No.

IN THE

Supreme Court of the United States

THE DOW CHEMICAL COMPANY AND SUBSIDIARIES,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Taxpayers must satisfy the judicially crafted economic substance doctrine in order to invoke the specific provisions of the Internal Revenue Code. Under this fact intensive doctrine, taxpayers may not obtain any federal tax benefits from transactions that have no appreciable economic effect apart from tax savings. The trial court in this case upheld the economic substance of petitioner's transactions and the claimed tax deductions based on the court's finding that petitioner would make cash investments in later years consistent with its long-term business needs and financial incentives. On appeal, a divided panel of the Sixth Circuit reversed, holding that the trial court's determination on economic substance is subject to *de novo* review and that future taxpayer investment must be disregarded as a matter of law if it "departs drastically" from the taxpayer's prior conduct during the course of the transaction. The questions presented are:

1. Whether the Sixth Circuit erred by holding, in direct conflict with at least five circuits (but in accord with at least two others), that the trial court's determination on economic substance is subject to *de novo* review.

2. Whether the Sixth Circuit erred by creating, in direct conflict with decisions of this Court and other circuits, an exclusionary rule for economic substance cases that bars consideration of future taxpayer investment merely because the taxpayer has engaged in a long-term transaction in which a substantial portion of its out-of-pocket expenditure is deferred.

RULE 29.6 STATEMENT

The Dow Chemical Company has no parent corporation, and there is no publicly held company owning 10% or more of its stock. It is the parent of the subsidiaries included within the consolidated group for tax purposes as of the date of this petition, and no other publicly held company owns 10% or more of the stock of any of those subsidiaries. Subsidiaries that were members of the consolidated group for tax purposes during the tax years at issue, but are no longer included in The Dow Chemical Company's consolidated tax group, are not financially interested in the outcome of this litigation.

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JURISDICTION

The Sixth Circuit entered judgment on January 23, 2006, and denied the petition for rehearing on May 24, 2006. Justice Stevens extended the time to file this certiorari petition to and including October 6, 2006. App. No. 06A86. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of 26 U.S.C. §§ 162, 163, and 264 are reproduced at Appendix 209a - 212a. Unless otherwise indicated, this petition refers to the provisions of Title 26 as in effect during tax years 1989-91.

STATEMENT OF THE CASE

1. **Introduction.** The Dow Chemical Company ("Dow") is a diversified chemical company based in Midland, Michigan, that files a consolidated federal income tax return. During tax years 1989-1991, Dow deducted about $33 million consisting of both administrative fees and policy loan interest related to corporate-owned whole life insurance ("COLI") plans. The Internal Revenue Service ("IRS") contended that Dow's COLI plans lacked economic substance and hence disallowed the deductions, resulting in an assessment of income tax deficiencies and interest thereon totaling over $22 million. Dow paid this amount and filed this refund action in federal district court to recover that amount plus interest.

Following a two-month bench trial in which 26 witnesses testified and over 1,500 exhibits were received, the district court filed a 139-page opinion (as well as a 15-page postjudgment decision) rejecting the IRS's economic substance arguments and sustaining Dow's right to the deductions. The district court succinctly described the issue before it as "whether the deductions would be enhancing the benefit of an already economically viable set of transactions." App. 202a. The court answered "yes" because it found that Dow intended from the outset to invest substantial cash in its COLI plans over time, consistently with its business needs and the economic incentives of the plans.

The government appealed, claiming principally that the district court's finding that Dow would make such future investments was clearly erroneous. A divided panel of the U.S. Court of Appeals for the Sixth Circuit left this and all other findings by the district court undisturbed, but nevertheless reversed. It relied on a *de novo* standard of review to assess the trial court's ultimate determination on economic substance, and crafted *sua sponte* an exclusionary rule that the majority held to be dictated by a footnote in this Court's decision in *Knetsch v. United States,* 364 U.S. 361 (1960). According to the majority, *Knetsch* requires courts in determining economic substance to ignore a future investment by the taxpayer that "drastically" exceeds the taxpayer's prior cash expenditures, even if the investment is a crucial part of the taxpayer's plan in undertaking the transaction and is consistent with its business needs and financial incentives. The majority applied this formulaic rule to bar consideration, as a matter of law, of the trial court's finding regarding Dow's intended cash investments, thereby allowing the majority to conclude that Dow's COLI policies lacked economic substance. Disagreeing "with the legal principles my colleagues invent and mistakenly attribute to *Knetsch*," the third member of the Sixth Circuit panel dissented. App. 21a. The dissent took issue with the majority's exclusionary rule, concluding that "there is no such precedential rule of law and no warrant for creating one in this case." *Id.*

A grant of certiorari is warranted to (i) resolve the conflict among the circuits over the proper standard of review for trial court determinations of economic substance and (ii) correct the Sixth Circuit's distortion of *Knetsch* and other conflicts with decisions of this Court.

2. **COLI, the Tax Code, and the Economic Substance Doctrine.** COLI policies are long-term whole life insurance plans purchased by a corporate employer to insure the life of one or more of its employees. The employer ordinarily owns the policy, pays the premiums, and is the policy beneficiary. A portion of the premium that the employer pays exceeds the mortality and other policy costs of insuring the employee's life and represents a financial investment. This investment earns a return from the insurance company, which compounds over time creating "inside buildup." The employer's investment and inside buildup (together, the "cash value" of the policy) is paid out to the employer in cash as a death benefit when the insured employee dies.

Corporate policy owners, like other holders of whole life policies, are entitled to access the cash value during the term of the policy through (1) policy loans and (2) partial withdrawals. First, employers may take out loans from the insurance company, using the policy's cash value as security. If an insured employee dies while a policy loan is outstanding, the insurance company uses the death benefit first to repay the loan and accrued interest and disburses only the balance to the employer. Policy loans come with a price, however, as the insurance company charges interest at a rate greater than the inside buildup rate it pays. Second, policy owners can withdraw funds from the policy's cash value that do not secure policy loans. The policy owner has no obligation or right to repay such partial withdrawals.

To the extent that cash value does not secure policy loans and is not withdrawn, a COLI policy, like other whole life insurance, creates "net cash value" (also known as "net equity"), which through the compounding of interest can accumulate to a large sum over the life of each insured. This net cash value generates significant cash flow when eventually paid out as death benefits, yielding a healthy return for the employer. COLI plans thus customarily constitute long-term investments.

Beyond the financial benefits of life insurance, Congress has long treated life insurance favorably for federal income tax purposes. Inside build-up is tax-deferred and generally is wholly exempt from tax if paid out in the form of a death benefit. Partial withdrawals of cash value also are tax-free up to "basis" – *i.e.*, up to the amount of the policy holder's investment in the policy, not including inside buildup. *See* 26 U.S.C. §§ 72, 101(a). Importantly, interest paid by policy holders on policy loans has long been deductible under 26 U.S.C. § 163(a). Congress, however, has limited these loan interest deductions over the years; with respect to COLI, for example, it began in 1986 to allow deductions only on loans of $50,000 per employee or less, and in 1996 it phased out deductions on loans under post-1986 contracts involving more than a limited number of key corporate officers or 20-percent corporate owners. *See id.* §§ 264(a)(4) and (e) (2006); Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, § 501, 110 Stat. 1936, 2090 (1996); Tax Reform Act of 1986, Pub. L. 99-514, § 1003, 100 Stat. 2085, 2388 (1986).

In addition to compliance with the literal terms of the Internal Revenue Code, the courts have required that transactions have "economic substance" to entitle the taxpayer to interest and other deductions. *See, e.g.*, *Knetsch,* 364 U.S. at 367. This overarching doctrine, which requires a close examination of the relevant facts and circumstances, serves as a hurdle that *every* transaction must surmount to qualify for benefits under the tax laws. *See Lerman v. Comm'r*, 939 F.2d 44, 52 (3d Cir. 1991), *cert. denied*, 502 U.S. 984 (1991) ("Per *Gregory v. Helvering*, 293 U.S. 465 (1935), it is settled federal tax law that for transactions to be recognized for tax purposes they must have economic substance. Therefore, economic substance is a *prerequisite* to the application of any Code provisions allowing deductions").

The correct legal test for economic substance is not disputed in this case. That test is whether the transaction "appreciably" affects the taxpayer's "beneficial interest except to reduce his tax." *Knetsch*, 364 U.S. at 366 (internal quotation marks omitted); *see also*, *e.g.*, App. 8a (the issue is "whether the transaction has any practicable economic effects other than the creation of income tax losses") (internal quotation marks omitted). Whether the transaction absent tax deductions yields a profit is generally a key factor in making this determination. *See, e.g.*, 364 U.S. at 366.

3. **Dow's COLI Plans.** One use of COLI that has been recognized in guidelines issued by the National Association of Insurance Commissioners, the Office of the Comptroller of the Currency, and the State of Michigan is to fund employee benefit programs. *See* App. 223a, 227a, 260a. As found by the district court below, in 1988 and 1991, Dow purchased COLI plans covering about 4,000 and 17,000 consenting employees from Great West Life Assurance Company ("Great West") and Metropolitan Life Insurance Company ("MetLife"), respectively, for precisely this purpose. App. 36a, 60a-61a, 70a, 100a-101a. The expected costs of the medical benefits Dow was providing its retirees had grown rapidly over time to a net present value of over $1 billion by 1987, and Dow's executives had become concerned that the company might be unable to continue to offer such benefits unless it found a way to fund the escalating expenses. App. 61a. Dow responded to the problem by forming task forces and hiring an outside actuarial consultant to study COLI as a possible solution. App. 61a, 65a, 95a. Ultimately, following task force recommendations, Dow's Board of Directors approved the Great West and MetLife purchases. App. 80a-81a, 99a-100a.

Dow's plan from the outset in acquiring its COLI policies had two phases. First, it would reduce (but by no means eliminate) initial out-of-pocket expenditures by financing premium payments and other policy costs through (a) policy loans up to $50,000 per insured and (b) withdrawals of cash value up to basis.[1] Thereafter, Dow would pay policy costs with its own cash rather than through further financing. Over time, this plan would generate net cash value resulting in substantial cash flow from death benefits to help fund Dow's retiree medical costs. App. 132a-134a, 144a, 148a-149a, 150a. For example, in purchasing the MetLife policy, Dow intended to rely on loans and withdrawals during the first 18 years of a 60-year policy, as shown in a financial projection called "Case 23." Dow would then pay policy costs with its own cash. The resulting net cash value would create substantial inside buildup, producing an aggregate "pre-tax" cash flow (*i.e.*, cash flow without considering the benefit of the interest deductions on the policy loans) of $3.6 billion over the 60 -year term. App. 97a-99a, 147a-149a, 150a. This cash flow had a positive pre-tax net present value at valid discount rates under the discounting methods employed by both Dow's and the government's experts. App. 149a-150a; *see also* App. 201a-203a.

As planned, Dow took out policy loans and deducted interest and COLI administrative fees on its 1989-1991 income tax returns. The IRS disallowed the deductions, contending that Dow's policies lacked economic substance

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[1] In financing policy costs with loans and withdrawals, Dow engaged in essentially simultaneous netting transactions under which it paid the insurance company the difference between the amount of costs due and the amount of the loan or withdrawal taken. The government argued (1) that these transactions were shams in fact (*i.e.*, that they did not actually occur) and (2) that they disqualified Dow's interest deductions under 26 U.S.C. § 264. The district court rejected both claims (App. 192a-199a, *modifying* App. 153a-161a, 166a-168a), and the government abandoned them on appeal. *See* App. 7a n.7.

because Dow never intended to make the future cash investments and thus would never build net cash value and earn positive pre-tax cash flow. App. 118a-119a, 130a.

4. **The District Court Decision.** The trial court (Lawson, J.), which had jurisdiction over Dow's refund action under 28 U.S.C. § 1346(a), began its decision by distinguishing this case from prior COLI cases where the courts had found that the COLI plans were devoid of economic substance, "functioning only as interest-deduction engines that drove no legitimate financial vehicles." App. 45a-58a (quotation at 57a). *See American Electric Power Co. v. Comm'r,* 326 F.3d 737 (6th Cir. 2003), *cert. denied,* 540 U.S. 1104 (2004) ("*AEP*"); *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002); *Winn-Dixie Stores, Inc. v. Comm'r,* 254 F.3d 1313 (11th Cir. 2001), *cert. denied,* 535 U.S. 986 (2002). That conclusion stemmed in part from the fact that the taxpayers there had agreed to pay an "artificially high" interest rate on policy loans – *i.e.*, a rate substantially in excess of the industry standard and regulatorily approved Moody's Corporate Average. This magnified the interest deductions and hence greatly reduced taxable income, but had "no practical adverse effect on the borrower" because the rate that the insurer credited to cash value securing the loans was ratcheted up by the same artificial amount. App. 57a, 59a-60a, 155a-157a. At the same time, the insurers undertook to credit only a "relatively small" rate on cash value in excess of the loan balance, which "discourage[d] [the taxpayers from] leaving cash in the policies." App. 57a. As the pre-purchase projections and marketing information in those cases confirmed, there consequently "could be . . . no return on inside build-up because all the cash was stripped from the policies *throughout the program*." App. 57a (emphasis added); App. 153a. In essence, the taxpayers had taken such extreme advantage of the tax benefits offered by COLI that they had emptied their programs of any non-tax economic significance.

The trial court found that there were "critical differences" between Dow's policies and those in the prior cases. App. 58a. Most importantly, resolving "a principal factual dispute," the court found that, unlike the other taxpayers, Dow specifically intended in acquiring its policies to build significant net cash value. App. 133a-134a. In making this finding, the court relied on the following evidence: (1) the "accurate and truthful" testimony by former Dow employees and non-company witnesses knowledgeable about its plans "that it was Dow's intention to cap loans at $50,000 and withdraw only to basis," and then "inject cash . . . in the middle years" (App. 133a-134a; *see also*, *e.g.*, App. 148a-149a); (2) contemporaneous documentary evidence corroborating Dow's intent to create net cash value, including written pre-acquisition recommendations and projections like MetLife Case 23 (App. 134a, 148a-150a); (3) the fact that capping loans at $50,000 per insured was "more consistent" than permanently stripping net cash from the policies "with Dow's stated purpose of embarking on this project at the outset," as it "produce[d] higher positive cash flow to fund retiree medical costs" and "yielded more favorable financial performance" in the future (App. 134a; *see also*, *e.g.*, App. 148a-149a); and (4) Dow's insistence on limiting its policy loan interest rates to Moody's Corporate Average (App. 67a, 107a), while negotiating *high* crediting rates on unborrowed net cash value (App. 77a, 148a-149a). This combination of rates "did not financially 'compel' borrowing . . . as existed in the other COLI cases." App. 134a. Instead, the high crediting rates on net cash value encouraged Dow to invest cash by "provid[ing] a substantial return, especially considering that the inside build-up occurs tax free." App. 150a.[2]

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[2] Still other evidence supported the court's critical finding on Dow's intended plan of operation. *See*, *e.g.*, App. 134a, 149a (by limiting loans and withdrawals, Dow avoided paying (1) non-deductible interest and (2)

Given Dow's intent and incentives to operate the plans as a whole to generate large cash flows from net cash value, the trial court had no trouble "find[ing] that Dow ha[d] established by a preponderance of the evidence that both its Great West and MetLife COLI plans . . . had substantial [non-tax] effects on the beneficial interest of the taxpayer" and so "were imbued with economic substance." App. 153a.

5. **The Panel Majority Decision.** On appeal to the Sixth Circuit, a divided panel (Moore and Cook, JJ.) reversed. In rulings that apply broadly to economic substance disputes, the majority first held that, although "there may appear to be some tension" in the Sixth Circuit's own case law, the standard of review for the ultimate determination on economic substance is *de novo*.[3] App. 9a & n.8. Then, expressly declining the government's invitation to reverse as clearly erroneous the trial court's finding that Dow intended to invest substantial cash in the policies, the majority *sua sponte* imposed a rule excluding, as a matter of law, any consideration of that finding. App. 9a-15a. With the planned investments disregarded, the majority concluded that Dow's COLI policies would enjoy little or no inside buildup, produce no positive pre-tax cash flow, and thus have no economic substance. App. 13a-16a.

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tax on withdrawals above basis); App. 96a, 147a (Dow's status as Alternative Minimum Taxpayer at time of MetLife purchase underscored that it was "examining the prospect of generating cash through the COLI plan after the acquisition phase of the policy and viewed the performance of the plan over its whole life"); App. 115a-18a (Dow retained its policies after Congress phased out the interest deduction for large-scale COLI).

[3] The majority stated that both parties agreed to the *de novo* standard. But, in fact, Dow argued against *de novo* review (*see* App. 214a n.15), and the majority addressed those arguments (App. 9a n.8). Dow accepted *de novo* review only on the condition that the "ultimate determination follows directly from affirmance or reversal of *the trial court's finding on Dow's capped-loan intent*" (App. 214a (emphasis added); *see also* App. 218a n.1) – a condition that the majority vitiated by adopting a novel rule excluding that factual finding.

The majority based its exclusionary rule on a brief footnote in this Court's decision in *Knetsch*, 364 U.S. at 366 n.3. The majority asserted that this footnote dictates that "[c]ourts may consider future profits contingent on some future taxpayer action, *but only when that action is consistent with the taxpayer's actual past conduct*." App. 13a (emphasis added). The majority further held that courts should not even attempt to assess the likelihood that the future action will actually occur by taking into account whether it was part of the taxpayer's initial plans or how profitable it would be to the taxpayer. Instead, "the better course is to remain true to *Knetsch* by limiting the inquiry to whether the future investment drastically departs from past conduct." App. 14a n.13.

Rather than remand to the district court, the majority applied the exclusionary rule itself. It first noted that Dow paid in cash out of its own pocket \$59.7 million to Great West from 1988 to 2000 and \$83.8 million to MetLife from 1991 to 1998. App. 5a. It then calculated that Dow would have to pay in cash in the middle years an additional \$30 million to Great West and \$285 million to MetLife "to make the COLI plans profitable." App. 10a n.9. "On these facts," the majority concluded, the exclusionary rule applied because there could "be no doubt that the projected cash infusions would have required Dow to depart drastically from its past conduct." App. 14a n.13. The majority stated that it would be permissible to take account of a contractual commitment "to infuse additional cash into an investment at some point in the future" because, in its view, "the eventual outlay would [then] be consistent with actual past conduct." But Dow was under no such contractual requirement in this case. App. 15a n.14.

In sum, the majority held that, despite the trial court's factual finding that Dow would invest large amounts of cash in the policies in future years, "the teachings of *Knetsch*" precluded consideration of that finding regardless of the evidence supporting it. App. 14a-15a. Dow's COLI policies then would forever have little or no net cash value and negative pre-tax cash flow, allowing the majority to conclude that the policies lacked economic substance. App. 15a-16a.[4]

6. **The Dissent.** Disagreeing "with the legal principles my colleagues invent and mistakenly attribute to *Knetsch*," the third member of the panel (Ryan, J.) dissented. App. 21a. He took issue with the majority's exclusionary rule, concluding that "there is no such precedential rule of law and no warrant for creating one in this case." *Id.* In his view, this Court in *Knetsch* "did not hold that, as a matter of law, a feasible projected future investment of cash in a particular plan is irrelevant to the economic substance inquiry"; rather, "[t]he question is what the taxpayer intended." App. 22a. Once Dow's "potential future cash flows are not arbitrarily excluded from the economic substance inquiry," he continued, the "case turns on the district court's findings of fact regarding the intended operation of Dow's COLI plans." *Id.* And, as to that, the trial court's findings of fact were not clearly erroneous. App. 21a, 23a.

7. **Dow's Rehearing Petition.** Because the majority's exclusionary rule transformed a routine challenge to the district court's findings into a major economic substance decision, Dow sought rehearing. The majority denied the petition. App. 206a. Judge Ryan would have granted the petition for the reasons stated in his dissent. *Id.*

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4 "The presence of risk transfer and the possibility of a mortality profit on a plan-wide basis" also provided "one of the grounds" for the district court's decision. App. 200a-201a (emphasis omitted). Although the majority overturned this finding too (App. 17a-20a), the trial court's finding regarding Dow's intent to build net cash value would establish economic substance by itself if this Court were to decide that it cannot be disregarded. *See AEP*, 326 F.3d at 742 (policies devoid of economic substance because taxpayer could not benefit from "either" inside buildup or mortality gain); App. 22a-23a (dissenting opinion below).

REASONS FOR GRANTING THE PETITION

This petition raises two related questions meriting this Court's review. First, the *de novo* standard adopted by the Sixth Circuit to review the district court's determination on economic substance was critical to the judgment below, directly conflicts with the clearly erroneous test followed in most circuits, and presents an important question because the standard of review provides the framework for every appeal involving the economic substance doctrine. This Court over the years has developed principles for resolving issues exactly like this, but remarkably, with few exceptions, the lower courts, including the Sixth Circuit, have failed even to consult them. If the Court were to resolve the circuit split by applying its standard of review jurisprudence here, it would reverse the decision below.

Second, the exclusionary rule adopted by the Sixth Circuit on the merits turns this Court's decision in *Knetsch* on its head, directly conflicts with this Court's contrary ruling in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), disregards this Court's teachings in *Comm'r v. Duberstein*, 363 U.S. 278 (1960), and contradicts the decisions of other circuits that sensibly rely on the taxpayer's intent and economic incentives in evaluating economic substance. Because the root of the error below lies in misuse of this Court's decisions, this Court should correct the error. Moreover, the rule imposed below is plainly wrong and, unless overturned, will confound future development of the economic substance doctrine, a fundamental and frequently recurring issue especially in tax cases of large economic importance.[5] Contrary to Congressional intent, it also will

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[5] According to our count, from 1995 to the present, the government has challenged transactions on economic substance grounds in over 170 decided court cases involving over $4.4 billion in taxable income. Since 2000, the appellate courts have been particularly active in this area, handing down decisions involving over $2.7 billion. These dollar amounts may be significantly understated because adequate information

threaten deductions in long-term financing and other commonplace business transactions.

I. THE SIXTH CIRCUIT'S APPLICATION OF THE *DE NOVO* STANDARD OF REVIEW CONFLICTS WITH DECISIONS OF OTHER CIRCUITS

The government argued below that the trial court's finding on Dow's intent to make future cash investments in its COLI plans was clearly erroneous. Rather than pass on this claim, the majority held that the trial court's "ultimate conclusion" on economic substance is subject to *de novo* review. App. 9a & n.8, 11a. That ruling was critical to the Sixth Circuit's judgment because it enabled the majority to forego clear error review of the trial court's finding and instead address whether the positive cash flow due to Dow's planned cash infusions was "relevant *as a matter of law* to the economic-sham analysis." App. 11a (emphasis added).[6] The majority's adoption of the *de novo* standard warrants this Court's review because (1) the circuits are deeply divided on the issue, (2) the debate in the lower courts largely ignores this Court's standard of review jurisprudence, which strongly supports the clearly erroneous standard, and (3) the standard of review sets the stage for consideration of every appeal involving economic substance issues.

1. The courts of appeals are in sharp conflict regarding the correct standard of review of the ultimate determination

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is not readily available for all relevant cases. The figures, moreover, do not take account of economic substance controversies settled before trial.

[6] Had the Sixth Circuit applied the clearly erroneous standard to the district court's ultimate determination of economic substance, it would have been required to affirm the trial court's well substantiated finding that Dow's COLI plans had economic substance because the plans would generate substantial net cash value and positive pre-tax cash flow and because there was no dispute that appreciable non-tax economic effects establish economic substance.

of economic substance. In 1990, for example, recognizing the split, the Tenth Circuit held that "the ultimate characterization of the transactions as shams" should be reviewed *de novo* even though a number of other "circuits treat sham determinations as questions of fact." *James v. Comm'r*, 899 F.2d 905, 909 & n.5 (10th Cir. 1990). Today, the circuits are divided with at least five supporting deferential review and three supporting *de novo* review. In particular, the Second, Third, Fourth, Seventh, and D.C. Circuits adhere to the clearly erroneous standard.[7] By contrast, in addition to the Sixth Circuit, the Tenth and Federal Circuits have adopted the *de novo* standard.[8] In some circuits, the test is impossible to ascertain due to the

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[7] *See, e.g.*, *Nicole Rose Corp. v. Comm'r*, 320 F.3d 282, 284 (2d Cir. 2002) ("Whether a transaction lacks economic substance is a question of fact that we review under the clearly erroneous standard."); *ACM P'ship v. Comm'r*, 157 F.3d 231, 245 & n.25 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) ("[W]e review [the Tax Court's] factual findings, including its ultimate finding as to the economic substance of a transaction, for clear error."); *Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006), *following Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 92 (4th Cir. 1985) ("Whether . . . a particular transaction is a sham is an issue of fact, and our review of the tax court's subsidiary and ultimate findings on this factual issue is therefore under the clearly erroneous standard."); *Yosha v. Comm'r*, 861 F.2d 494, 499 (7th Cir. 1988) ("The question whether a particular transaction has economic substance, like other questions concerning the application of a legal standard to transactions or events, is governed by the clearly erroneous standard."); *ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 511 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000) (stating that in sham partnership cases "mixed questions of law and fact are to be treated like questions of fact").

[8] *See, e.g.*, *James*, 899 F.2d at 909 & n.5 ("[W]e review de novo the ultimate characterization of the transactions as shams."); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1357 (Fed. Cir. 2006) (explaining that, in an economic substance dispute, "[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference").

proliferation of conflicting authorities.[9]

For the most part, the circuit court decisions have engaged in rote recital of conclusory language from earlier opinions, with little analysis. Moreover, in some circuits, including the court below, the precedents have evolved like a

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[9] *Compare, e.g., Gulig v. Comm'r*, 293 F.3d 279, 281 (5th Cir. 2002) (stating that sham partnership determination reviewed "for clear error"), *and Lukens v. Comm'r*, 945 F.2d 92, 97 (5th Cir. 1991) ("The tax court's determination that the transaction was a 'sham' is a finding of fact, and therefore reviewable under the clearly erroneous standard."), *with, e.g., Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 780-81 (5th Cir. 2001) ("'[L]egal conclusions' that transactions are shams in substance are reviewed de novo."). *Compare Massengill v. Comm'r*, 876 F.2d 616, 619 (8th Cir. 1989) (characterizing economic substance inquiry as "essentially factual," subject to clearly erroneous review), *with, e.g., IES Indus., Inc. v. United States*, 253 F.3d 350, 351 (8th Cir. 2001) (characterizing economic substance of transaction for tax purposes as question of law).

Compare, e.g., Harbor Bancorp v. Comm'r, 115 F.3d 722, 727 (9th Cir. 1997), *cert. denied*, 522 U.S. 1108 (1998) ("[T]he Tax Court's [sham] determination . . . is a finding of fact we review for clear error."), *Erhard v. Comm'r*, 46 F.3d 1470, 1476 & n.7 (9th Cir. 1995), *cert. denied*, 516 U.S. 930 (1995) ("The tax court's determination that a transaction is lacking in economic substance is a factual determination that this court reviews for clear error."), *and Casebeer v. Comm'r*, 909 F.2d 1360, 1362 & n.6 (9th Cir. 1990) ("We review the tax court's ultimate conclusion that the transactions were shams for clear error."), *with Sacks v. Comm'r*, 69 F.3d 982, 986 (9th Cir. 1995) (stating that, in economic substance cases, "application of the legal standards to the facts found [is] reviewed *de novo*.").

Finally, *compare Karr v. Comm'r*, 924 F.2d 1018, 1023 (11th Cir. 1991), *cert. denied*, 502 U.S. 1082 (1992) ("[T]he Tax Court's finding that a transaction is a sham is normally subject to the clearly erroneous standard of review."), *with United Parcel Service of America, Inc. v. Comm'r*, 254 F.3d 1014, 1017 (11th Cir. 2001) ("The question of the effect of a transaction on tax liability, to the extent it does not concern the accuracy of the tax court's fact-finding, is subject to de novo review."), *and Kirchman v. Comm'r*, 862 F.2d 1486, 1490 (11th Cir. 1989) (stating that, in the case of transactions held by Tax Court to be shams as a matter of law, standard of review is *de novo*).

game of judicial hopscotch in which, notwithstanding the doctrine of *stare decisis*, the appellate court jumps freely from one standard of review to another. *Compare* the decision below (App. 9a & n.8), *AEP*, 326 F.3d at 741-42, *and Smith v. Comm'r*, 937 F.2d 1089, 1096 (6th Cir. 1991), *with Rink v. Comm'r*, 47 F.3d 168, 173 (6th Cir. 1995), *Kennedy v. Comm'r*, 876 F.2d 1251, 1255 (6th Cir. 1989), *and Ratliff v. Comm'r*, 865 F.2d 97, 98-99 (6th Cir. 1989). *See also* note 9 above.

2. At the same time, in an increasingly long line of opinions in other areas of the law, this Court has developed a principled jurisprudence for settling standard of review questions. This jurisprudence, generally ignored by the circuit courts in reviewing economic substance determinations, firmly supports application of the clearly erroneous standard here.

As this Court has explained, the "standard of deference for appellate review of district court determinations [should] reflect an accommodation of the respective institutional advantages of trial and appellate courts." *Salve Regina College v. Russell*, 499 U.S. 225, 233 (1991) (review of state law determination under *Erie*). Accordingly, *de novo* review may be favored where appellate courts can "identify[] recurrent patterns, and advanc[e] uniform outcomes." *Thompson v. Keohane*, 516 U.S. 99, 114 (1995) (review of "in custody" determination under *Miranda*). This is especially true where overriding constitutional interests are at stake, as in determinations of "actual malice" in defamation suits, *see Bose Corp. v. Consumers Union of United States, Inc.*, 466 U.S. 485 (1984), or of reasonable suspicion to stop and probable cause to search, *see Ornelas v. United States*, 517 U.S. 690 (1996).

On the other hand, deferential review is appropriate for situations in which "factual nuance may closely guide the legal decision," *Buford v. United States*, 532 U.S. 59, 65 (2001) (review of "consolidation" determination under U.S.

Sentencing Guidelines), or in which *de novo* review will "fail to produce the normal law-clarifying benefits that come from an appellate decision on a question of law," as when "'multifarious, fleeting, special, narrow facts . . . utterly resist generalization . . . .'" *Pierce v. Underwood*, 487 U.S. 552, 561-62 (1988) (review of "substantial justification" under Equal Access to Justice Act); *see also Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 404 (1990) (review of Fed. R. Civ. P. 11 determinations).

"Treating issues of intent," for example, "as factual matters for the trier of fact [subject to deferential review] is commonplace" and required even when the finding is an "ultimate fact" dispositive of the case. *Pullman-Standard v. Swint*, 456 U.S. 273, 286, 288 (1982) (review of discriminatory purpose determination under Title VII); *see also Hernandez v. New York*, 500 U.S. 352 (1991) (review of discriminatory intent determination under *Batson*); *Duberstein*, 363 U.S. at 290-92 (review of donative intent for "gift" determination under Internal Revenue Code). This, of course, is because of "the unique opportunity afforded the trial court judge to evaluate the credibility of witnesses and to weigh the evidence." *Inwood Labs., Inc. v. Ives Labs., Inc.*, 456 U.S. 844, 855 (1982) (review of mislabeling determination under Trademark Act); *see also Bose Corp.*, 466 U.S. at 516 (deference "tends to increase when trial judges have lived with the controversy for weeks or months instead of just a few hours").

This Court has yet to apply these principles to the standard of review issue presented here. In *Frank Lyon*, 435 U.S. at 581 n.16, the Court stated that "[t]he general characterization of a transaction for tax purposes is a question of law subject to review." But this statement did not squarely address the proper standard of review for the determination whether a transaction has economic substance, and has failed to bring uniformity in the lower courts to the review of such determinations. *See* notes 7-9 above.

Moreover, it largely preceded development of the Court's standard of review jurisprudence, which argues strongly for clear error review of the ultimate finding on economic substance. As the Seventh Circuit observed in considering whether the taxpayer made bona fide sales of surplus inventory in *Rexnord, Inc. v. United States*, 940 F.2d 1094, 1096-97 (7th Cir. 1991), the dispute "seems to raise predominately factual questions" over which "[t]here is no reason to conclude that" appellate judges "are in a better position to weigh the relative significance of specific facts and assess the total character of" the matter "than the district court." Moreover, "[c]onsiderations which favor a de novo standard, such as the desire to create a uniform rule, are not present here since no single rule could embrace the varied fact patterns which may arise . . . ." *Id.* at 1097; *see also Thompson v. Comm'r*, 631 F.2d 642, 646 (9th Cir. 1980), *cert. denied*, 452 U.S. 961 (1981).[10]

3. The standard of review, on which the circuits are split, establishes the fundamental framework for consideration of every economic substance issue and thus significantly colors every appeal in this area. *See* Fed. R. App. P. 28(a)(9)(B) and (b)(5) (briefs must state standard of review for each question presented); *see also* Fed. R. App. P. 28, Advisory

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[10] The *Thompson* court explained: "[W]e find that the Tax Court's determination whether a transaction is lacking in economic substance is essentially a factual determination, and therefore, subject to the clearly erroneous standard of review. *Weisbart v. Commissioner*, 564 F.2d 34, 36 (10th Cir. 1978). This is because the Tax Court's inquiry is not directed toward the application of a statute or an express legal standard. Instead, it requires the Tax Court to focus on the facts and circumstances of particular transactions and resolve whether, as a practical matter, those transactions have any economic impact outside the creation of tax deductions. Enmeshed as it is in factual considerations, the conclusion reached by the Tax Court will spring more from its experience 'with the mainsprings of human conduct' rather than the application of any legalistic formula, and makes appropriate a narrow standard of review. *See Commissioner v. Duberstein*, 363 U.S. 278, 289-91 (1960)."

Comm. Notes, 1993 Amendments ("[R]equiring a statement of the standard of review generally results in arguments that are properly shaped in light of the standard."). In addition, the outcome of the case often turns on the standard of review, as it did here. Hence, the circuit split is important and warrants this Court's review.

II. THE SIXTH CIRCUIT'S EXCLUSIONARY RULE CONFLICTS WITH DECISIONS OF THIS COURT AND OTHER CIRCUITS

A. The Majority's Decision Conflicts With Supreme Court Precedents

1. The panel majority's exclusionary rule is flatly inconsistent with this Court's precedents. The majority incorrectly grounded the rule entirely on *Knetsch*. According to the majority, the Court held there that, in any economic substance inquiry, investment by the taxpayer that somehow departs from the taxpayer's actual prior conduct is irrelevant as a matter of law even if the evidence shows that that investment in fact will be made and, indeed, is the only prudent economic course. But *Knetsch* held no such thing. Instead, *Knetsch* stands for the proposition that the future profitability of the taxpayer's transaction *is* legally relevant to the economic substance inquiry, and therefore future investment affecting profitability must be taken into account unless the taxpayer has no intention of making it. By disregarding Dow's planned investments without such evidence, the majority excluded from consideration a relevant – indeed, crucial – step in Dow's transactions in direct conflict with *Knetsch*.

Knetsch purchased annuity savings bonds with an initial face value of $4,004,000, using $4,000 cash and a $4 million loan, on which he was not personally liable, secured by the bonds. At their maturity in 30 years, the bonds would generate a monthly annuity in an amount of more than $90,000 if Knetsch did not borrow against the bonds' available equity. Each year, however, he did precisely that, with the result that the net cash value of the bonds never exceeded $1,000. Knetsch surrendered the bonds after three years, prior to generating any economic gain apart from tax deductions. *Knetsch*, 364 U.S. at 364-66.

Knetsch argued that the bonds had economic substance because of their eventual annuity value. This Court recognized that the profitability of a transaction helps determine whether the transaction has economic substance by "appreciably affect[ing]" the taxpayer's "beneficial interest" apart from reducing taxes. *Id.* at 366 (internal quotation marks omitted). But the Court held that Knetsch's bonds offered no prospect for meaningful profits other than tax deductions because his borrowings each year "kept the net cash value, on which any annuity . . . would depend, at the relative pittance of $1,000." *Id.*

Knetsch further contended that the bonds had economic substance because their net cash value in 10 years would have exceeded the amounts paid as interest. *Id.* at 366 n.3. The Court also rejected this argument, stating that it was "predicated on the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 'loan.'" *Id.* The exclusionary rule imposed by the majority below was based entirely on this single sentence. But, contrary to the majority's assertion, this Court did not summarily reject the taxpayer's claim about future investment as legally irrelevant. Any such ruling would have contradicted the Court's overriding premise that future profitability is legally relevant in determining economic substance. Future profitability due to a *future* investment that the taxpayer proves will be made, after all, affects the taxpayer's beneficial interest apart from tax savings as much as future profitability flowing from an *initial* investment.

As the plain language of the *Knetsch* footnote demonstrates, rather than reject the legal relevance of a future investment, the Court assessed *the factual probability* of Knetsch's claimed investment actually being made and concluded (as was surely correct on the record before the Court) that it was "wholly unlikely."[11] *Id.* As the dissent below explained:

> [T]he Court made a credibility assessment and determined that the taxpayer did not *intend* to make the greater future investment by paying off the loan, and *therefore*, the potential future cash flows were not relevant to the economic substance analysis. The Court did not hold that, as a matter of law, a feasible projected future investment of cash in a particular plan is irrelevant to the economic substance inquiry .... The question is what the taxpayer intended.

App. 22a. By disregarding the crucial distinction between legal and factual relevance, the majority thus both misread *Knetsch*'s language and misapprehended its reasoning.

2. By arbitrarily disregarding Dow's planned and economically driven cash infusion in the middle years of its policies, the majority also squarely contradicted this Court's decision in *Frank Lyon.* Reduced to bare essentials, the issue there was whether the taxpayer (Lyon) was entitled to depreciation and other deductions as the legal owner of a building that it had simultaneously bought from and leased back to a bank, subject to various repurchase options available to the bank. The government attacked the transaction as a sham on the ground that the bank, not Lyon,

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[11] Not only had Knetsch stripped the bonds of net cash value each year and then prematurely terminated the transaction, but also Knetsch cited no evidence to the Court indicating that, in acquiring the bonds, he had even considered paying off the entire loan. To the contrary, the trial court had found that he "did not enter into [the] transaction for profit" (Transcript of Record at 57, *Knetsch,* 364 U.S. 361 (No. 23)), which this Court concluded would have required him to retire the loan. Thus, "the record permit[ted] only one resolution of the factual issue" – Knetsch never intended to pay off the loan. *Pullman-Standard v. Swint*, 456 U.S. 273, 292 (1982).

in substance owned the building. Despite the fact that Lyon had negative cash flow apart from tax deductions over the first 25 years of the transaction,[12] the Court rejected the government's argument. Although a number of considerations entered into the Court's decision, prominent among them was respect for the district court's findings about the bank's economic incentives not to exercise any of its repurchase options. Justice Stevens in dissent maintained that "speculation as to what might happen in 25 years" – *i.e.*, whether the bank would exercise one of its repurchase options – "cannot justify the *present* characterization of petitioner as the owner of the building." *Frank Lyon*, 435 U.S. at 587. This Court, however, rejected that view and instead credited (*id.* at 581) a finding by the trial court that "it was *highly unlikely*, as a practical matter, that any purchase option would ever be exercised." *Id.* at 570 (emphasis added).[13] Thus, in contrast to the majority below, the Court considered a factual finding regarding the likelihood of a future payment by a party to the transaction to be highly relevant in determining economic substance and *rejected* the argument that courts as a matter of law should not assess such likelihoods.

3. Finally, the decision below conflicts with this Court's teachings in *Duberstein*. The majority below declared that

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[12] Lyon's mortgage obligations equaled the bank's rental payments. Lyon's additional expenses, including ground rents that it owed the bank, consequently resulted in negative pre-tax cash flow. *See* 435 U.S. at 566-67.

[13] The *Frank Lyon* trial court explained that the bank's "future capital requirements and the option prices stipulated on the one hand and the reasonable rentals stipulated on the other make this quite clear." *Frank Lyon Co. v. United States*, 1975 U.S. Dist. LEXIS 11934, at *19 n.2 (E.D. Ark. 1976); *see also id.* at *1-*2, *7 (concluding that taxpayer's proposed finding explaining in more detail why a repurchase option would not be exercised was "accurate," though not adopted because merely a restatement of "facts previously found by the Court.").

"[c]ourts should be *skeptical* . . . when the asserted future profits hinge on future taxpayer action that seriously departs from past conduct, especially where such departure involves the expenditure of large sums of money." App. 13a (emphasis added). The majority then elevated this skepticism into an exclusionary rule permitting no contrary proof that the future action in fact will occur – regardless of the strength of that evidence. In *Duberstein*, the government similarly argued for "a new 'test'" of what constitutes a gift under the Internal Revenue Code, including "such propositions as . . . payments by an employer to an employee, even though voluntary, ought, by and large," not to be regarded as gifts. 363 U.S. at 287. The Court rejected the proposed test because the government's "propositions," even if correct, were "not principles of law but rather maxims of experience" and, furthermore, at best were overstatements true only in certain circumstances, but not in others. *Id. See also, e.g., Pa. Board of Probation v. Scott*, 524 U.S. 357, 364 (1998) (because an "exclusionary rule precludes consideration of reliable, probative evidence, it imposes significant costs: it undeniably detracts from the truthfinding process").

The Court's teachings in *Duberstein* apply with full force here. Skepticism is not itself a legal principle, and it cannot properly be turned into an "absolute" irrebuttable presumption trumping trial court findings. 363 U.S. at 287. Instead, as *Knetsch*, *Frank Lyon*, and *Duberstein* demonstrate, determining whether a prospective investment step in a transaction will be undertaken can properly be made only on the basis of all probative facts in each individual case, including the intent of the parties and the economic incentives that drive them – factors that the majority below incorrectly ignored.

B. The Majority's Decision Conflicts With Decisions Of Other Circuits

When confronted with whether a future investment or other action will occur in determining the economic substance of a transaction, other courts of appeals have considered evidence of that likelihood to be highly relevant and, indeed, in assessing that likelihood have, like this Court, given great weight to precisely the two factors that the majority below disregarded: the intent of the parties and their economic incentives.

1. In *Shirar v. Comm'r*, 916 F.2d 1414 (9th Cir. 1990), the Ninth Circuit addressed whether loans obtained to fund an insurance policy, in circumstances comparable to those here, had economic substance. Shirar had purchased a policy on his wife's life to cover an estimated future estate tax liability and had paid the premiums during the first three years in part with amounts lent by the insurer against the cash value of the policy. Shirar's policy plan, however, indicated that he would not borrow against increased cash value during the following four years, and would make a disproportionately large policy payment nine years into the plan. *Id.* at 1416. Relying on *Knetsch*, the Tax Court had held that Shirar's loan transactions lacked economic substance. The Ninth Circuit reversed, distinguishing Shirar's life insurance arrangement from the one in *Knetsch* by looking to Shirar's intent, as evidenced by the policy plan, and the relevant economic incentives: "Unlike the situation in *Knetsch*," the court explained, "Shirar did not plan to borrow the entire increased cash value of the [policy] on an annual basis." *Id.* at 1418. As a result, the policy "provided Shirar with a substantial return for his out-of-pocket costs, a return absent in *Knetsch*." *Id.* "Additionally, . . . absent the increased insurance coverage provided by the [policy], Shirar would not have had sufficient liquidity to meet the estate tax obligations upon the death of his wife." *Id.* Thus, far from regarding the taxpayer's intent and economic incentives as legally irrelevant, the Ninth Circuit treated those factors as central to its analysis of the economic substance of the transaction.

2. In *Sacks v. Comm'r*, 69 F.3d 982 (9th Cir. 1995), the Ninth Circuit dealt with whether an equipment sale and leaseback lacked economic substance. The Tax Court had concluded that the taxpayer, who had bought the equipment and then leased it back to the seller, had not been at risk with respect to the debt obligations he had incurred to finance the purchase. *Id.* at 989. The Ninth Circuit reversed this finding as clearly erroneous in light of evidence that the taxpayer not only was personally liable on the obligations, but also "was likely to be able to pay them," and, indeed, it was "hard to see how he [could] expect not to pay them." *Id.* Furthermore, there was "no basis . . . for inferring any sort of 'gentleman's agreement' not to collect" on the debt. *Id.* Thus, in applying the economic substance doctrine, the Ninth Circuit did not simply rely on a contractual obligation, but rather also assessed the likelihood of the taxpayer's future action by reference to both intent and economics.

3. In *Odend'hal v. Comm'r*, 748 F.2d 908 (4th Cir. 1984), *cert. denied*, 471 U.S. 1143 (1985), the Fourth Circuit considered whether notes given by the taxpayers on which they were not personally liable in exchange for property represented genuine indebtedness. The Fourth Circuit explained that whether such a nonrecourse obligation is genuine debt depends on whether the borrower has an economic incentive to pay it off at the time the debt is incurred. *Id.* at 912. If the fair market value of the property is at least equal to the amount of the debt, the taxpayer "has an economic incentive to pay [it] off . . . rather than to lose the collateral." *Id.* On the other hand, if the amount of the debt exceeds the fair market value of the property, "the taxpayer has no equity in the property to protect and no economic incentive to pay [it] off. . . ." *Id.* Thus, the Fourth Circuit assessed the likelihood of a future cash payment by the taxpayer, not compelled by contract, by determining the taxpayer's financial interest in making the payment.

4. Other circuits have followed a similar approach in

considering the economic substance of nonrecourse obligations.[14] Particularly noteworthy is *Bailey v. Comm'r*, 912 F.2d 44, 46-47 (2d Cir. 1990), where the Tax Court denied interest deductions claimed by taxpayers on 10-year nonrecourse notes taken out to acquire certain film rights. The majority below would have affirmed this decision on the ground that the taxpayers' projected cash expenditures "drastically departed" from their prior conduct because the notes required large balloon payments at maturity dwarfing the taxpayers' initial cash outlay. The Second Circuit, however, adopted no such formalism. While agreeing with the Tax Court that "the nonrecourse nature of purchase notes, especially when they are payable out of exploitation proceeds of the purchased asset, is a factor that argues against recognition of debt as genuine" (*id.* at 48), the Second Circuit held that "this factor is not necessarily determinative":

> Other factors, particularly a reasonable relationship between the amount of the debt and the value of the securing asset, and incentives to the debtor to pay the debt out of personal assets, may require a different conclusion notwithstanding that notes are nonrecourse.

Id. Accordingly, the Second Circuit reversed and remanded for further fact-finding.

Not surprisingly, of over 500 federal cases citing *Knetsch*, *only* the decision below has found it to require the exclusion as a matter of law of the taxpayer's intended future action unless consistent with prior conduct or contractually

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14 *See, e.g., Pleasant Summit Land Corp. v. Comm'r*, 863 F.2d 263, 276 (3d Cir. 1988), *cert. denied sub nom, Comm'r v. Prussin*, 493 U.S. 901 (1989); *Lukens v. Comm'r*, 945 F.2d 92, 98 (5th Cir. 1991); *Upham v. Comm'r*, 923 F.2d 1328, 1335 (8th Cir. 1991); *Estate of Franklin v. Comm'r*, 544 F.2d 1045, 1049 (9th Cir. 1976); *Brannen v. Comm'r*, 722 F.2d 695, 701 (11th Cir. 1984).

required. On the other hand, as the cases above show, the lower courts in determining economic substance have routinely evaluated the parties' intent and the financial incentives driving them, regardless of the formality of any written agreement.

C. The Rule Adopted By The Majority Below Is Plainly Wrong

The need for this Court's review in this case is particularly pressing because the rule adopted by the majority is plainly wrong and, unless overturned, will obstruct rational resolution of future economic substance disputes. The rule asserted by the majority (1) is illogical on its face because it requires courts to ignore highly probative factors, (2) inexplicably upholds economic substance based on legal compulsion, but not on economic compulsion, (3) places no principled boundary on its own application, and (4) is founded on an irrebuttable presumption that, without warrant in the tax laws, denies deductions in commonplace business transactions.

1. The majority held it to be improper under *Knetsch* to consider the taxpayer's actual plan and financial incentives to make a future investment and the likelihood that the investment actually will be made. App. 14a n.13. But courts cannot judge the economic substance of a transaction without first determining which steps, given the parties' plans and incentives, are part of the transaction – *i.e.*, which steps will actually occur. *See Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (explaining that, in determining the substance of a transaction, "the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant"); *Shirar*, 916 F.2d at 1418 (considering taxpayer's plans and economic incentives in determining transaction's economic substance). This inquiry obviously *must* be made before the pre-tax profitability of the transaction as a whole can be assessed. By shutting the court's eyes to the taxpayer's

actual intent and the actual economics of the transaction from beginning to end, the majority's contrary rule calls for a game of blind man's bluff – which nothing in *Knetsch* condones. In fact, the evidence that the majority ruled irrelevant is likely to be among the most probative on the real economic substance of the transaction.

2. The majority's analysis of contractual obligations is equally misguided. The majority asserted that investments to be made pursuant to a contractual obligation may be taken into account because "the eventual outlay would be consistent with actual past conduct, i.e., the obligation that existed all along." App. 15a n.14. But an obligation is not the "conduct," much less the "actual" conduct, that matters. It is the investment itself that counts, which a promise cannot guarantee, since the parties may freely amend or even completely extinguish it. In any event, there is no basis for ruling that economic incentives always provide a less reliable indication that the taxpayer will actually make the investment than a contractual commitment. To the contrary, not only the courts (as discussed above), but also, importantly, the IRS itself has recognized the predictive force of economic compulsion:

> If the characterization of an instrument or a transaction for federal income tax purposes either depends on, or could be affected by, the existence of a person's legal right or option to elect a certain course of action, *the tax consequences often depend on whether the exercise (or nonexercise) of the right or option is economically compelled based on all the facts and circumstances.*

Rev. Rul. 2003-97, 2003-2 C.B. 380 (July 23, 2003) (emphasis added).

3. Furthermore, the majority's exclusionary rule requires the courts to make a subjective determination whether a planned investment reflects a "drastic departure" from the

taxpayer's prior conduct. This standard has no metes and bounds and thus provides no standard at all. In this very case, for example, the majority found Dow's planned investments to be such "drastic departures" from its prior behavior that the majority applied this standard itself rather than remand to the trial court to do so. But Dow had invested approximately $60 million in cash through 2000 in its Great West policies (*see* App. 92a) and was planning, by the majority's own reckoning, to invest only about *half* that amount in the future. *See* App. 10a n.9. If this constituted a "drastic departure," one wonders what future investment would ever be entitled to be considered under the majority's exclusionary rule.

4. At bottom the ruling below rests on an arbitrary irrebuttable presumption that taxpayers who enter into transactions requiring a substantial future investment can be counted on to actually make the investment only if they are contractually bound to do so. Nothing in the economic substance doctrine, let alone the Internal Revenue Code, supports a distinction between investments made at the beginning of the transaction and those made subsequently, or between those that are contractually stipulated and those that are planned in accordance with the taxpayer's business needs and financial incentives. The presumption embodied in the ruling below thus undermines principled application of the Internal Revenue Code. If permitted to stand, the presumption – which the government has now endorsed (*see* App. 216a; App. 221a) – will frustrate not only long-term financing transactions, but also many other legitimate business transactions that are not initially profitable but become so over time. *See* Sheryl Stratton, *Circular 230 Changes Moving Slowly as Courts Offer Up Shelter Analyses*, 2006 Tax Notes Today 182-2 (Sept. 20, 2006) ("The conflict with *Knetsch* and the de novo standard of review espoused by the court in *Dow* threaten the legitimacy for tax purposes of many business transactions that would be

under review by the Sixth Circuit that take time and more than one contribution of cash to generate profits") (quoting Jeff Paravano, former Senior Advisor to the Assistant Secretary for Tax Policy at the Department of Treasury); Richard M. Lipton, *What Will Be the Long-Term Impact of the Sixth Circuit's Divided Decision in* Dow Chemical?, 104 J. Tax'n 332, 337 (2006) ("The expansive interpretation of *Knetsch* . . . is likely to continue the impression that the government is more interested in favorable results than the rule of law, which can only lead to long-term adverse consequences.").

As the preceding discussion shows, the irrebuttable presumption imposed by the decision below is at odds with this Court's decisions and the decisions of other courts of appeals. Thus, the Sixth Circuit's ruling urgently calls for this Court's review.

CONCLUSION

For the foregoing reasons, the petition should be granted.[15]

Respectfully submitted,

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15 In view of the patent conflict between the decision below and this Court's holdings in *Knetsch*, *Frank Lyon*, and *Duberstein*, the Court may wish to consider summary reversal.