco Investors, L.L.C. v. United States*, 515 F3d 749, 750 (7th Cir. 2008). Although the specific facts underlying Krause's tax shelter are not relevant to the issue in this matter, a brief explanation of the tax shelter is provided.

9. This was Krause's second tax shelter. In 1999, he entered into a tax shelter (Curr-Spec Partners, L.P.) which utilized Treasury short sales to generate an ordinary loss.[2] Gov. Ex. 12, Krause Dep., p. 36, l. 7 - p.37, l. 8.

10. In 2002, Krause decided to engage in a second tax shelter transaction for his own benefit. Gov. Ex. 12, Krause Dep., p. 36, l. 1 - p. 37, l. 8. Despite the fact that (i) the IRS had identified the Son-of-BOSS tax shelter as an abusive tax transaction in 2000, several years *before* Krause engaged in this tax shelter transaction, and (ii) Krause was aware of IRS Notice 2000-44 *prior* to entering into the tax shelter transaction, Krause nevertheless engaged in the tax shelter for his own personal benefit. *Id.*, p. 34, l. 10.

[2] The Tax Court and Fifth Circuit decisions (which involved a statute of limitations issue) relating to this shelter can be found at *Curr-Spec Partners, L.P. v. Commissioner*, 94 T.C.M. (CCH) 314 (2007) and *Curr-Spec Partners, L.P. v. Commissioner*, 579 F.3d 391 (5th Cir. 2009).

11. Tax benefits played a substantial role in Krause's decision to engage in the tax shelter. *Id.* p. 42, ll. 13-16. As noted below, Krause did not challenge the tax determinations of the IRS.

12. Krause formed Krause & Associates Advanced Strategies LP ("KAAS"). *See* Gov. Ex. 8, RBC Dain Rauscher Certification of Investment Powers for Krause & Associates Advanced Strategies, LP; *see also* Gov. Ex. 12, Krause Dep., p. 118, l. 23 – p. 119, l. 17. The original partners of KAAS were Krause & Associates, L.P. ("KALP") and Krause Holdings, Inc. (an S Corporation 100% owned by Krause, also formed in March 2001, which held less than a 1% partnership interest at all times). Gov. Ex. 12, Krause Dep., p. 83, ll. 2-11. KALP is Krause's law firm (of which he is the only partner). *Id.* p. 10, l. 25. Krause (through Krause Holdings, Inc.) was the tax matters partner for KAAS. *Id.*, p. 33, l. 17. KAAS was formed for the purpose of engaging in "more specialized" matters than those being undertaken in KALP. *Id.*, p. 23, l.19. Through KAAS, Krause offered clients "sophisticated" estate planning strategies and strategies that were more focused on tax savings. *Id.*, p. 31, l. 23 – p. 33 , l. 5. Although KAAS and KALP were ostensibly separate entities, Krause was the only person involved in these entities. *Id.*, p. 32, l. 13.

13. In 2001, KAAS filed a Form 1065, U.S. Return of Partnership Income. *See* Gov. Ex. 5, KAAS 2001 Form 1065. On this return, KAAS reported $298,549 in gross income. *Id.* This was income generated from legal services provided by Krause connected to "extra high value services . . . [t]ypically tax planning, estate planning . . . corporate transactions." Gov. Ex. 12, Krause Dep., p. 82, ll. 7-12. In 2002, KAAS filed a Form 1065 for the year January 1

ending December 26.[3] Gov. Ex. 2, KAAS 2002 Form 1065, for January 1, 2002 to December 26, 2002. For this year, KAAS reported income of $167,000, which was also generated by Krause advising clients on various tax transactions. *Id.*; *see also* Gov. Ex. 12, Krause Dep., p. 85 l. 25 - p. 86, l. 12. In addition to the income generated through Krause's provision of "extra high value services," Krause (through KAAS) also generated income by advising clients on tax shelter transactions promoted and implemented by the law firm of Jenkens & Gilchrist, P.C. ("Jenkens & Gilchrist"). Gov. Ex. 12, Krause Dep., p. 82, ll. 13 - p. 83, l. 1; p. 86, l. 12; p. 123, ll. 11-15.

14. Following its termination, KAAS filed another Form 1065 for the year December 26 to December 31, 2002. *See* Gov. Ex. 3, KAAS 2002 Form 1065, for December 26, 2002 to December 31, 2002. In this five-day period, KAAS reported a loss of $2,791,708, which, as explained below, was generated by the tax shelter at issue in this matter.

15. Krause implemented his Son of BOSS tax shelter through KAAS. To implement the tax shelter, on December 6, 2002, Krause sold two offsetting, over-the-counter, non-publicly traded European style options (collectively the "Options") with Gamma Trading Partners LLC (the "Counterparty").[4] *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tabs 2-3) ; *see also* Gov. Ex. 11, Jenkens & Gilchrist Opinion. Option A was a U.S. Dollar ("USD")/Japanese Yen ("JPY") option with strike prices of 123.850 JPY/USD (the "barrier

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[3] As explained in more detail below, KAAS technically terminated as part of Krause's shelter transaction. Although KAAS technically terminated, it continued after termination as a partnership with the same name. *See* Gov. Ex. 11, Jenkens & Gilchrist, P.C. Tax Opinion Letter (the "Jenkens & Gilchrist Opinion") dated April 11, 2003; *see also* Gov. Ex. 12, Krause Dep., p. 84, ll. 1-3; p. 87, ll. 10-16.

[4] The only time Krause ever dealt with Gamma Trading Company, LLC, was for purposes of implementing the tax shelter transaction. Gov. Ex. 12, Krause Dep., p. 47, l. 15.

rate") and 125.900 JPY/USD (the "bonus rate"), an expiration (barrier) date of 12/17/02 and a "bonus date" of 12/23/02, for which Krause received a premium of $2,791,250 from the Counterparty. *See* Gov. Ex. 10 (Tab 2). If the spot rate at 10:00 a.m. on 12/17/02 was ***greater than*** the barrier rate and the spot rate at 10:00 a.m. on 12/23/02 was less than or equal to the bonus rate, Krause would have to pay Counterparty $82,500 on 12/24/02. *Id.* If the spot rate at 10:00am on 12/17/02 was ***less than or equal*** to the barrier rate, Krause would be required to pay the Counterparty $5,543,238 on 12/19/02 and Option A would terminate. *Id.*

16. Option B was an offsetting option to Option A. Option B was an option on the USD/JPY exchange rate and the Hong Kong Dollar ("HKD")/JPY exchange rate.[5] *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab 3) ; *see also* Gov. Ex. 11, Jenkens & Gilchrist Opinion. Option B had strike prices of 123.850 JPY/USD ("barrier rate") and 16.141 JPY/HKD ("bonus rate"), with an expiration (barrier) date of 12/17/02, and a "bonus date" of 12/23/02, for which Krause received a premium of $2,791,250 from the Counterparty. *See* Gov. Ex. 10, Documents Relating to Krause & Associates Advanced Strategies, LP 2002 Tax Transaction (Tab 3). Option B offset Option A: if the spot rate at 10:00 a.m. on 12/17/02 was ***less than*** or equal to the barrier rate and the spot rate at 10:00 a.m. on 12/23/02 was less than or equal to the bonus rate, Krause would have to pay Counterparty $82,500 on 12/24/02. *Id.* (Tab 3). If the spot rate at 10:00am on 12/17/02 was ***greater than*** the barrier rate, Krause

[5] Despite Krause's "representation" in the Jenkens & Gilchrist Opinion that Krause entered into the Options because of "[his] belief that the Japanese Yen/U.S. Dollar exchange rate and the Japanese Yen/Hong Kong Dollar exchange rate would change," Krause was not the one who chose to invest in the Japanese Yen and the HKD. Rather, the Counterparty made this decision. *See* Gov. Ex. 11, Jenkens & Gilchrist Opinion; Gov. Ex. 12, Krause Dep., p. 153, l. 15 – p. 154, l. 4.

would be required to pay Counterparty, $5,543,238 on 12/19/02 and Option B would terminate. *Id.* (Tab 3).

17. The Offsetting option positions limited Krause's risk of loss, as well as Krause's potential for realizing gain. If Krause was required to make a $5,543,238 payment on one option, there would be an $82,500 or $0 payment required on the other option. Thus, Krause was exposed to risk only to the extent of the difference between the total premiums received, $5,582,500, and the total payout amount, either $5,543,238, or $5,625,738.

18. On December 6, 2002, Krause also personally purchased an over-the-counter, non-publicly traded debt instrument ("Outside Debt") from Counterparty for $5,623,750. *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab 4) ; *see also* Gov. Ex. 11, Jenkens & Gilchrist Opinion. The Outside Debt called for payments to Krause on the same dates set for the payments of the amounts due on the Options: $5,543,238 payable on 12/19/02, and $82,500 on 12/24/02. *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab 4). Because Krause's sale of both the Options and his purchase of the Outside Debt were treated as a net-cash settlement transaction, Krause was obliged to pay only the net difference of $41,250 to the Counterparty.

19. Option A terminated by its terms on 12/17/02. *See* Gov. Ex. 11, Jenkens & Gilchrist Opinion. On this date, the spot rate was less than or equal to the barrier rate (123.850), and Krause was required to pay Counterparty $5,543,238 on 12/19/02. *Id.* Simultaneously, on 12/19/02, Counterparty made its first debt repayment of $5,543,238, ($5,541,250, plus $1,988 interest). *Id.* The net payment due between the parties was thus $0.

20. On December 20, Krause contributed his interest in Option B to KAAS. *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab 8) ; *see also* Gov. Ex. 11, Jenkens & Gilchrist Opinion. On that same day, KAAS purchased an over-the-counter, non-publicly traded debt instrument (the "KAAS Debt") from the Counterparty for $82,500. *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab 5). The terms of the KAAS Debt provided that the Counterparty was required to pay $82,500 to KAAS on December 24, 2002. *Id.* This was the same day on which Option B's payment of $82,500 was due.

21. At Krause's request, on 12/23/02, KAAS used $20,000 to purchase Canadian Dollars. *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab7); *see also* Gov. Ex. 11, Jenkens & Gilchrist Opinion. Also on 12/23/02, Option B expired according to its terms. *See* Gov. Ex. 11, Jenkens & Gilchrist Opinion.

22. On 12/24/02, under the terms of Option B, KAAS paid $82,500 to the Counterparty upon expiration of Option B (because the spot rate on 12/17/02 was less than or equal to the barrier rate, and the spot rate on 12/23/02 was less than or equal to the bonus rate, KAAS was required to pay Counterparty $82,500 on 12/24/02). Gov. Ex. 11, Jenkens & Gilchrist Opinion.

23. On 12/24/02, the remaining payment of $82,500 on the KAAS Debt was made by Counterparty to KAAS pursuant to its terms. *Id.*

24. On 12/26/02, Krause contributed his entire partnership interest in KAAS (in the amount of $2,791,250) to KALP, the partnership containing Krause's law practice. This transfer (i) terminated Krause's partnership interest in KAAS, (ii) resulted in a technical termination of KAAS, and (iii) and effectively returned partnership ownership in KAAS back to its original two

partners, KALP and Krause Holdings, Inc. *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab 9); *see also* Gov. Ex. 11, Jenkens & Gilchrist Opinion; Gov. Ex. 12, Krause Dep., p. 84, ll. 1-3; p. 86, l. 23 - p. 87, l. 16.

25. As noted in the Jenkens & Gilchrist Opinion, KAAS purportedly made an election per I.R.C. § 754 to increase the basis in the Canadian Dollars by $2,791,250 to reflect Krause's transferred basis. *See* Gov. Ex. 11, Jenkens & Gilchrist Opinion. On 12/27/02, at Krause's request, KAAS sold the Canadian Dollars, claiming a loss of $2,791,708 (claimed basis of $2,811,250 in the Canadian Dollars less a sales price of $19,542). *See* Gov. Ex. 10, Documents Relating to KAAS 2002 Tax Transaction (Tab 10); Gov. Ex. 3, KAAS 2002 Form 1065 for December 26, 2002 to December 31, 2002. The economic loss resulting from the sale was only $458 ($20,000 purchase price less sales price of $19,542). Gov. Ex. 12, Krause Dep., p. 92, l. 25 – p. 93, l. 9. As noted above, a post-termination short-period tax return for the period from 12/26/02 through 12/31/02 was filed by the (New) KAAS which reported a foreign-currency loss of $2,791,708. Gov. Ex. 3, KAAS 2002 Form 1065 for December 26, 2002 to December 31, 2002; *see also* Gov. Ex. 12, Krause Dep., p. 93, l. 9-22. Of this total, $2,791,429 was allocated to KALP and $279 was allocated to Krause Holdings, Inc. *See* Gov. Ex. 4, KAAS 2002 Form 1065; Gov. Ex. 12, Krause Dep., p. 93, l. 23 - p. 94, l. 1.

26. The gain reported by KAAS on the expiration of Option B was passed through and reported on Krause's Form 1040 Schedule E for the tax year 2002, where it was offset by the foreign currency loss which Krause reported on Form 4797 resulting from Option A. *See* Gov. Ex. 1, J. Winston & Sheri S. Krause 2002 Form 1040. At the same time, Krause reported the

$2,791,429 flow-through loss from KALP , which was KALP's share of the flow through loss from KAAS' sale of the Canadian currency. *Id.*

27. In summary, Krause reported income of $2,791,250 on Schedule E of his 2002 Form 1040, upon the expiration of Option B. Krause also reported an offsetting loss of $2,791,250 on Form 4797 (also attached to his 2002 Form 1040) resulting from Option A.[6] *Id.* Finally, Krause reported the flow through loss of $2,791,429 (which resulted in a net flow-through loss of $2,377,279) from KALP on his 2002 Form 1040. *Id.* The $2,791,429 loss was the result of KAAS' sale of the Canadian Dollars. *See* Gov. Ex. 3, KAAS LP 2002 Form 1065 December 26, 2002 to December 31, 2002; *see also* Amended Complaint Filed February 17, 2009, Docket No. 8 ("Amended Complaint") ¶ 8.

28. According to Krause, the shelter worked as follows:

> Q. And can you explain how that -- how the basis of the Canadian currency became -- well, according to the form $2.8 million?
>
> A. Well, according to partnership tax accounting rules, when there is a partnership termination, then it's treated as if the assets were distributed out and the recontributed. And so when the assets were distributed out, then, you know, the basis of the partnership interest is attached to the -- or and allocated among the assets.
>
> Q. And the assets were the Canadian currency?
>
> A. Yes.
>
> Q. And the basis of the partnership interest arose due to the fact that you treated the option -- you took

[6] When asked about this loss which he reported on Line 14 of his 2002 Form 1040, Krause responded "Isn't that a beautiful thing." *See* Gov. Ex. 12, Krause Dep., p. 75, l. 17.

the basis of one of the options and ignored the other option; is that a fair statement?

A. No, I think that what happened was is that there was an option that was contributed, you know, into the partnership and then when it expired, it generated all this income, and then that increased the basis of the partnership interest and the termination took that increased basis of partnership interest and that became the basis of the inside assets. And then that, you know, with the rules that say on a technical termination, that it's a recontribution, well, the inside assets now have the basis that it had because of the rules and when it sold, then that generates a loss.

Q. And you didn't have to recognize income on the expiration of an option because you had another option that expired that offset that income; is that right? That's how the transaction worked; is that correct?

A. Well, let's see, there was one option that was on the outside and that always was on the outside and that produced a loss. There was another option that was contributed to the partnership and it produced a gain. That gain flowed through and caused the basis in the partnership interest to be increased, then the termination took that partnership basis and put it on the partnership assets that remained at the time, which is the Canadian currency, and then this Canadian currency with the -- with the new basis is then recontributed to the partnership and when sold, it realizes a loss. So it sounds -- after we've been through this whole thing, that there was really just two option legs.

Q. There were two options legs?

A. One that always was outside and the other one that was transferred in.

Q. Right. And the one that was outside generated a loss for you individually?

A. Uh-huh.

Q. And you reported that on your individual 1040. The one on the inside generated income that eventually flowed up to you on your individual return; those two offset, correct?

A. Well, I'm actually thinking that what offset -- and of course they all offset, you know, but I'm not sure which offset, because there is -- one large loss and then one large piece of income realized, then one large loss. So I've got two losses and one income, so they set off to whatever they set off to.

Q. Right. And the -- the loss on the outside exactly matched the option loss on the inside, so those two would offset, dollar for dollar?

A. Well, maybe.

Q. Well, let's look. Go back to the Exhibit 8.

Q. On the first page of Exhibit 8, you report income of 2.791,250?

A. That's right.

Q. Now go back to your 1040, which is Government Exhibit 6.

A. Let's see here. I want to look at 6. Let's look at six.

Q. And there's the 2,791,250 loss that you're -- that's the outside option, and that's what you reported on 4797?

A. Right, right. And then that's also the same as on Page 2 Schedule E, 2,791,250.

Q. Absolutely, and that's the -- that's the gain that we just looked at on Exhibit 8?

A. That's the gain. It sure is.

Q. That flowed through down from KAAS; is that

right?

A. Right.

Q. So those two offset, then it's the sale of the Canadian currency that generates the actual monetary loss.

A. Oh, okay.

Q. Is that a fair statement?

A. Yeah, it's coming back to me now.

Q. Okay. So you have this sale of Canadian currency, which would you agree that economically your loss was less than $1,000; is that a fair statement?

A. Closer to 500.

Q. Out of pocket, cash out of pocket?

A. Yes.

Q. You bought it for 20,000, you sold it for 19,500 so it's about a $500 economic loss; is that a fair statement?

A. Would appear to be so.

Q. You took $2.7 million ordinary loss as a result of the transaction you entered into with Jenkins. That was part of that; is that right? Is that a fair statement?

A. You know, I am not running away from what these things say.

Q. And I'm not -- I'm not trying to trick you, I'm just trying to -- I need to get an understanding of how the transaction worked. This 2 million, $2.7 million, close to $2.8 million loss that KAAS reported for it's year December 26 through December 31; that loss -- a portion of that loss then flowed through to Krause &

Associates, LP?

A. It appears so.

Q. On the K1, for Government Exhibit 9, you've got 2,791,429 flowing through to KALP, Krause & Associates, LP.

A. Apparently.

(Government Exhibit No. 10 marked for
(identification.

Q. Then if you take look at the one, which is, we'll call 10, this is the Krause & Associates 1065 for the tax year 2002, correct?

A. Yes, sir.

Q. And that's your signature?

A. It is.

Q. And you prepared this return as well?

A. I did.

Q. And we can see where that 2,791,429 flowed through if you turn to 5th page; one of the supplemental schedules?

A. There it is.

Q. Right. So that came from Krause & Associates Advanced Strategies and Krause & Associates, LP, for 2002 ended up reporting about a $2.3 million net loss?

A. Correct.

Q. That loss would have then flowed through to your individual return?

A. Yes.

> Q. And that's the $2.377 million loss we see on Schedule E from Krause & Associates, says LC, but it should have been LP; is that right?
>
> A. Yep.

See Gov. Ex. 12, Krause Dep., p. 89, l. 9 – p. 95, l. 1.

29. The Plaintiffs did not use all of the loss generated in 2002. Rather, a substantial portion of the loss generated in 2002 was carried over to the 2003 tax year and deducted on that return. *See* Gov. Ex. 6, J. Winston & Sheri S. Krause 2003 Form 1040.

Krause Filed this Lawsuit Challenging Only the Accuracy-Related Penalties

30. On October 6, 2006, the IRS issued a Notice of Final Partnership Administrative Adjustment ("FPAA") to Krause as the Tax Matters Partner of KAAS. *See* Gov. Ex. 13, KAAS FPAA; *see also* Exhibit D to Amended Complaint. Exhibit A to the FPAA, entitled "Explanation of Items," contains thirteen paragraphs describing the reasons for the adjustments (the IRS disallowed the income and loss deductions relating to the shelter transaction reported by Krause on his tax return), and a fourteenth paragraph pertaining to penalties. *Id.* In Paragraph 14, the Commissioner imposed the following alternative, accuracy-related penalties (I.R.C. § 6662): the 40% gross valuation misstatement penalty, the 20% negligence penalty,[7] the 20% substantial understatement penalty,[8] and the 20% substantial valuation misstatement penalty. *Id.*

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[7] Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code or exercise ordinary and reasonable care in the preparation of the tax returns. I.R.C. § 6662(c). Treasury Regulation § 1.6662-3(b)(1)(ii) explains that a taxpayer is negligent if he fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem "too good to be true" under the circumstances to a reasonable and prudent person.

[8] An understatement of tax exists if the correct tax exceeds the reported tax, and an understatement is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be

31. Also on October 6, 2006, the IRS issued a Statutory Notice of Deficiency to the Taxpayers. *See* Gov. Ex. 14, IRS Notice of Deficiency; *see also* Exhibit C to Amended Complaint. Similar to the FPAA, the Notice of Deficiency contains numerous paragraphs outlining the reasons for the adjustments. *Id.* In the Notice of Deficiency, the Commissioner imposed the following alternative, accuracy-related penalties (I.R.C. § 6662): the 40% gross valuation misstatement penalty, the 20% negligence penalty, the 20% substantial understatement penalty, and the 20% substantial valuation misstatement penalty. *Id.*

32. Neither KAAS, nor KAAS' Tax Matters Partner (which was Krause) challenged the FPAA issued by the IRS to KAAS. *See* Amended Complaint ¶ 11; *see also* Gov. Ex. 12, Krause Dep., p. 39, l. 5. Accordingly, the IRS assessed the additional tax and penalties arising as a result of the adjustments outlined in the FPAA. Gov. Ex. 12, Krause Dep., p. 105, ll. 2-7; *see also* Amended Complaint ¶ 10. Further, as noted in their Amended Complaint, the Taxpayers did not contest the Statutory Notice of Deficiency. *See* Amended Complaint ¶ 13; *see also* Gov. Ex. 12, Krause Dep., p. 39, l. 11. The Taxpayers paid the tax, penalties and interest and filed this suit. As the Taxpayers clearly note, they are only challenging the imposition of the 40% accuracy-related penalty. Gov. Ex. 12, Krause Dep., p. 39, l. 16; p. 69, l. 23 – p. 70, l. 4; p. 100, l. 9.

33. As previously noted, the Plaintiffs deducted a substantial portion of the loss generated in 2002 on their 2003 Federal income tax return. *See* Gov. Ex. 6, J. Winston & Sheri S. Krause 2003 Form 1040. On November 17, 2004 (barely a month after filing their original 2003 Form 1040), the Plaintiffs (apparently having second thoughts regarding deducting the

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shown on the return. I.R.C. § 6662(d)(2)(A).

loss) amended this return by filing a Form 1040X for the 2003 tax year. *See* Gov. Ex. 7, J. Winston & Sheri S. Krause 2003 Form 1040X. According to the amended return, the reason for filing an amended return was that the "return as filed reflected an NOL [net operating loss] and Taxpayers now wish to disregard the NOL in determining their income tax." *Id.* When asked why an amended 2003 return was filed, Krause responded it was the "best thing to do, you know, I think the settlement issue was coming out and I think I -- it was the best thing to do." Gov. Ex. 12, Krause Dep., p. 97, l. 13 – p. 99, l. 4. As noted below, the IRS settlement initiative applicable to taxpayers who invested in a "Son of BOSS" tax shelter had been out for several months.

34. Taxpayers timely filed their Claim for Refund on March 6, 2008 seeking a refund of the 40% gross valuation misstatement penalty assessed by the IRS under Internal Revenue Code (I.R.C.) Section 6662(e). *See* Exhibit A to Amended Complaint. The Taxpayers assert that "an accuracy-related penalty for such a valuation misstatement may only be assessed for understatement of tax attributable to a valuation misstatement – and not for merely disallowing a deduction." *Id.*

35. The Taxpayers originally filed their Complaint in this matter on November 25, 2008. *See* Complaint Filed November 25, 2008, Docket No. 1. The Taxpayers amended their Complaint on February 17, 2009.

36. The Taxpayers did not raise any reasonable cause argument in their claim for refund filed with the IRS or in their Amended Complaint filed in this matter. *See* Amended Complaint and Exhibit A to Amended Complaint. The Taxpayers do not assert that they acted in good faith with respect to the underpayment of tax for the years at issue or that they had

substantial authority for the position taxed by the Taxpayers on their returns. Gov. Ex. 12, Krause Dep., p. 69, l. 22; p. 70, ll. 9, 12, 23; p. 100, ll. 13-16.

37. On May 5, 2004 (*prior* to the dates Krause filed both his original 2003 Federal income tax return and his amended 2003 Federal income tax return), the IRS announced a settlement initiative applicable to taxpayers who invested in a "Son of BOSS" tax shelter. *See* IRS Announcement 2004-46, 2004-21 I.R.B. 964.[9] The transactions to which the settlement initiative applied are described in IRS Notice 2000-44, 2000-2 C.B. 255. *Id.* Under the terms of the agreement, eligible taxpayers would concede 100 percent of the claimed tax losses, pay all applicable interest, and accept the imposition of a penalty unless they had previously disclosed their participation in the transaction. *Id.* Participating taxpayers were allowed to deduct as a loss their out of pocket transaction costs, which were typically promoter and professional fees. *Id.* Krause received timely notice of this settlement initiative and could have participated in the settlement initiative had he chosen to participate. Gov. Ex. 12, Krause Dep., p. 28, ll. 2-10. Krause also advised his clients regarding the settlement initiative. *Id.*, p. 143, l. 12. Despite (i) receiving notice of the settlement initiative, and (ii) the fact that some of his clients who participated in this shelter settled with the IRS under the settlement initiative, Krause chose not to participate because, as Krause states, "I thought that I would be rejected if I tried to participate." *Id.*, p. 28, ll. 7-8.

[9] A courtesy copy of IRS Announcement 2004-46 is included in the Appendix.

Krause Advised Other Taxpayers Regarding Their Participation in Tax Shelters

38. Krause also (i) advised several taxpayers regarding their participation in tax shelters marketed by Jenkens & Gilchrist, and (ii) acted as the "go between" for his clients and Jenkens & Gilchrist. *Id.* p. 29, ll. 3-13. For example, Krause advised at least three clients regarding their participation in tax shelters for the years 2000, 2001 and 2002. *Id.*, p. 28, l. 11 – p. 31, l. 3. Additionally, Krause was often the one who explained the tax shelter transaction to his clients. *Id.*, p. 59, l. 13;. p. 122, ll. 20-22. At one point, Krause prepared an "executive summary" to help explain to one of his clients a Jenkens & Gilchrist tax shelter using foreign currency to generate an ordinary tax loss. *Id.*, p. 136, ll. 5-13; *see also* Gov. Ex. 9, Executive Summary.

39. Krause received fees for advising his clients regarding their participation in Jenkens & Gilchrist tax shelters. Gov. Ex. 12, Krause Dep., p. 29, l. 15; p. 125, l. 20. As noted, these fees were most likely reported on KAAS' tax return for the tax years ending 2001 and 2002. *Id.*, p. 82, l. 13 – p. 83, l. 1; p. 85 l. 23 - p. 86, l. 12; p. 123, ll. 11-15. In addition to providing advice relating to the shelters, Krause also helped prepare documents necessary for the execution of the tax shelter for these clients. According to Krause, he would (i) gather company documents from his clients to provide to Jenkens & Gilchrist, and (ii) receive requests from Jenkens & Gilchrist for documents relating to his clients, which Krause would obtain from the clients and provide to Jenkens & Gilchrist. *Id.*, p. 30, ll. 15-21. Furthermore, Krause reviewed the Jenkens & Gilchrist tax opinions on behalf of his clients who were engaging in the tax shelter. *Id.*, p. 30, l. 24 – p. 31, l. 3. In essence, Krause's job was to "facilitate" Jenkens &

Gilchrist's representation of his clients relating to their involvement in Jenkens & Gilchrist's tax shelters. *Id.*, p. 121, l. 17-20; p. 158, ll. 17-20.

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CERTIFICATE OF SERVICE

I certify that a true and correct copy of the foregoing was served upon the following via electronic means as listed on the Court's ECF Noticing System or by regular mail on the 2nd day of November 2009:

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