

The Future of Tax Planning: From *Coltec* to *Schering-Plough*

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This report examines the recent district court decision in *Schering-Plough v. United States*, in which the court determined that Schering-Plough's swap-and-assignment transactions: (1) were loans in substance, (2) lacked economic substance, and (3) did not comport with the overall intent of subpart F under the court's newly created doctrine: "assimilation with applicable tax laws."

This report considers the impact of *Schering-Plough* and *Coltec*, as well as the likely codification of the economic substance doctrine, on future tax planning. The authors also examine economic substance codification and argue that if a taxpayer has acted in good faith and reasonably attempted to comply with the tax law, the taxpayer should not automatically be subject to a 40 percent penalty for failing to anticipate the novel tests of the next *Coltec* or *Schering-Plough*.

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I. Introduction

Economic substance, business purpose, sham transaction, substance over form, step transaction — these antiabuse doctrines should be familiar to tax practitioners. The "assimilation with applicable tax laws" test, however, is unlikely to be familiar. Rather, the test appears to have been newly fashioned by the U.S. District Court for the District of New Jersey in *Schering-Plough v. United States*.¹

Schering-Plough Corp. entered into two interest swaps with an unrelated bank, then assigned its rights to receive swap payments from the bank in specific future years to foreign subsidiaries (together, swap-and-assignment transactions). Schering-Plough treated the assignments as sales for U.S. federal income tax purposes and, relying on Notice 89-21, reported the income from the sales by amortizing the proceeds over the years for which the future income streams had been assigned. The IRS challenged the characterization of the assignments as sales, contending that the transactions were in substance loans. Because the assignments were loans from controlled foreign corporations, the IRS argued that the loans were "investments in United States property" under section 956(c)(1)(C)² and that Schering-Plough should be required to pay immediate U.S. tax on the amount of the loan.

The court determined that the swap-and-assignment transactions should be recharacterized and taxed under section 956(c)(1)(C) because the transactions: (1) were in substance loans, not sales; (2) lacked economic substance; and (3) did not "comport with the overall intent of subpart F," and Notice 89-21 could not be construed "to allow repatriation of foreign earnings and profits free from immediate taxation."³ The court concluded that in

¹*Schering-Plough Corp. v. United States*, No. 05-2575, *5, *88 (D.N.J. Aug. 28, 2009), *Doc 2009-19512*, 2009 TNT 167-3 (examining the transactions at issue for "their assimilation with applicable tax laws" and in light of "The Big Picture: Subpart F vs. Notice 89-21").

²Under section 956, a CFC's "investment in U.S. property" is treated as a deemed dividend to its U.S. shareholders. Under section 956(c)(1)(C), "U.S. property" includes an obligation of a U.S. person.

³*Schering-Plough Corp.*, *supra* note 1, at *42. It should be noted that the court appears to confuse "subpart F," which consists of sections 951 to 965 of the code, and general "purposes" of subpart F, with section 956 and the "purposes" of section 956. For example:

Congress has enacted its policy judgment . . . that when a foreign subsidiary invests in the corporate debt of its domestic parent, the use of the loaned funds is no different than a dividend to the parent shareholder, and should be taxed accordingly. This regime, known as

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testing the transactions for their “assimilation with applicable tax laws,” “in a clash between the short-lived notice and the enveloping Subpart F regime, the Court is faced with an easy choice, especially when the consequences of elevating the notice over the legislative regime would be to ‘permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation.’”⁴

Some have suggested that the ultimate outcome in *Schering-Plough* is correct. This may be; however, as we will explain, the court’s analysis is, in our view, fundamentally flawed in several respects. Perhaps the case is an example of bad facts making bad law. Less “bad law” would have been created, however, if the court had ended its opinion after determining that the transaction was in substance a loan, avoiding a further expansion of the economic substance doctrine and the creation of a new “assimilation with applicable tax laws” test.

Three years ago, the Federal Circuit’s application of the economic substance doctrine in *Coltec Industries, Inc. v. United States*⁵ was described as “misguided,” a “marked change,”⁶ and “stunningly wrong.”⁷ *Coltec* involved a contingent liability transaction in which a taxpayer transferred contingent liabilities and assets to a dormant subsidiary in exchange for newly issued stock and then sold the subsidiary’s stock. The contingent liabilities reduced the value of the subsidiary stock, but the taxpayer’s basis in the subsidiary stock was not reduced. As a result, when the subsidiary stock was sold, the taxpayer recognized a capital loss.⁸ In *Coltec*, the court

Subpart F of the tax code, is intended to prevent United States corporations from sheltering their subsidiaries’ income in so-called ‘tax-haven’ countries, while simultaneously putting the money to domestic use.
Id. at *2.

Further, the court also mischaracterizes the operation of subpart F generally: “The legislation — Subpart F of the Internal Revenue Code — mandates taxation of foreign [earnings and profits] upon repatriation to the United States.” *Id.* at *7. Foreign earnings are subject to tax under general corporate tax rules when distributed by corporations to their U.S. shareholders. See section 301.

⁴*Schering-Plough Corp.*, *supra* note 1, at *90.

⁵*Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *Doc* 2006-13276, 2006 TNT 134-10, *cert. denied*, 127 S. Ct. 1261 (2007).

⁶Mark J. Silverman, Matthew D. Lerner, and Gregory N. Kidder, “A New Form of Obscenity? Sorting Through the Federal Circuit’s ‘We Know It When We See It’ Ruling in *Coltec*,” *Tax Executive* (Nov.-Dec. 2006); see also Mark J. Silverman, Philip R. West, and Aaron P. Nocjar, “Establishing Business Purpose in a Transparent World,” *Doc* 2004-16634, 2004 TNT 159-17 (raising questions regarding the application of business purpose and economic substance tests to certain transactions, pre-*Coltec*).

⁷Sheryl Stratton, “Government, Tax Bar Disagree Over Impact of *Coltec*,” *Doc* 2006-22346, 2006 TNT 212-1 (quoting Jasper L. Cummings, Jr., as calling *Coltec* “stunningly wrong”).

⁸Under section 358(h), which was enacted in 2000 to address basis-value disparities such as the disparity in *Coltec*, if the application of section 358 results in a stock basis exceeding fair market value, the stock basis is reduced by the amount of the liabilities, but not lower than FMV unless: (1) the trade or

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disallowed the capital loss, stating that the assumption of the liabilities by the taxpayer lacked economic substance. According to the court:

We must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale. That transaction is [the subsidiary’s] assumption of [the liabilities]. . . . It is this exchange that provided [the taxpayer] with the high basis in the [subsidiary] stock, this exchange whose tax consequence is in dispute, and therefore it is this exchange on which we must focus.

The court acknowledged that the use of the subsidiary had some business purpose but disputed that the transfer of the liabilities was necessary to accomplish the business benefits created by the subsidiary. The court said that the same business benefits could have been obtained even without the transfer of the liabilities, and thus the transfer should be disregarded.⁹

In its analysis of whether the transaction had economic substance, the court stated that the economic substance doctrine consists of five principles: (1) the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality; (2) the taxpayer bears the burden of proving economic substance; (3) the economic substance of a transaction must be viewed objectively rather than subjectively; (4) the transaction to be analyzed is the one that gave rise to the alleged tax benefit; and (5) arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.¹⁰ The *Coltec* court’s proposition that under the economic substance doctrine, “the transaction to be analyzed is the one that gave rise to the alleged tax benefit” was a striking change from the courts’ usual consideration of multiple-step transactions as a whole, rather than as a series of individual steps. The court’s analysis did not make clear how these five principles related to the two-prong economic substance test applied (subjectively, disjunctively, or as factors to consider) by most courts (including the pre-*Coltec* Federal Circuit). As a result, it was unclear whether the court’s five principles, including the focus on individual steps, would be viewed by other courts as a viable new articulation of the economic substance doctrine.

business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or (2) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange. Consolidated Appropriations Act, P.L. 106-554, section 309(a) (2000).

⁹*Coltec*, 454 F.3d 1340 at 1358.

The transfer of the liabilities in exchange for the note is separate and distinct from the fact that Garrison took a managerial role in administering the asbestos liabilities, as demonstrated by the fact that Garrison managed another entity’s asbestos liabilities (Anchor’s liabilities) without assuming Anchor’s liabilities. The taxpayer has not demonstrated any business purpose to be served by linking Garrison’s assumption of the liabilities to the centralization of litigation management.

¹⁰*Id.* at 1355-1357.

The *Coltec* approach of applying the economic substance doctrine to individual steps of a transaction has since been adopted by other courts,¹¹ and it has been advanced by the government in litigation both inside and outside the Federal Circuit.¹² If the “assimilation with applicable tax laws” test offered by the district court in *Schering-Plough* takes a path similar to *Coltec*’s focus on individual steps, and if taxpayers are required to show why a transaction should not be recharacterized to carry out a legislative “purpose,” the vitality of administrative pronouncements such as Notice 89-21 — or even common transactions with seemingly clear consequences under the code itself — could be eroded. Moreover, if courts read *Schering-Plough* and *Coltec* together as mean-

ing that the economic substance doctrine requires that each step of a transaction be tested for its “assimilation with applicable tax laws,” even greater uncertainty would result.

Given the history of *Coltec*, the “new life” of economic substance codification in President Obama’s 2010 budget proposals,¹³ and Congress’s frequent inclusion of economic substance codification as a revenue-raising provision in proposed bills (including the House-passed healthcare reform bill),¹⁴ *Schering-Plough* must be considered in the broader context of tax antiabuse doctrines and their application by courts. Further, the *Schering-Plough* opinion and the recent trend of IRS victories in economic substance cases¹⁵ raise questions about how tax practitioners and tax departments can and should approach tax planning.

¹¹*Klamath Strategic Investment Fund v. United States*, 568 F.3d 537, 545 (5th Cir. 2009), *Doc 2009-11265*, 2009 TNT 94-15 (“Various courts have held that when applying the economic substance doctrine, the proper focus is on the particular transaction that gives rise to the tax benefit, not collateral transactions that do not produce tax benefits.”); *Southgate Master Fund LLC v. United States*, No. 3:06-cv-02335 (N.D. Tex. Aug. 18, 2009), *Doc 2009-18785*, 2009 TNT 160-6; see also *Consolidated Edison Co. v. United States*, No. 06-305T (Fed. Cl. Oct. 21, 2009), *Doc 2009-23332*, 2009 TNT 203-7; *Stobie Creek Investments LLC v. United States*, Nos. 05-748T, 07-520T (Fed. Cir. July 31, 2008), *Doc 2008-5274*, 2008 TNT 49-13; *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007), *Doc 2007-28072*, 2007 TNT 248-5; *H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007), *Doc 2007-12834*, 2007 TNT 103-16. But see *Shell Petroleum Inc. v. United States*, 2008-2 USTC para. 50,422 (S.D. Tex. 2008), *Doc 2008-14880*, 2008 TNT 131-10 (before the Fifth Circuit’s decision in *Klamath*, stating that “the Court has found no Fifth Circuit cases, and the parties have cited none, similarly dissecting, or ‘slicing and dicing’ as it was referred to in oral arguments, an integrated transaction solely because the Government aggressively chooses to challenge only an isolated component of the overall transaction.”).

¹²See United States’ Post-Trial Brief, *Schering-Plough Corp. v. United States*, No. 05-2575 (D.N.J. June 13, 2009) (“Unlike the step-transaction doctrine, which considers the transaction as a whole, the focus of the economic substance inquiry is solely on the portion of the transaction that generated the tax consequences.”) (citing *ACM* and *Coltec*); see also Brief of the United States, *Stobie Creek Investments LLC et al. v. United States*, No. 2008-5190 (Fed. Cir. May 13, 2009); Brief for the United States, *Sala v. United States*, No. 08-1333 (10th Cir. Mar. 6, 2009) (“The transaction to be analyzed for economic substance is the specific one that gave rise to the claimed tax benefit.”); Brief for the United States, *Jade Trading, LLC v. United States*, No. 2008-5045 (Fed. Cir. Oct. 10, 2008) (“In this case, the spread transaction, which gave rise to the claimed tax benefits, is the transaction to be analyzed for economic substance.”); Brief for the United States, *H.J. Heinz Co. v. United States*, No. 2007-5146 (Fed. Cir. Dec. 17, 2007) (“Here, the transaction that generated the desired tax benefit was Heinz’s redemption of HCC’s stock. It was that transaction that explains why HCC was inserted into the stock-repurchase program and that resulted in the basis-shift that left HCC holding 175,000 shares of stock with an artificially high basis to sell at an inevitable and substantial tax loss.”); United States’ Post-Trial Brief, *Klamath Strategic Investment Fund*, No. 07-40861 (5th Cir. Dec. 18, 2006) (“When applying the economic substance doctrine, courts have taken pains to emphasize that the transaction to be analyzed is the particular transaction that gave rise to the tax benefit, and not collateral transactions which do not produce tax benefits.”).

¹³Jeremiah Coder, “Treasury Official Upbeat About Economic Substance Codification,” *Tax Notes*, June 22, 2009, p. 1414, *Doc 2009-13563*, or 2009 TNT 113-4 (quoting Byron Christensen, attorney-adviser in Treasury’s Office of Tax Legislative Counsel, as stating that codification of the economic substance doctrine is “getting new life” as part of the Obama administration’s fiscal 2010 budget proposal); Amy S. Elliott, “Debate Is Over on Codification of Economic Substance Doctrine, Treasury Official Says,” *Tax Notes*, Oct. 5, 2009, p. 23, *Doc 2009-21793*, 2009 TNT 189-2 (quoting Joshua Odintz, Treasury tax legislative counsel, as stating Congress is likely to pass economic substance codification in the next few years).

¹⁴See, e.g., America’s Affordable Health Choices Act of 2009, H.R. 3200, 111th Cong.; Stop Tax Haven Abuse Act, S. 506, 111th Cong.; James Zadroga 9/11 Health and Compensation Act of 2008, H.R. 7174, 110th Cong.; AMT Relief Act of 2008, H.R. 6049, 110th Cong.; Middle Class Tax Fairness Act of 2008, H.R. 6595, 110th Cong.; Manufacturing, Assembling, Development, and Export in the USA Tax Act, S. 3162, 110th Cong.; Universal Homeowner Tax Act of 2008, H.R. 5790, 110th Cong.; Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242, 110th Cong.; AMT Relief Act of 2007, H.R. 4351, 110th Cong.; Responsible Fatherhood and Healthy Families Act of 2007, H.R. 3395, 110th Cong.; Clean Energy Production Tax Incentives Act of 2007, S. 1508, 110th Cong.; Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong.; Health Care for Hybrids Act, H.R. 1920, 110th Cong.; Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2007, H.R. 2345, 110th Cong.; Fair Flat Tax Act of 2007, S. 1111, 110th Cong.; Growing Our Manufacturing Employment Act, S. 592, 110th Cong.; Export Products Not Jobs Act, S. 95, 110th Cong.

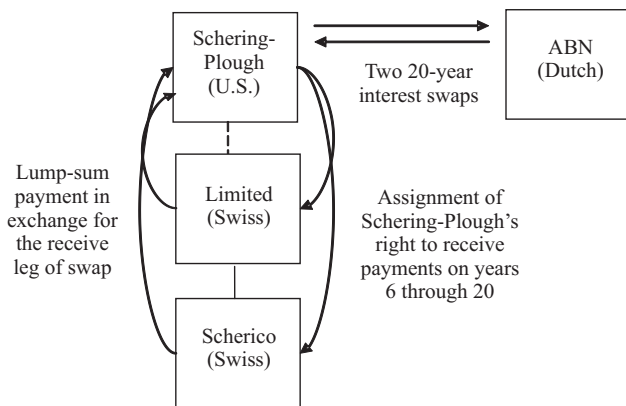
¹⁵See, e.g., *Palm Canyon X Investments LLC v. Commissioner*, T.C. Memo. 2009-288, *Doc 2009-27494*, 2009 TNT 239-11; *Country Pine, LLC v. Commissioner*, T.C. Memo. 2009-251, *Doc 2009-24438*, 2009 TNT 213-9; *Southgate Master Fund*, No. 3:06-cv-02335; *Klamath Strategic Investment Fund*, 568 F.3d 537 at 543; *Clearmeadow Investments LLC v. United States*, 2009-1 para. 50,449 (Fed. Cl. 2009), *Doc 2009-13949*, 2009 TNT 117-14; *Jade Trading*, 80 Fed. Cl. 11. In the last five years, the most significant taxpayer victories have occurred in *Consolidated Edison*, No. 06-305T; *Countryside Limited Partners v. Commissioner*, T.C. Memo. 2008-3, *Doc 2008-61*, 2008 TNT 2-15; and *Shell Petroleum*, 2008-2 USTC para. 50,422. However, *Shell Petroleum* has been appealed to the Fifth Circuit, *Countryside* was settled, and *Consolidated Edison* may be appealed to the Federal Circuit.

II. Schering-Plough

A. The Transactions

At the time of the transactions at issue, Schering-Plough was a New Jersey corporation. Through its wholly owned domestic subsidiaries, Schering-Plough owned a majority of the voting stock of a Swiss corporation, Schering-Plough Ltd. (Limited).¹⁶ Limited owned a majority share in a Swiss corporation, Scherico Ltd.

Schering-Plough entered into two 20-year interest swaps with a Dutch investment bank, Algeme Bank Nederland N.V. (ABN). Under the first swap, entered into in 1991, Schering-Plough agreed to pay ABN interest based on the London Interbank Offered Rate (LIBOR), and ABN agreed to pay Schering-Plough interest based on the federal funds rate. The notional principal amount of the swap was \$650 million. Payments were to be made every six months. Under the terms of the agreement, ABN and Schering-Plough could net the two payments, so that only one payment was made by the party owing the higher amount. ABN was permitted to terminate the swap if Schering-Plough's credit rating fell below a specified level.



ABN also entered into a swap with Merrill Lynch. That swap had a notional principal amount of \$650 million. ABN agreed to pay interest based on LIBOR, while Merrill Lynch agreed to pay interest based on the federal funds rate. Merrill Lynch also paid 10 basis points to ABN.

Under the terms of the 1991 swap, Schering-Plough was permitted to assign its rights to receive payments. If Schering-Plough assigned its rights, the payments would no longer be netted, so that each periodic payment would be paid in full to the party entitled to payment.

Schering-Plough assigned its right to receive interest on \$60 million of the notional principal to Banco di Roma, an unrelated bank. Banco di Roma paid Schering-Plough \$26.4 million for the assignment. Under the assignment, ABN had an option to terminate its payment obligation and require Banco di Roma to sell the payment rights

back to ABN. ABN agreed to pay Banco di Roma 15 basis points each year until the option was exercised. The option was exercised in full by 1993.

Schering-Plough also assigned a portion of its right to receive payments under the 1991 swap to one of its foreign subsidiaries, Scherico. The assignment gave Scherico the right to receive payments on \$460 million of notional principal for years 6 to 20 of the swap. Scherico paid Schering-Plough \$202.4 million for the assignment. Also, Scherico and Schering-Plough entered into a put option agreement, under which Scherico could assign the payment rights back to Schering-Plough in exchange for Schering-Plough's payment of the fair market value of the remaining income streams.

Schering-Plough also made an assignment to another foreign subsidiary, Limited. The assignment provided Limited with the right to receive payments from ABN in years 6 through 20 on \$100 million of notional principal. Limited paid Schering-Plough \$44 million for this assignment. Limited also received a put option to reassign the leg back to Schering-Plough. ABN agreed to both assignments of the 1991 swap and agreed that it would make payments to Scherico regardless of whether Schering-Plough made its payments to ABN.

Schering-Plough and ABN entered into a second interest rate swap in 1992, under which Schering-Plough agreed to make payments based on LIBOR, while ABN agreed to make payments based on a 30-day commercial paper rate plus 0.05 percent. The notional principal amount was \$950 million. The 1992 swap permitted netting and contained a 60-day credit trigger. As in the 1991 swap, ABN entered into a swap with Merrill Lynch.

Schering-Plough assigned its rights to receive income streams on \$25 million of the notional principal to Rabobank Nederland. Schering-Plough also assigned to Scherico the right to receive payments from ABN for years 6 through 20 on a notional principal of \$920 million. Scherico paid Schering-Plough \$444 million for this assignment. As in the 1991 swap, ABN agreed to the assignment and agreed that it would make payments to Scherico regardless of whether Schering-Plough made its payments to ABN.

B. Taxpayer's Treatment of the Transactions

Schering-Plough treated the assignments of the income rights under the swaps as sales for U.S. federal income tax purposes. Schering-Plough determined the timing of the income inclusion under Notice 89-21, which required that proceeds received in one tax year from the assignment of a notional principal contract be taken into account over the life of the assigned contract.¹⁷

¹⁷Notice 89-21, 1989-1 C.B. 651. In its refund action in the U.S. District Court for the District of New Jersey, Schering-Plough also contended that the government treated it differently from similarly situated taxpayers because one of Schering-Plough's competitors entered into swap-and-assignment transactions materially similar to Schering-Plough's transactions, and the IRS in a field service advice memorandum determined that Notice 89-21 applied to the competitor's transactions. See FSA 1997-29 (Aug. 29, 1997), Doc 2009-27142, 2009 TNT 237-25. The

(Footnote continued on next page.)

¹⁶Schering-Plough wholly owned Schering Corp., a U.S. corporation that owned all the voting stock of Schering-Plough International Inc. (International), also a U.S. corporation. International owned a majority of the voting stock of Limited.

C. Decision

The district court concluded that the swap-and-assignment transactions were properly characterized as loans under the general substance-over-form doctrine. Although this conclusion alone would result in a taxpayer loss, the court continued its legal analysis to conclude that the transaction failed the economic substance doctrine. Further, the court determined that the transactions failed an apparently newly developed test: “whether the structured transactions comport with the overall intent of subpart F” or, more generally, “their assimilation with applicable tax laws.”

1. Substance-over-form analysis. The court determined that the swap-and-assignment transactions involved loans, not sales. The court concluded that the lump sums paid by the foreign subsidiaries to Schering-Plough represented principal and that the income streams paid to the foreign subsidiaries by ABN constituted repayment of the principal amount plus interest.¹⁸ Although the income streams were paid to the foreign subsidiaries by ABN, not Schering-Plough, the court determined that ABN was a conduit in routing payments from Schering-Plough to the foreign subsidiaries.

The court said that “for a given transaction to ‘constitute [a] true loan’ there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure payment.”¹⁹ Schering-Plough pointed to 17 factors suggesting that the transactions were sales, not loans, including:

- the transactions were documented, accounted for, and reported as sales;
- Schering-Plough had no payment obligations to the Swiss subsidiaries;
- the receive leg of each swap was transferred absolutely;
- the Swiss subsidiaries paid fixed prices that were not contingent on their receipt of future amounts;
- the Swiss subsidiaries, not Schering-Plough, were entitled to receive the future income streams from ABN;
- the Swiss subsidiaries, not Schering-Plough, had enforcement rights for the future income streams from ABN;
- the Swiss subsidiaries received payments from ABN, not Schering-Plough;

district court rejected Schering-Plough’s argument in *Schering-Plough Corp.*, No. 05-2575 at *5-*7 (D.N.J. Dec. 3, 2007), *Doc 2007-26557*, 2007 TNT 234-8. It said that taxpayers cannot rely on field service advice because they are not binding on the IRS.

¹⁸Note, however, that the payments from ABN were determined by applying a floating interest rate to the notional principal amount of the swap and not the principal (the lump sum paid for the assignment) of the purported loan.

¹⁹*Schering-Plough Corp.*, *supra* note 1, at *42 (quoting *Geftman v. Commissioner*, 154 F.3d 61, 68 (3d Cir. 1998), *Doc 98-25919*, 98 TNT 159-8).

- Schering-Plough was not obligated to reimburse the Swiss subsidiaries if ABN failed to make payments; and
- the Swiss subsidiaries had the right to sell or dispose of the assigned swap receive legs.²⁰

Although it is true that “the simple expedient of drawing up papers” is not controlling for tax purposes when objective economic realities are to the contrary,²¹ the court in *Schering-Plough* did not consider general principles of tax ownership, which are used to determine whether a transaction is in substance a sale. In determining whether ownership has been transferred for tax purposes, courts typically consider whether the benefits and burdens of ownership have passed to the purported buyer. As the Tax Court stated in *Grodt & McKay Realty Inc.*, “this is a question of fact which must be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attending facts and circumstances.”²² Courts typically consider (1) whether legal title passes, (2) how the parties treat the transaction, (3) whether an equity interest was acquired in the property, (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments, (5) which party bears the risk of loss or damage to the property, and (6) which party receives the profits from the operation and sale of the property.²³

Without discussing whether the benefits and burdens of ownership had transferred, the court rejected the significance of the factors cited by Schering-Plough as supporting sale treatment because they could be “easily manipulated by the related parties appearing on both sides of the swap-and-assign transactions.”²⁴ The receive legs of the swaps, however, were transferred absolutely, and the transactions were documented and treated as sales by the parties. Further, the transaction transferred credit risk (of ABN) and interest rate risk (the risk that the rates used to calculate the receive leg would fall) to the subsidiaries. For example, if the floating rate to be paid by ABN decreased, the subsidiaries would receive less money from the receive leg of the swaps. Further, if ABN did not pay on the swaps, it was the subsidiaries that would suffer. The court appeared to find these facts insignificant, arguing that “particular scrutiny” should be applied in the case “because the control element suggests the opportunity to contrive a fictional” transaction.²⁵

The court found that the parties viewed the transactions as involving loans. As evidence of this intention, the court cited an internal ABN credit proposal, which stated: “The reason for this structure is the fact that the parent through this mechanism receives a 20-year amortizing

²⁰*Id.* at *43-*44.

²¹See *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) (quoting *Commissioner v. Tower*, 327 U.S. 280, 291 (1946)).

²²*Id.* (quoting *Haggard v. Commissioner*, 24 T.C. 1124 (1955)).

²³*Id.*

²⁴*Id.* at *43.

²⁵*Id.* at *42 (quoting *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968)).

loan from its subsidiary without incurring any negative tax implications in the U.S.”²⁶ Further, the court pointed to notes taken by Schering-Plough’s director of financial reporting and compliance, which stated: “We are really accounting for the net deferred income as a loan, but tax could not have us record it as a loan.”

The court did not view ABN’s participation in the transaction as significant, agreeing with the government that “ABN was a mere pass-through in routing payments from Schering-Plough to its subsidiaries.”²⁷ The court evaluated whether ABN was a conduit by using the factors described by the U.S. District Court for the Southern District of Texas in *Enbridge Energy Co. v. United States*²⁸:

(1) whether there was an agreement between the principals to do a transaction before the intermediary participated, (2) whether the intermediary was an independent actor, (3) whether the intermediary assumed any risk, (4) whether the intermediary was brought into the transaction at the behest of the taxpayer, and (5) whether there was any non-tax-avoidance business purpose to the intermediary’s participation.²⁹

The *Enbridge Energy* conduit factors were met, according to the court. It found that (1) ABN had no substantive involvement in Schering-Plough’s initial decision to effect the swap-and-assignment transactions; (2) ABN was an independent actor, but its participation was limited to facilitating the transactions; (3) ABN minimized its risk using mirror swaps, credit default provisions, and other contractual provisions to limit its regulatory capital requirements; (4) Merrill Lynch, on behalf of Schering-Plough, approached ABN to participate in the transactions; and (5) ABN participated in the transaction

²⁶*Id.* at *37.

²⁷*Id.* at *54.

²⁸*Enbridge Energy Co. v. United States*, 553 F. Supp.2d 716 (S.D. Tex. 2008), *Doc 2008-7171*, 2008 TNT 64-9, *aff’d*, 103 A.F.T.R.2d 2009-7289 (5th Cir. Nov. 10, 2009), *Doc 2009-24917*, 2009 TNT 217-10. In *Enbridge Energy*, the taxpayer sought to sell his wholly owned pipeline business, The Bishop Group Ltd., but could not agree on a price with potential buyers. To help facilitate a sale, his tax advisers designed a transaction to create tax benefits for the buyer (stepped-up basis) and the seller (capital gain treatment) using an intermediary. In the transaction, the taxpayer sold his Bishop stock to an intermediary, K-Pipe Merger Corp. (a newly created subsidiary of Fortrend International LLC), which then merged into Bishop, with Bishop surviving. Bishop then changed its name to K-Pipe Group. K-Pipe Group sold all the Bishop assets to Midcoast Energy Resources Inc. The district court disregarded the involvement of K-Pipe as a mere conduit and treated the transaction as a purchase of the Bishop stock by Midcoast, followed by a liquidation of Bishop. Thus, Midcoast did not receive a cost basis in Bishop’s assets. Although there was no formal agreement between Bishop and Midcoast, the court found that Midcoast’s tax advisers identified the intermediary and that there was no nontax business purpose for the intermediary’s participation. Moreover, the entity formed for the transaction, K-Pipe, was a mere shell and did not have any other business activities.

²⁹*Schering-Plough*, *supra* note 1 (quoting *Enbridge*, 553 F. Supp.2d at 730).

because of the tax consequences for Schering-Plough if no intermediary had been used.³⁰

Schering-Plough had argued that ABN did bear risk in the transactions, and thus could not be a conduit. Schering-Plough argued that ABN had credit exposure because it was obligated to make payments to the Swiss subsidiaries on the assigned receive legs of the swaps whether or not Schering-Plough complied with its obligations to make payments to ABN on the pay legs.³¹ Further, Schering-Plough argued that ABN would have faced “substantial” interest rate risks had it not entered into the swaps with Merrill Lynch, and that entering into those swaps created additional risk: credit exposure to Merrill Lynch.³² Schering-Plough also argued that ABN had litigation and reputation risks.

The court in *Schering-Plough* dismissed ABN’s risk as not “material.” In *Enbridge Energy*, however, the court asked whether the counterparty assumed *any* risk — it did not evaluate whether any risk rose to the level of being material. *Enbridge Energy* involved an intermediary sales transaction designed to create tax benefits for both the buyer (stepped-up basis) and the seller (capital gain treatment). In *Enbridge Energy*, the alleged conduit, K-Pipe, was a new subsidiary, created solely for purposes of the transaction. It had no assets. Moreover, unlike ABN in *Schering-Plough*, K-Pipe’s obligations “were almost entirely indemnified by [counterparty] Midcoast through various side agreements and under the Stock and Asset Purchase Agreements.” Midcoast agreed that if it failed to close the asset purchase by a specified date, it would pay K-Pipe \$15 million. Further, Midcoast agreed to be liable to any third-party donee or creditor beneficiaries of K-Pipe if the deal failed. Midcoast also agreed to guarantee some of K-Pipe’s obligations under the stock purchase agreement with the taxpayer, including an obligation to indemnify the taxpayer if the transaction was subject to any tax besides capital gain tax on the sale of the Bishop stock to K-Pipe. Midcoast also facilitated financing for K-Pipe. Although K-Pipe financed its acquisition of the stock with a loan from a third-party bank, Midcoast provided security for the loan. As a result, K-Pipe did not appear to have any risk in entering into the transaction.

The court in *Schering-Plough* also based its determination that ABN was a “mere conduit” on the Court of Claims’ decision in *Mapco Inc. v. United States*.³³ The government, citing *Mapco*, had argued that a “loan is no less a loan merely because the borrower chooses to repay it by designating a third party to make future payments to the lender.”³⁴ The *Mapco* court had determined that an assignment of future income in exchange for a lump-sum payment was a loan. The transaction involved three taxpayers: Mapco (the taxpayer), Chemical Bank, and

³⁰*Id.* at *56-58.

³¹*Schering-Plough’s Post-Trial Brief at 9-15; Schering-Plough*, No. 05-2575 (D.N.J. June 13, 2008).

³²*Id.* at *15.

³³*Mapco Inc. v. United States*, 556 F.2d 1107 (Ct. Cl. 1977).

³⁴*United States’ Post-Trial Memorandum at 29; Schering-Plough*, No. 05-2575 (D.N.J. June 13, 2008).

Rock Creek Corp. (an unrelated corporation). Mapco, in exchange for \$4 million in cash, assigned to Rock Creek a 75 percent interest in its future unearned revenues until Rock Creek had received \$4 million plus interest on the outstanding balance. The \$4 million that Rock Creek paid to Mapco was borrowed by Rock Creek from Chemical Bank and secured by the assignment of Mapco's future earnings. Mapco used the \$4 million received from Rock Creek to purchase Chemical Bank certificates of deposit (CDs), the maturity dates of which matched the anticipated dates for the repayment to Chemical Bank of the \$4 million borrowed by Rock Creek.

The Court of Claims determined that the transaction constituted a nonrecourse secured loan from Rock Creek to Mapco:

Because Rock Creek was to receive 75 percent of Mapco's pipeline revenues until it received \$4 million, the transaction appears to be a loan for that amount. Further, although Rock Creek had no rights against Mapco, Mapco had a consistent record of earning pipeline revenues, of which Rock Creek and Chemical Bank were aware. Since Rock Creek had a right to receive payments until it was repaid, even if Mapco's revenues declined, Rock Creek was certain to be repaid eventually. This certainty of repayment is more characteristic of a loan than a sale.³⁵

The court stated that, by depositing the proceeds of the Mapco-Rock Creek transaction with Chemical Bank, Mapco essentially assured Chemical Bank that it would comply with the assignment of revenue agreement. The maturity dates on the CDs were selected to coincide with the repayment dates of the \$4 million borrowed by Rock Creek. The court noted that "the exhibits to the record evidence an understanding between Mapco and Chemical Bank that Mapco would acquire that bank's certificates."

The court in *Schering-Plough* compared Mapco's depositing of CDs with Chemical Bank to Schering-Plough's continuing payments to ABN:

Schering-Plough's continued payments to ABN — the middle-man in the transaction which was responsible for directing payment to the Swiss subsidiaries — indirectly and recurrently ensured the subsidiaries that they would recoup the lump-sum advancements. The Court finds that this indirect assurance is identical in substance to Mapco's depositing the CDs — which were used to repay the Rock Creek loan — with Chemical Bank, the third-party in the transaction.³⁶

The *Schering-Plough* court appears to mischaracterize the facts and decision in *Mapco*. In *Mapco*, Rock Creek advanced funds to Mapco in exchange for Mapco's future revenues. It was clear that the payments to Rock Creek would be from Mapco's revenues and that the payment would equal \$4 million (the amount advanced to Mapco) plus interest. The CDs helped facilitate the transaction

and indicated that Mapco intended that the revenue assigned to Rock Creek amount to \$4 million. However, they did not create Mapco's obligation to repay the \$4 million — that obligation was already a part of the agreement between Mapco and Rock Creek. The main question in the case was whether Rock Creek bore the risk that Mapco would not generate revenue. According to the court, the important facts were that:

Rock Creek was only to receive a sum certain at an interest rate which approximated the standard prevailing rate; that Rock Creek had no risk of eventual nonpayment; that Rock Creek had none of the usual risks or benefits associated with ownership of property; that Rock Creek had no dominion or control over the revenue payments; that Mapco was not free to do as it wished with the proceeds of the transaction; and that Mapco indirectly secured the repayment of Rock Creek's loan to Chemical Bank.³⁷

Further, in *Mapco*, the sole purpose of the transaction was a tax reason. Mapco admitted that "it did not need or use the \$4 million for any business purpose, except to create in 1966 taxable income to offset a net operating loss carryover which otherwise was scheduled to expire."³⁸ In *Schering-Plough*, it would appear difficult to conclude that Schering-Plough had absolutely no business reason for obtaining funds for its U.S. business, as discussed below.

a. Step transaction doctrine. The court tested the swap-and-assignment transactions under both the end result and mutual interdependence tests of the step transaction doctrine.³⁹ According to the court, the evidence established "that the swaps and subsequent assignments of the 1991 and 1992 transactions were pre-arranged and indispensable parts of a broader initiative." It found that all the steps "function[ed] to achieve the underlying goal of repatriating funds." The court said that the steps were not independent; rather, "the amount Schering-Plough sought to repatriate would be used to back-solve for the notional principal amount and the amount of the assignments."⁴⁰

The court's use of the step transaction doctrine to support the characterization of the transaction as a loan requires viewing the Swiss subsidiaries' lump-sum payment for the assigned swap receive legs as happening first, followed by repayment of that amount through the alleged conduit bank. This reordering of steps may be done under the step transaction doctrine, according to the court: "The step transaction doctrine includes re-ordering the steps of the transactions to illustrate the *de facto* loan structure that the Swiss subsidiaries used to pass funds to the parent corporation."⁴¹ However, the court's use of the step transaction doctrine appears

³⁷*Mapco*, 556 F.2d 1107 at 1108.

³⁸*Id.*

³⁹The court stated that the "binding commitment" test is "rarely applied" and thus did not address it. *Schering-Plough*, *supra* note 1 at *69 n.30 (D.N.J. Aug. 28, 2009).

⁴⁰*Id.* at *70-*73.

⁴¹*Id.* at *73.

³⁵*Mapco*, 556 F.2d 1107.

³⁶*Schering-Plough*, *supra* note 1.

inconsistent with previous decisions stating that the doctrine should not be used to reorder steps, but only to collapse them.⁴²

2. Economic substance. Although the court could have ended its analysis after concluding that the swap-and-assignment transactions were loans in substance, it continued its analysis to conclude that the transactions did not have economic substance.

Courts have used different interpretations of the economic substance doctrine. The Federal, First, Seventh, and Eleventh circuits apply a conjunctive test and require a transaction to have both objective economic substance (a change in the taxpayer's economic position) and a subjective nontax business purpose.⁴³ Other courts have determined that the presence of either economic substance or business purpose is sufficient to satisfy the doctrine. The Second, Fourth, Eighth, and D.C. circuits apply that disjunctive economic substance test.⁴⁴ A third approach, used by the Third, Fifth, Sixth, Ninth, and Tenth circuits, is to view economic substance and business purpose as relevant factors to consider in determining whether a transaction satisfies the economic substance doctrine.⁴⁵

The *Schering-Plough* court purported to apply the principles described by the Third Circuit in *ACM Partnership v. Commissioner*.⁴⁶ In *ACM*, the Third Circuit said that the court must look to "both the objective economic substance of the transactions and the subjective business motivation behind them."⁴⁷ Under *ACM*, these inquiries "do not constitute discrete prongs of a rigid two-step analysis, but rather represent related factors both of which inform the analysis of whether the transaction[s]

had sufficient substance, apart from its tax consequences, to be respected for tax purposes."⁴⁸

In *ACM*, the Third Circuit said that in applying the economic substance test, "we must view the transactions 'as a whole, and each step, from the commencement... to the consummation... is relevant.'"⁴⁹ In *Schering-Plough*, however, the government, citing *Coltec* and *ACM*, argued that "because it is the assignments themselves that generated the disputed tax consequences, the Court should ignore the stated business motivations behind the swap portion of the 1991 and 1992 transactions."⁵⁰ The district court agreed with the government that the assignments were the driving force behind the tax effects but said it would look to the asserted business purposes for both the swaps and the assignments. It determined, however, that the result was "largely academic, as the Court finds in any event that the asserted purposes with respect to both the swaps and assignments do not disturb its conclusion that these transactions were solely tax-motivated."⁵¹

Under the Third Circuit's economic substance test, which looks to economic substance and business purpose as "related factors both of which inform the analysis of whether the transaction[s] had sufficient substance, apart from its tax consequences, to be respected for tax purposes," it is unclear that the transaction should have been considered not to have economic substance for the reasons described below.⁵²

a. Objective economic substance. In considering whether the transactions had objective economic substance, the court in *Schering-Plough* asked "whether the transaction has any practical economic effects other than tax avoidance."⁵³ *Schering-Plough* argued that the transactions had objective economic substance because they "objectively affected [its] net economic position" by giving it additional, immediate funds. The court, however, described the argument as circular: "Schering-Plough would have the Court believe that the very tax-sheltered money it repatriated can itself provide the objective economic effect it seeks to prove." But it is unclear how *Schering-Plough's* argument is circular. *Schering-Plough* obtained cash in the transactions. For a lump sum, it traded the right to receive payments over time and the risk that those payments might decrease because of interest rate changes or a counterparty default.

The court dismissed *Schering-Plough's* argument, based on *Frank Lyon*, that the effect of the transaction on an unrelated party, such as ABN, was an important consideration in determining whether the transaction had economic substance. Referring to its determination that ABN was a mere conduit, the court said that the

⁴²*Esmark v. Commissioner*, 90 T.C. 171 (1988), *aff'd without opinion*, 886 F.2d 1318 (1989). ("Useful as the step transaction doctrine may be in the interpretation of equivocal contracts and ambiguous events, it cannot generate events which never took place just so an additional tax liability might be asserted.") *But see Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122, 207 (D. Conn. 2004), *Doc 2004-17390*, 2004 TNT 169-15 (stating that prior cases "support the Court's application of the step transaction doctrine here where, at a minimum, a clear understanding and prearrangement had been arrived at prior to OTC's contributions that OTC would exercise its put options and force LTCM to purchase OTC's partnership interest. There are no fictitious events created here only realities recognized").

⁴³*Coltec*, 454 F.3d 1340; *Deweese v. Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *United Parcel Service of Am., Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), *Doc 2001-17453*, 2001 TNT 122-5.

⁴⁴*DeMartino v. Commissioner*, 862 F.2d 400 (2d Cir. 1988); *Rice's Toyota World*, 752 F.2d 89 (4th Cir. 1985); *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), *Doc 2001-16769*, 2001 TNT 116-12; *Horn v. Commissioner*, 968 F.2d 1229, 1236 (D.C. Cir. 1992).

⁴⁵*ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *Merryman v. Commissioner*, 873 F.2d 879 (5th Cir. 1989); *Rose v. Commissioner*, 868 F.2d 851 (6th Cir. 1989); *Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990); *Keeler v. Commissioner*, 243 F.3d 1212 (10th Cir. 2001), *Doc 2001-7470*, 2001 TNT 53-71.

⁴⁶*ACM*, 157 F.3d 231.

⁴⁷*Id.* at 247 (quotations omitted).

⁴⁸*Id.*

⁴⁹*Id.* (quoting *Weller v. Commissioner*, 270 F.2d 294 (3d Cir. 1959)).

⁵⁰*Schering-Plough*, *supra* note 1 at *78 (D.N.J. Aug. 28, 2009) (summarizing government's argument on this point).

⁵¹*Id.*

⁵²*ACM*, 157 F.3d at 247.

⁵³*Schering-Plough*, *supra* note 1 at *75 (D.N.J. Aug. 28, 2009).

transactions had a “minimal impact on ABN’s net financial position beyond the reliable ten-basis-point remuneration it received for its participation.” The court disagreed that ABN had any significant credit risk in the transaction.

b. Business purpose. The court rejected Schering-Plough’s argument that it had several nontax reasons for entering into the transactions. First, Schering-Plough claimed that it had balance sheet management objectives, including acquiring cash for domestic use without incurring additional debt. The company argued that “where the taxpayer has acquired *cash* as a result of the underlying transaction, courts examine the uses of that cash (precisely what the government asks the Court to ignore) to determine if the underlying transaction had economic substance.”⁵⁴ Although the court recognized that “the repatriated cash was used to gross down the balance sheet by either paying off debt or using the money for [Schering-Plough’s] stock repurchase programs without incurring new debt,” it determined that “the use for which a disputed transaction is put is not relevant in determining whether the transaction itself has sufficient substance.”⁵⁵

The court’s assertion that “the use for which a disputed transaction is put is not relevant in determining whether the transaction itself has sufficient substance” does not appear to be a correct application of the business purpose inquiry of the economic substance test. In fact, an inquiry into the use for which a disputed transaction is put appears to be the same as an inquiry into why the transaction was conducted, which is the question to be considered in determining whether a transaction has business purpose.

The court rejected Schering-Plough’s argument that obtaining cash is a valid business purpose, relying on several cases involving corporate-owned life insurance:

Schering-Plough attempts to distinguish these cases on the ground that they focus on the manner in which tax savings from sham *deductions* was used, as opposed to the manner in which *cash* obtained from a tax-motivated transaction (as in this case) was used. But the use of tax savings through deductions and the use of cash obtained are flip sides of the same coin. In the cases cited by the government, extra money (albeit in the form of reduced tax) was obtained using deductions; here, cash was acquired from the assignments. Differentiating the tax viability of transactions based on the particular mode of the tax benefit conferred puts too fine a point on the inquiry.⁵⁶

The court, however, appears to misinterpret Schering-Plough’s argument, and therefore misses the necessary focus of the business purpose inquiry. Schering-Plough did not argue that the corporate-owned life insurance cases were distinguishable because they involved obtaining deductions, not cash. It argued that those cases were

distinguishable because Schering-Plough, unlike the taxpayers in the COLI cases, was not “pointing to any tax savings to justify the swap-and-assignment transactions.”⁵⁷ Rather, Schering-Plough argued, it “instead has focused upon the business uses for the assets Schering-Plough acquired in the underlying transactions — cash.”⁵⁸

In other words, one of Schering-Plough’s purposes for the swap-and-assign transactions was to obtain an asset (cash) that could be used in its domestic business. The purpose of the transactions was not to obtain a tax benefit that itself would be helpful for the business by leaving it with more cash post-tax. In the COLI cases, however, the taxpayers argued that the purpose of achieving a tax benefit (deductions) was itself a valid purpose if the tax savings were used for a business reason. But as the Tax Court in *Winn Dixie Stores, Inc. v. Commissioner* recognized, “if this [argument] were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, every sham tax-shelter device might succeed.”⁵⁹

Schering-Plough also argued that the transactions sought to achieve hedging and yield enhancement objectives, pointing to correspondence between the company and its financial advisers. Regarding hedging, Schering-Plough argued that it wanted to hedge against the possibility that the positive spread between LIBOR (which it earned on its foreign cash positions) and commercial paper rates (which it paid on its domestic debt) would decline. To achieve that objective, Schering-Plough said, it had entered into a swap with a LIBOR pay leg and a commercial paper receive leg. Regarding yield enhancement, Schering-Plough argued that a purpose of the 1992 swap was to enhance the yield earned by the Swiss subsidiaries on their short-term LIBOR investments by moving to a longer-term interest rate.

The court, however, determined that the evidence did not show that the swaps were undertaken to implement these objectives, and, relying on the government’s experts, determined that the transactions did not work as hedges. Much of the court’s analysis indicates disbelief that Schering-Plough had business reasons for entering into the transaction, mentioning several times that the transactions had been planned and marketed by Merrill Lynch. According to the court, “the general atmosphere under which the transactions were implemented, along with the manner in which the transactions played out in fact, suggest that cash management, hedging, and yield enhancement had no contemporaneous force behind Schering-Plough’s decision to enter into the transactions.”⁶⁰

3. ‘Assimilation with applicable tax laws’ and ‘overall intent of subpart F.’ In what the court says is an attempt

⁵⁴Schering-Plough Post-Trial Brief at *37, *Schering-Plough*, No. 05-2575, *supra* note 1.

⁵⁵*Schering-Plough*, *supra* note 1 at *81 (D.N.J. Aug. 28, 2009).

⁵⁶*Id.* at 79.

⁵⁷Schering-Plough Post-Trial Brief at *46, *Schering-Plough*, No. 05-2575, *supra* note 1.

⁵⁸*Id.*

⁵⁹*Winn-Dixie Stores Inc. v. Commissioner*, 113 T.C. 254, 287 (1993).

⁶⁰*Schering-Plough*, *supra* note 1 at *87 (D.N.J. Aug. 28, 2009).

not to “miss the forest for the trees,”⁶¹ it considers whether the transactions are inconsistent with the intent of subpart F. The court’s determination that a transaction may be recharacterized, contrary to the IRS’s own pronouncement, to fulfill Congress’s “intent” raises questions about the vitality of administrative pronouncements, such as Notice 89-21, and the results of transactions with seemingly clear consequences under the code itself.

The court notes the “powerful fact that Schering-Plough desired — from the outset — to bring \$690 million of previously untaxed foreign income back to the United States without paying an up-front tax” and states that subpart F “was specifically designed to prevent this.” In one of the most striking passages of the opinion, the district court says:

Notice 89-21 does not supplant, qualify, or displace Subpart F. The statutory scheme and the “administrative pronouncement” are not on equal footing. The former reflects congressional will, and the latter “merely represents the Commissioner’s position with respect to a specific factual situation” To the extent the IRS previously determined that consideration received in exchange for the sale of income rights under a notional principal contract should be amortized over the life of the contract, it did not do so with the purpose of granting corporate taxpayers an “out,” so to speak, from Subpart F taxation.⁶²

Thus, the court asserts that, even if a transaction is respected as a sale under substance-over-form principles, if the transaction allows “United States shareholders of controlled foreign corporations to repatriate offshore revenues without incurring an immediate repatriation tax,” the “principle” of subpart F mandates that the transaction be recharacterized to result in immediate U.S. tax.⁶³ In fact, the court says that, “insofar as Notice 89-21 could be construed to allow repatriation of income to the United States in such a way that the income is not subject to U.S. taxation,” Notice 89-21 is meaningless.⁶⁴

The court’s test apparently would conclude that an administrative pronouncement may be disregarded if a judge determines that the results of the pronouncement are inconsistent with a perceived congressional policy judgment.⁶⁵ Although the administrative pronouncement at issue in *Schering-Plough* is a notice, the IRS could attempt to apply the court’s analysis to a variety of other administrative pronouncements, including regulations, revenue rulings, revenue procedures, and announcements. Further, although the court’s analysis focuses on an administrative pronouncement’s alleged inconsis-

tency with the “policy” of section 956, it is unclear whether the case should be read as applying only in the case of section 956, subpart F, or, more broadly to all instances in which the tax results of a transaction are viewed by a court as being inconsistent with some general congressional policy. The possibility that a court could later invalidate a transaction fully consistent with published authority because it believed the results of the transactions were inconsistent with some other congressional policy could create uncertainty regarding the tax consequences of various transactions.

The court cites no precedent for its “big picture”⁶⁶ analysis. It appears to be applying a new, broader anti-abuse doctrine, referring to concepts such as “the intended scope of the Internal Revenue Code provision at issue,” “whether the notice permitted avoidance of the scheme implemented by the statute,” and Congress’s “policy judgment” and “legislative intent” in enacting subpart F. Under the district judge’s big picture test, it appears that a transaction could be recharacterized to result in different tax treatment even if the transaction satisfies code requirements, has a business purpose, and has a material impact on the taxpayer’s economic position.

For example, certain transactions, even though sanctioned by the code or administrative pronouncements, could be perceived as providing an out from subpart F under the *Schering-Plough* court’s formulation. Although we do not believe the results of these transactions should be in doubt, we describe below how *Schering-Plough* ultimately could be applied to raise questions about their vitality.

a. Example 1: Foreign-to-foreign, all-cash, repatriated. Could a *Schering-Plough* analysis be applied to challenge an all-cash, foreign-to-foreign D reorganization that results in the tax-free repatriation of cash to the United States? In this transaction, a U.S. parent corporation, USP, transfers the stock of one of its wholly owned foreign subsidiaries, CFC 1, to another of its wholly owned foreign subsidiaries, CFC 2, in exchange for cash. USP’s basis in CFC 1, which was recently acquired, is equal to the FMV of CFC 1. As part of the transaction, CFC 1 is liquidated or is deemed to liquidate by a check-the-box election. Assuming there is a good business purpose for the transaction, it should be treated as a reorganization under section 368(a)(1)(D).⁶⁷

⁶¹*Id.* at *88.

⁶²*Id.* at *89.

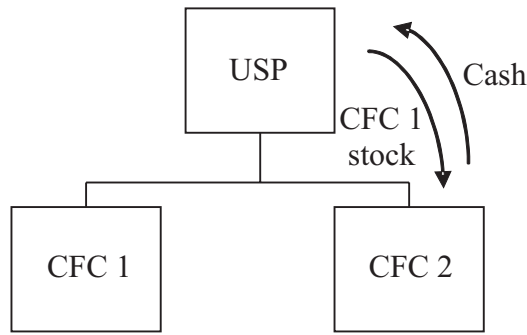
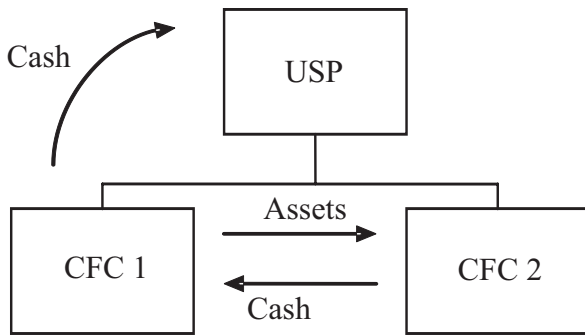
⁶³*Id.* As described above, foreign earnings are subject to tax under general corporate tax rules, not under subpart F, when distributed by corporations to their U.S. shareholders. See *supra* note 3, section 301.

⁶⁴*Schering-Plough*, *supra* note 1 at *89 (D.N.J. Aug. 28, 2009).

⁶⁵“The statutory scheme and the ‘administrative pronouncement’ are not on equal footing.” *Id.*

⁶⁶*Id.* at *88.

⁶⁷Reg. section 1.368-2(l); Rev. Rul. 70-240, 1970-1 C.B. 81; Rev. Rul. 2004-83, 2004-2 C.B. 157, *Doc 2004-14660*, 2004 TNT 138-9; see *King Enterprises*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 67-274, 1967-2 C.B. 1412.



Under section 356(a) and the “boot within gain” rule, USP’s gain is limited to its gain in the stock of CFC 1.⁶⁸ Because USP’s basis in CFC 1 is equal to the FMV of the stock of CFC 1, USP has no gain in the transaction. Cash should be repatriated without U.S. tax.

Under *Schering-Plough*, must the transaction be tested for its “assimilation” with subpart F? The transaction results in USP receiving cash from a CFC without the payment of tax — does this violate the “principle” of subpart F? Does it matter that the tax-free repatriation results from the application of a code provision rather than administrative guidance? Could a court conclude that, even if the boot-within-gain rule appears to allow for tax-free repatriation, subpart F requires that the cash be taxed?⁶⁹

b. Example 2: Section 304(a)(1) stock sale. Issues similar to those arising in an all-cash, foreign-to-foreign D reorganization may also arise in a U.S. parent corporation’s sale of the stock of one of its CFCs to another CFC. In this example, USP sells the stock of CFC 1 to CFC 2.

Under section 304(a)(1), USP generally is treated as contributing the stock of CFC 1 to CFC 2 in a section 351 transaction, followed by an immediate redemption of the CFC 2 stock received. The transaction may allow USP to repatriate cash carrying foreign tax credits while avoiding foreign withholding taxes.⁷⁰ Under *Schering-Plough*, is this transaction suspect?

c. Example 3: Checking the box on foreign subsidiaries. One purpose of subpart F was “to ensure that all passive income earned by U.S.-owned foreign corporations would be subject to current U.S. tax, whether or not such income was earned through tax haven operations.”⁷¹ With the check-the-box regulations, however,

⁶⁸Note that Obama’s fiscal 2010 budget proposal would repeal the boot-within-gain limitation in the case of any reorganization in which the acquiring corporation is foreign and the shareholder’s exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2). According to Treasury’s General Explanations of the Administration’s FY 2010 Revenue Proposals (the green book):

In cross-border reorganizations, the boot-within-gain limitation of current law can permit U.S. shareholders to repatriate previously-untaxed E&P of foreign subsidiaries with minimal U.S. tax consequences. For example, if the exchanging shareholder’s stock in the target corporation has little or no built-in gain at the time of the exchange, the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the corporation has previously untaxed profits equal to or greater than the boot. This result is inconsistent with the principle that previously untaxed E&P of a foreign subsidiary should be subject to U.S. tax on repatriation.

⁶⁹*Schering-Plough*, *supra* note 1 at *89 (D.N.J. Aug. 28, 2009) (citing Micah Levy, “Impact of the American Jobs Creation Act of 2004 on the Internal Revenue Code Section 956(c)(2)(a) Exception from U.S. Property for Deposits with Persons Carrying on the Banking Business,” 24 *Ann. Rev. Banking & Fin. L.* 295, 303 (2005)).

⁷⁰Another transaction with similar consequences would involve the sale of the stock of a first-tier CFC to its wholly owned second-tier CFC. *See* section 304(a)(2).

A different section 304 transaction that might be used to repatriate overseas profits without current tax appears to have been targeted by recent temporary regulations (temp. reg. section 1.304-4T), T.D. 9477 (Dec. 29, 2009), *Doc 2009-28422, 2009 TNT 248-3*. These regulations, however, would not change the result in the transaction described above. The preamble to the temporary regulations provides an example in which a domestic corporation that wholly owns two foreign corporations, F1 (which has no E&P) and F2 (which has E&P) forms a new foreign corporation (F3), contributes the stock of F2 to F3 in exchange for F3 stock, and then, in a transaction subject to section 304(a)(1), transfers the stock of F3 to F1 for cash. Because neither F1 (the acquiring corporation) nor F3 (the newly formed issuing corporation) has E&P, the U.S. parent reports the cash received as a return of basis under section 301(c)(2) rather than as a dividend. This type of transaction might be used to repatriate earnings without including a dividend in income. The temporary regulations previously applied to “deemed acquiring corporations” only. New temp. reg. section 1.304-4T maintains the antiavoidance rule for deemed acquiring corporations and adds a new antiavoidance rule for deemed issuing corporations. New temp. reg. section 1.304-4T makes both antiavoidance rules self-executing (unlike the antiavoidance rule for deemed acquiring corporations, which was applicable at the discretion of the district director). The preamble notes, “No inference is intended as to the potential applicability of other Code or regulatory provisions of judicial doctrines (including step transaction or substance over form) to transactions described in the regulations.” With *Schering-Plough* and *Coltec*, however, is the new regulation even necessary?

⁷¹Office of Tax Policy, Department of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, A Policy Study (2000), at 14.

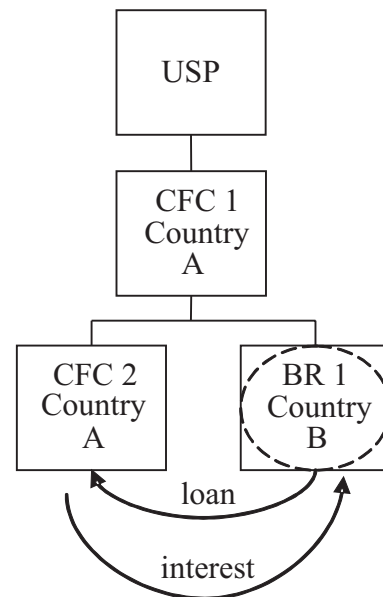
subpart F taxation of passive income may be avoided through the use of disregarded entities.

The use of disregarded entities to avoid subpart F income can be illustrated with a transaction described in Notice 98-11.⁷² In this transaction, CFC 1 owns all of the stock of CFC 2. Both are incorporated in Country A. CFC 1 also owns BR 1, a Country B hybrid entity that is classified as a corporation for Country A and Country B purposes. CFC 1 elects to treat BR 1 as a disregarded entity for U.S. tax purposes. BR 1 makes a loan to CFC 2, and CFC 2 pays interest to BR 1. For U.S. tax purposes, the loan is treated as made by CFC 1 to CFC 2, and the interest is treated as paid from CFC 2 to CFC 1. The same-country exception of section 954(c)(3) applies to exclude the interest from subpart F income.

If a *Schering-Plough* analysis is used, can the principle of subpart F override the check-the-box regulations and require taxation of the passive income? One could argue that the transaction involves the use of an administrative pronouncement (the check-the-box regulations) to opt out of subpart F.

Even if CFC 1 had not checked the box to treat BR 1 as a disregarded entity, the look-through rule of section 956(c)(6) might apply so that the interest was not subject to U.S. taxation under subpart F. Does Congress's passage of the look-through rule of section 956(c)(6) suggest that the transaction between disregarded entities should withstand a *Schering-Plough* analysis?⁷³ What if Congress allows the look-through rule to expire?

What if CFC 1 checked the box to treat CFC 2 as a disregarded entity? In that case, the loan and interest payments between CFC 2 and BR 1 would be disregarded for U.S. tax purposes. Can a *Schering-Plough* analysis be used to regard a transaction that is otherwise disregarded?



d. Example 4: Check and sell. In *Dover Corp. v. Commissioner*,⁷⁴ the taxpayer's CFC elected to treat a foreign subsidiary as a disregarded entity. The CFC then sold the ownership interests in that entity. The taxpayer argued that, after the check-the-box election, the CFC should be deemed to have sold the assets of the subsidiary, not the stock of the subsidiary, and should be considered to have been engaged in its subsidiary's trade or business. Further, the taxpayer argued that this sale of assets should be excluded from subpart F income under reg. section 1.954-2(e)(3)(ii) through (iv). Under the applicable regulations, property that does not give rise to income includes tangible property used or held in the CFC's trade or business, some real property to the extent used or held for use in the CFC's trade or business, and intangible property to the extent used or held in the CFC's trade or business.

The Tax Court determined that the taxpayer should be treated as having held or used in a trade or business the subsidiary assets deemed liquidated in the check-the-box election. Further, the court held that the sale of the ownership interests should be treated as a deemed asset sale. As a result, the deemed sale of the assets was not treated as foreign personal holding company income under section 954.

Under a *Schering-Plough* analysis, is the check-the-box election (and deemed liquidation) inconsistent with the purposes of subpart F? Could a court view the statutory scheme (subpart F) and the administrative pronouncement (the check-the-box regulations) as "not on equal footing," and determine that, because the check-the-box regulations allowed the taxpayer to avoid an income inclusion under section 954, the purposes of subpart F should prevail and the transaction should be taxable?

⁷²Notice 98-11, 1998-1 C.B. 433, *Doc 98-2983*, 98 *TNT* 12-8, *withdrawn*, Notice 98-35, 1998-2 C.B. 34, *Doc 98-20115*, 98 *TNT* 119-6. Note that Obama's 2010 budget proposal would limit the use of foreign disregarded entities. Under the proposal, a foreign entity could be treated as a disregarded entity only if the owner of the entity and the entity are organized in the same country. The proposal "generally" would not apply to a first-tier entity wholly owned by a U.S. person, "except in cases of U.S. tax avoidance." Treasury green book, *supra* note 68, at 28.

⁷³Under the look-through rule, dividends, interest, rents, and royalties are not treated as foreign personal holding company income when received by one CFC from a related CFC, to the extent the income is attributable or properly allocable to income of the payer that is neither subpart F income nor effectively connected with a U.S. trade or business. Thus, in this case, even if CFC 1 had not checked the box to treat BR 1 as a disregarded entity, it is likely that the interest would not be subject to U.S. taxation because of the look-through rule. Congress enacted section 956(c)(6) to "allow U.S. companies to reinvest their active foreign earnings where they are most needed" without incurring U.S. tax. H.R. Rep. No. 109-304, at 45 (2005).

⁷⁴*Dover Corp. v. Commissioner*, 122 T.C. 324 (2004), *Doc 2004-9660*, 2004 *TNT* 88-15.

e. Example 5: Temporary investments in U.S. property. Under Notice 2008-91, Notice 2009-10, and Notice 2010-12, for purposes of section 956, a CFC may exclude from the definition of “obligation” an obligation held by the CFC that would constitute an investment in U.S. property if the obligation is collected within 60 days from the time it is incurred.⁷⁵ Under a *Schering-Plough* analysis, can a CFC rely on Notice 2008-91 to temporarily hold an obligation that would otherwise constitute an investment in U.S. property?

In *Schering-Plough*, the court said that, “To the extent the IRS previously determined [in Notice 89-21] that consideration received in exchange for the sale of income rights under a notional principal contract should be amortized over the life of the contract, it did not do so with the purpose of granting corporate taxpayers an ‘out,’ so to speak, from Subpart F taxation.” In Notice 89-21, the IRS did not address whether it intended to give taxpayers an out from subpart F. The purpose of Notice 2008-91, however, is to give taxpayers an out from subpart F. Should this change the analysis?

f. Example 6: The Limited and purposive readings of subpart F. In *The Limited Inc. v. Commissioner*, a CFC owned by a U.S. corporation (USP) bought certificates of deposit from a U.S. corporation (US Sub) that was 100 percent owned by USP. US Sub’s business involved issuing credit cards to customers. USP took the position that the certificates of deposit qualified under the “deposits with persons carrying on the banking business” exception provided in section 956(b)(2)(A).⁷⁶

The Tax Court held that the certificates of deposits were not “deposits with persons carrying on the banking business.” After examining the legislative history of section 956, the Tax Court determined that the term “the banking business” meant “a group of activities carried on to aid the domestic business activities of controlled foreign corporations.”⁷⁷ The court concluded that US Sub was “a special purpose institution that is not of much use to a foreign business customer seeking banking services except as the issuer of a private-label credit card or as the recipient of large deposits of funds that are not needed immediately. Those are insufficient services for us to conclude that [US Sub] was ‘carrying on the banking business’ as Congress used that phrase in section 956(b)(2)(A).”⁷⁸ The Tax Court also said that Congress

did not intend for the section 956(b)(2)(A) exception to apply to deposits made with related persons and that a related party prohibition was “explicit in the exception for section 956 deposits.”⁷⁹

The Sixth Circuit reversed, stating that the Tax Court should have looked first to the plain meaning of the statute.⁸⁰ “Construing undefined terms in accordance with their ordinary and natural meanings,” the court of appeals held, US Sub was “carrying on the banking business.”⁸¹ Regarding the related-persons issue, the Sixth Circuit said, “it is not the Tax Court’s role to inject its own policy determinations into the plain language of statutes.”

Under *Schering-Plough*, how does one interpret an exception to section 956 in light of the purposes of subpart F? Does *Schering-Plough* suggest a purposive reading of subpart F, an approach that generally has been rejected by courts?⁸² Does taking into account the purposes of subpart F require a narrow reading of exceptions?

III. Economic Substance, Future of Tax Planning

After the Federal Circuit’s decision in *Coltec*, practitioners criticized that court’s application of the economic substance doctrine to individual steps as “untenable” and “a troubling expansion of the court’s authority [with] the potential to undo the tax consequences in numerous legitimate transactions.”⁸³ Despite that criticism, the individual steps approach has been adopted by additional courts and asserted by the government in litigation as the proper standard.

It is too early to know with certainty whether the “assimilation with applicable tax laws” test in *Schering-Plough* will go the direction of *Coltec*’s “the transaction to be analyzed is the one that gave rise to the alleged tax benefit” test or whether the decision ultimately will be viewed as an outlier district court decision. However,

⁷⁹*Id.* at 189. The Tax Court also said, “Petitioner has offered no policy reason why Congress would permit deposits (particularly deposits for an indefinite period) with a related bank but prohibit investments in a related corporation.” *Id.*

⁸⁰*The Limited Inc. v. Commissioner*, 286 F.3d 324 (6th Cir. 2002), *Doc 2002-8860*, 2002 TNT 71-10.

⁸¹*Id.*

⁸²*See Dover Corp.*, 122 T.C. 324; *Ludwig v. Commissioner*, 68 T.C. 979 (1977) (holding that a U.S. shareholder’s pledge of CFC stock as collateral for a loan did not make the CFC a guarantor of the loan under section 956); *Brown Group v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), *Doc 96-2911*, 96 TNT 19-6 (“Although our holding may result in a tax windfall to the Brown Group due to the particularized definition of ‘related person’ under the pre-1987 version of section 954(d)(3) of the Internal Revenue Code, such a tax loophole is not ours to close but must rather be closed or cured by Congress.”); *Vetco v. Commissioner*, 95 T.C. 579 (1990) (holding that a wholly owned subsidiary of a CFC was not a branch within the meaning of section 954(d)(2), despite the IRS’s argument that the “branch rule intended as a broad loophole-closing device to prevent the use of multiple foreign countries to take advantage of lower tax rates in those countries” and thus could include subsidiaries).

⁸³Silverman et al., “A New Form of Obscenity?” *supra* note 6.

⁷⁵Notice 2008-91, 2008-43 IRB 1001, *Doc 2008-22166*, 2008 TNT 202-8; Notice 2009-10, 2009-2 IRB 267, *Doc 2009-811*, 2009 TNT 9-15; Notice 2010-12, 2010-4 IRB 1, *Doc 2009-28354*, 2009 TNT 247-2. Notice 2010-12 extended the application of Notice 2008-91 to tax years beginning before January 1, 2011. Notice 2008-91 applied to the first two tax years of a foreign corporation ending after October 3, 2008. Notice 2009-10 extended the relief to the third consecutive tax year of a foreign corporation, if any, that ends after October 3, 2008, and on or before December 31, 2009.

⁷⁶In 2004 Congress amended section 956 to limit the exception to deposits with a bank holding company or a corporation owned by a bank holding company. *See* section 956(c)(2)(A).

⁷⁷*The Limited Inc. v. Commissioner*, 113 T.C. 169, 186 (1999), *Doc 1999-29280*, 1999 TNT 173-5.

⁷⁸*Id.* at 188.

Schering-Plough raises important questions about anti-abuse doctrines, especially in light of the potential for economic substance codification. Further, the case may set the framework for debate about antiabuse doctrines and how they should be viewed by the IRS, tax practitioners, and taxpayers. The case may also cause one to consider, in light of the differing applications of anti-abuse doctrines — particularly the economic substance doctrine — whether it is time for the Supreme Court to weigh in again on tax antiabuse doctrines.

A. Codification of Economic Substance

Codification of the economic substance doctrine continues to appear in legislative tax proposals, including Obama's 2010 budget proposal and the House's health-care reform bill.⁸⁴ It appears that, despite protest by practitioners,⁸⁵ business organizations,⁸⁶ professional organizations,⁸⁷ academics,⁸⁸ and IRS officials,⁸⁹ the economic substance doctrine is likely to be codified in 2010.

Bills proposing codification have contained major ambiguities and have failed to address several critical issues. Rather than clarify the economic substance doctrine, the proposed legislation, if enacted, would create uncertainty regarding when and how the doctrine should be applied. Further, because the proposed codification does not address when courts should apply the economic substance doctrine, cases such as *Schering-Plough* could be relevant to a court's determination of whether a transaction is subject to the doctrine.

Congress should carefully consider the potential negative effects of economic substance codification on tax administration and compliance and consider whether these effects outweigh the revenue that may be raised.⁹⁰

⁸⁴*E.g.*, Tax Reduction and Reform Act of 2007, H.R. 3970 (2007); *see supra* note 14.

⁸⁵*See, e.g.*, "Steptoe & Johnson Attorneys Repeat Their Plea for Noncodification of Economic Substance Doctrine," *Doc 2005-23306*, 2005 TNT 220-20.

⁸⁶*See, e.g.*, Tax Executives Institute, "TEI Urges Rejection of the Economic Substance Provisions in the Senate Farm Bill," *Doc 2008-5544*, 2008 TNT 51-40.

⁸⁷Letter from Erika W. Nijenhuis, Chair, New York State Bar Association, to Senate Finance Committee Chair Max Baucus, D-Mont., and ranking minority member Chuck Grassley, R-Iowa, and House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., and ranking minority member Dave Camp, R-Mich. (Sept. 22, 2009), *Doc 2009-21110*, 2009 TNT 182-25.

⁸⁸*See, e.g.*, Prof. Dennis J. Ventry Jr., "Save the Economic Substance Doctrine From Congress," *Tax Notes*, Mar. 31, 2008, p. 1405, *Doc 2008-5227*, or 2008 TNT 63-33.

⁸⁹*See, e.g.*, Crystal Tandon, "Economic Substance Codification Would Create More Problems Than it Solves, Says Korb," *Tax Notes*, Feb. 18, 2008, p. 777, *Doc 2008-3288*, 2008 TNT 32-3. However, William J. Wilkins, IRS Chief Counsel, supports the codification of the economic substance doctrine. Amy S. Elliot, "IRS Seeks New Disclosure Policy for Uncertain Tax Positions," *Tax Notes*, Nov. 2, 2009, p. 509, *Doc 2009-23642*, 2009 TNT 206-3.

⁹⁰The JCT has estimated that codification of the economic substance doctrine and an accompanying penalty for underpayments attributable to transactions lacking economic substance in H.R. 3962, the Affordable Health Care for America Act, would raise \$5.7 billion over 10 years. JCT, Estimated Revenue Effects of the Revenue Provisions Contained in H.R. 3962, JCX-53-09

(Footnote continued in next column.)

Moreover, before economic substance is codified, Congress should consider amending its proposals to ameliorate these potential negative effects.

1. The Senate version of economic substance codification. The Farm, Nutrition, and Bioenergy Act of 2007 (the Senate bill) proposed to codify the economic substance doctrine by adding new code section 7701(p).⁹¹ Proposed section 7701(p) provides that a transaction would have economic substance only if: (1) the transaction changes "in a meaningful way (apart from Federal tax effects) the taxpayer's economic position," and (2) the taxpayer has a "substantial purpose (apart from Federal tax effects) for entering into such transaction." Transactions would not be treated as having economic substance solely by reason of pretax profit unless the present value of the reasonably expected pretax profit was substantial in relation to the present value of expected net federal tax benefits. In determining pretax profit, fees and other transaction expenses would be taken into account. Foreign taxes would be taken into account to the extent provided by Treasury. Financial accounting benefits could not be used to establish a substantial purpose if their origin is a reduction of federal tax. Also, taxpayers would not be treated as having a substantial purpose if the only purpose of a transaction was the reduction of nonfederal taxes and the transaction would result in a reduction of federal taxes substantially equal to or greater than the reduction in nonfederal taxes because of similarities between the laws imposing the taxes.

a. The Senate Finance Committee report. The Finance Committee report (the Senate report)⁹² on the Farm, Nutrition, and Bioenergy Act of 2007 further explains the economic substance codification proposal. According to that report, "if the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision."⁹³ This sentence may be intended to state that the codification of the economic substance doctrine should not require a court to test every transaction under the doctrine. However, the language used does not make this point clear. First, the phrases "clearly consistent," "all applicable provisions," and "purposes of such provisions" are ambiguous. It is unclear whether these phrases are intended to elevate

(Nov. 6, 2009), *Doc 2009-24634*, 2009 TNT 215-16. An earlier bill with similar provisions by Rangel was scored by the JCT at \$3.6 billion for the same period. *See* H.R. 3200, 110th Cong. (2007). The Senate version of economic substance codification and the penalty for understatement attributable to transactions lacking economic substance in H.R. 2419, the Farm, Nutrition, and Bioenergy Act of 2007, was been estimated to raise \$10.012 billion over 10 years. Senate Finance Committee, Farm Bill Tax Title Summary, H.R. 2419 (Dec. 14, 2007). We understand the revenue estimate is due in large part to "no fault" penalty provision (discussed below) included in the proposals.

⁹¹H.R. 2419, Farm, Nutrition, and Bioenergy Act of 2007, 110th Cong. (2007).

⁹²*See* S. Rep. No. 110-206 (2007).

⁹³*Id.* at 92.

“purpose” over the words of the statute. If so, how does one determine the purpose of the statute? By reference to legislative history, context, or something else? Who decides what the purpose of the statute is? If a transaction is within the letter of the law but results in a tax benefit not intended or not contemplated by Congress, is the transaction inconsistent with the “purpose” of “all applicable provisions?”

Further, under a *Schering-Plough* analysis, the “purpose” of “all applicable provisions” could be interpreted as requiring analysis of provisions and purposes other than those affecting the technical characterization of the transaction. For example, in *Schering-Plough*, section 956 and subpart F did not affect whether the swap-and-assignment transactions should be treated as a sale or a loan. Rather, section 956 dictated the tax consequences if the transactions were recharacterized. In such a case, should section 956 and subpart F be considered part of “all applicable provisions?” Also, does the Senate report’s reference to “all applicable provisions of the Code” mean to refer only to the provisions of the Internal Revenue Code, or must the tax benefits be clearly consistent with administrative pronouncements?

Although the “clearly consistent” standard is likely intended to be a sort of safe harbor from the newly codified economic substance test, it could result in courts analyzing the additional question whether the tax benefits are clearly consistent. Some commentators have recommended that Congress incorporate the “clearly consistent” standard in statutory language.⁹⁴ If this is done, however, additional issues will arise in interpreting the statute. For example, does a taxpayer have to prove that the tax benefits are clearly consistent? Does the taxpayer also have to prove the purpose of all applicable provisions? Is clearly consistent a higher standard of proof than a preponderance of the evidence? Is the IRS’s view that a tax benefit is not clearly consistent entitled to deference?

The Senate report says that new section 7701(p) “is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advan-

⁹⁴Monte A. Jackel, “Farming for Economic Substance: Codification Fails to Bear Fruit,” *Tax Notes*, Apr. 7, 2008, p. 59, *Doc 2008-5380*, 2008 TNT 68-49.

The Senate codification proposal also fails to incorporate into the proposed statutory language the exception set forth in the Finance Committee report for ‘transactions that are clearly consistent with all applicable provisions of the Code and the purposes of such provisions.’ It would be preferable if this language is expressly incorporated into the statutory language itself so that it would have the force of law and would not be viewed by the courts as a nonbinding expression of congressional intent. Guidance on the meaning and scope of this provision will need to be provided, either by Congress in a later draft of the proposal or by Treasury and the IRS, hopefully before the proposal is enacted into law and applied by a court.

tages.”⁹⁵ The report then gives several “illustrative” examples, including: (1) the choice between capitalizing a business with debt or equity, (2) the choice between foreign corporations and domestic corporations, (3) the treatment of a transaction or series of transactions as a corporate organization or reorganization under subchapter C, and (4) the ability to respect a transaction between related parties provided the arm’s-length standard of section 482 is satisfied.

If Congress indeed intends that economic substance codification not alter the tax treatment of “basic business transactions,” it should consider adding similar language to the text of the statute. Congress should recognize, however, that the phrase “basic business transactions” is ambiguous and will likely cause disputes. Lawmakers may wish to instruct Treasury to promulgate regulations on the meaning of “basic business transactions,” and could provide general principles to Treasury in committee reports.

Congress also could consider providing a statutory “angel list” of transactions, the tax treatment of which is not intended to be altered by economic substance codification. Further, Congress could provide Treasury the authority to promulgate such a list. However, the possibility of an angel list would raise several issues: What does it mean if a transaction is not on the angel list? Should the transaction automatically be subject to challenge under the economic substance doctrine? Would a transaction’s absence from the angel list carry a negative presumption, or would substantially similar transactions also be exempted?

Alternatively, a more viable approach might be to apply economic substance codification only to transactions identified by the IRS as abusive. For example, the proposal could apply only to listed transactions, including those conducted before the date they were officially “listed” by the IRS. Also, the IRS could supplement the list as abusive transactions are identified, or it could be given the authority to challenge transactions substantially similar to those listed.

Another troubling aspect of the Senate report is its endorsement of the courts’ ability to focus solely on the transaction giving rise to the alleged tax benefit by breaking a larger transaction into individual steps and applying the economic substance test to each step. The report states that:

the provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax motivated benefits.⁹⁶

By using the word “reiterate,” the Senate report appears to accept disaggregation of the steps of a transaction as a

⁹⁵S. Rep. No. 110-206, at 92 (2007).

⁹⁶*Id.* at 93; see also *Coltec*, 454 F.3d 1340. (“The transaction to be analyzed is the one that gave rise to the alleged tax benefit.”)

correct application of the economic substance doctrine.⁹⁷ If the doctrine is codified and that language is included in the legislative history, it is likely the IRS and courts will point to this discussion as support for a disaggregation approach to the economic substance doctrine. Congress should consider whether its statement about “not alter[ing] a court’s ability” is intended as an endorsement of the disaggregation approach.

Proposed section 7701(p) requires that the transaction change the taxpayer’s economic position in a “meaningful way,” but the Senate report does not provide further clarification about what would be a “meaningful” change. In *Schering-Plough*, the taxpayer received a lump sum and transferred the right to receive payments tied to a floating interest rate. Is trading an uncertain amount for a definite amount a meaningful change?

Under proposed section 7701(p), transactions would not be treated as having economic substance solely by reason of pretax profit unless the present value of the reasonably expected pretax federal tax profit is substantial in relation to the present value of expected net federal tax benefits. The Senate report does not clarify what is “substantial” in this context, nor does it provide guidance on how a court should calculate reasonably expected pretax federal profit. In fact, the Senate report says that “the provision does not require or establish a specified minimum return that will satisfy the profit potential test.”⁹⁸ Congress should provide further guidance, however, especially if Treasury is left to write regulations on how to determine if pretax profit is substantial compared with tax benefits. For example, should the test be numerical? The Senate report also fails to elucidate rules or standards for how a court should determine pretax profit, including the discount rate that should be used to determine present value, the time period over which expected profit from the transaction should be measured, and how to determine what a taxpayer “reasonably expected.”

Under the proposed economic substance test, taxpayers also would be required to have “a substantial purpose (apart from Federal tax effects) for entering into such transaction.” Again, the meaning of “substantial” is unclear. The Senate report does cite reg. section 1.269-2(b) and *ACM* in a footnote, but neither of those sources provides much guidance.⁹⁹ Reg. section 1.269-2(b) states, in relevant part:

Distortion [in tax liability] may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of

the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases.

The meaning of the Senate report’s reference to reg. section 1.269-2(b) is unclear: Does it intend to simply suggest that the “substantial purpose” requirement means the taxpayer must have a business purpose (“germane to the conduct of the business of the taxpayer”)? Reg. section 1.269-2 describes the “purpose and scope of section 269.” In general, section 269 disallows the tax benefits of some transactions if the principal purpose of the transaction was tax avoidance. Under section 269, “if the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose.”¹⁰⁰ As a result, under section 269 a taxpayer can still have a tax-motivated purpose, as long as that purpose does not exceed other purposes. Is the substantial purpose test a test for whether tax avoidance was the principal purpose?

The Senate report also refers to the following statement by the Tax Court in *ACM*:

Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and useful in light of the taxpayer’s economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.¹⁰¹

The Senate report’s reference to this quotation raises several issues. First, “rationally related,” “plausible,” and “useful” do not appear to be particularly stringent standards. Is this what the Senate means by a “substantial” purpose? Also, the “utility of the purpose” and the “rationality of the means” are to be evaluated by examining “commercial practices in the relevant industry.” In many cases, entering into certain tax-favorable transactions may be consistent with commercial practices in an industry. For example, many banks have entered into FTC generator transactions, and it is likely that many banks claim a business purpose of achieving a profit

⁹⁷The use of the word “reiterates” is confusing because it is unclear how the proposed statutory provision itself even addresses this issue. Perhaps the “reiteration” is implicitly found in proposed section 7701(p)(4), which states that “except as specifically provided in this subsection, the provisions of this subsection shall be construed as altering or supplanting any other rule of law, and the requirements of this subsection shall be construed as being in addition to any such other rule of law.”

⁹⁸S. Rep. No. 110-206, at 93 (2007), *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, Doc 97-6453, 97 TNT 44-17.

⁹⁹*Id.* at 94 n.136.

¹⁰⁰Reg. section 1.269-3(a).

¹⁰¹S. Rep. No. 110-206 at 94 n.136 (citing T.C. Memo. 1997-115).

through investment.¹⁰² If other taxpayers engage in similar transactions and have similar purported business purposes, is a taxpayer more likely to have a “substantial nontax purpose,” because the stated purpose and means are common in an industry.

2. The House version of economic substance codification. The House passed a provision codifying the economic substance doctrine in its healthcare reform bill, America’s Affordable Health Choices Act of 2009.¹⁰³ As in past House provisions proposing economic substance codification, the bill would add a new section 7701(o), which would provide:

In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.¹⁰⁴

This House provision slightly differs from the Senate version, which applies “in any case *in which a court determines* that the economic substance doctrine is relevant,” although it is unclear whether any substantive difference is intended. Both the House version (in the text of the proposed statute)¹⁰⁵ and the Senate version (in the Senate report)¹⁰⁶ state that codification is not intended to change when a court should apply the doctrine.

Like the Senate version, the House version of economic substance codification would look to whether the present value of the reasonably expected pretax profit from the transaction is substantial in relation to the

present value of the expected net tax benefits. The House version would require foreign taxes, as well as fees and other transaction expenses, to be taken into account as expenses in determining pretax profit, while the Senate version would require foreign taxes to be taken into account to the extent provided in regulations.

a. JCT report. The House Ways and Means Committee has not yet released a committee report on economic substance codification. The Joint Committee on Taxation, however, described the House version of economic substance codification in a report on the revenue provisions in America’s Affordable Health Choices Act of 2009.¹⁰⁷

The JCT report contains many of the same ambiguities as the Senate report. Like the Senate report, the JCT report says that codification is not intended to alter the tax treatment of basic business transactions. It also states that the provision does not alter a court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction.

3. Penalties. Both the House and Senate versions of economic substance codification would impose a penalty on transactions held to lack economic substance. The Senate version would apply a 30 percent penalty to nondisclosed transactions and a 20 percent penalty to disclosed transactions, while the House version would apply a 40 percent penalty to nondisclosed transactions and a 20 percent penalty to disclosed transactions. Under both versions, the penalty would be strict liability (that is, the penalty would have no exception for reasonable cause).

One important difference between the House and Senate versions of the economic substance penalty is that the House version applies to underpayments, while the Senate version applies to understatements. The term “underpayment” is used as the measure for the accuracy-related penalties and fraud penalty of sections 6662 and 6663, respectively. The Senate version would apply the penalty to the amount of an “understatement,” which is used as the amount against which accuracy-related penalties for listed and reportable avoidance transactions are applied.

An understatement generally is the increase in taxable income resulting from the “proper” treatment of the transaction multiplied by the highest applicable tax rate. By basing the penalty on the understatement, the Senate penalty provision may subject a taxpayer to a large penalty even if the taxpayer does not actually owe additional tax (for example, if a loss carryover would apply).

The House version of the economic substance penalty would apply to “a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.”¹⁰⁸ It is unclear what constitutes a similar rule of law — the sham transaction doctrine? Substance over form? Business purpose? The *Schering-Plough* “assimilation with applicable tax laws” test? Or must the similar rule of law

¹⁰²See, e.g., Complaint, *Am. Int’l Group v. United States*, No. 09-cv-1871 (S.D.N.Y. Feb. 27, 2009):

In the regular course of its general business activities, AIG-FP seeks to make a profit by borrowing funds at economically favorable rates, preferably below the London Interbank Offered Rate (‘LIBOR’), and by investing the funds at economically favorable rates, preferably above LIBOR. As part of their regular business activities, AIG-FP and its affiliates often invest in privately placed preferred shares expecting to realize profits from those investments. AIG-FP engaged in the transactions described in paragraphs 9-154 below to achieve one or more of those benefits and thereby generate a profit for the company.

¹⁰³H.R. 3200, 111th Cong. (2009).

¹⁰⁴*Id.*, section 452.

¹⁰⁵“The determination of whether the economic substance doctrine is relevant to a transaction (or series of transactions) shall be made in the same manner as if this subsection had never been enacted,” “Description of the Revenue Provisions of H.R. 3200, the ‘America’s Affordable Health Choices Act of 2009,’” JCX-30-09. JCT, “Description of the Revenue Provisions of H.R. 3200, the ‘America’s Affordable Health Choices Act of 2009,’” JCX-30-09 (July 14, 2009) (hereinafter JCT report), *Doc 2009-15985, 2009 TNT 133-13*.

¹⁰⁶“The provision does not change current law standards used by courts in determining *when* to utilize an economic substance analysis.” S. Rep. No. 110-206 at 92.

¹⁰⁷JCT report, *supra* note 105.

¹⁰⁸H.R. 3200, 111th Cong., section 452 (2009).

be a rule provided by the code or regulations, such as specific antiabuse rules? If “any similar rule of law” is intended to refer to antiabuse rules, the statute should list specific rules intended to be incorporated. Better yet, this language should be eliminated from the statute so that the penalty applies only to transactions found to lack economic substance.

The JCT report on the revenue-raising provisions in America’s Affordable Health Choices Act of 2009 states: “For example, the penalty would apply to a transaction that is disregarded as a result of the application of the same factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.”¹⁰⁹ However, this statement is unhelpful in determining what “any similar rule of law” might constitute. The statement is illustrative (“for example”), so other types of “similar rule[s] of law” could exist. Further, the report does not explain which “factors and analysis” are relevant. An analysis of whether a transaction has business purpose requires some of the same analysis as the economic substance test, so should any transaction found not to have a business purpose be subject to a strict liability penalty?

The Senate version of economic substance codification provides that “only the Chief Counsel [or, if delegated, a branch chief within the Office of Chief Counsel] for the Internal Revenue Service may assert a penalty imposed under this section or may compromise all or any portion of such penalty.”¹¹⁰ To assert the penalty, chief counsel must provide the taxpayer with a notice of intent to assert the penalty and “an opportunity to provide to the Commissioner a written response to the proposed penalty within a reasonable period of time after such notice.” If the Senate rule on penalty assertion is enacted, Treasury and the IRS will need to devote resources to developing procedures on how the penalty is asserted, how the taxpayer must respond, and how the IRS must evaluate the taxpayer’s response. In any event, the required procedures are likely to require the IRS to devote substantial resources to analyzing and justifying the application of the penalty.

The Senate bill also provides for limits on chief counsel’s ability to compromise a penalty, limiting the amount compromised to the extent the underlying understatement on which it is asserted is also compromised. This provision would likely limit the IRS’s ability to compromise on cases involving the economic substance doctrine, and thus may increase the number of cases proceeding to litigation.

It is unclear why the penalty applied to transactions found to lack economic substance should be higher and stricter than other penalties. A transaction motivated by a substantial business purpose could still fail a conjunctive economic test if the transaction does not change the taxpayer’s economic position in a “meaningful way.” Should that transaction automatically be subject to a 40 percent penalty? Also, it is unclear why a taxpayer who

acted in good faith and reasonably attempted to comply with the law should be penalized for entering into a transaction that fails to satisfy an ambiguous standard. As the American Institute of Certified Public Accountants said in its recent report on the need for reform of civil tax penalties, “penalties should not treat taxpayers who make a good faith effort to comply with the tax laws as harshly as those taxpayers who deliberately violate the law.”¹¹¹ Rather, the tax law should encourage voluntary compliance by lowering penalties for taxpayers that make reasonable attempts to comply with the law. Penalties that are “overbroad, vaguely defined, and disproportionate . . . particularly those administered as a part of a system that automatically imposes penalties or that otherwise fails to provide basic due process safeguards, create an atmosphere of arbitrariness and unfairness that is likely to discourage voluntary compliance.”¹¹²

B. Potential Supreme Court Review

The economic substance doctrine is based on various Supreme Court decisions, but the Court itself has never articulated an economic substance test labeled as such.¹¹³ Perhaps, in light of the differing standards among the federal courts in applying the economic substance doctrine, such as the broad antiabuse standard created in *Schering-Plough*, it is time for the Supreme Court to provide instruction on the application of the doctrine.

Several recent economic substance cases have been appealed to the Supreme Court. For example, Coltec Industries Inc. filed a petition for a writ of certiorari on January 12, 2007.¹¹⁴ The first question for review related to whether the economic substance doctrine should be applied conjunctively or disjunctively:

Where a taxpayer made a good-faith business judgment that the transaction served its economic interests, and would have executed the transaction regardless of tax benefits, did the courts of appeals (in acknowledged conflict with the rule of other circuits) properly deny the favorable tax treatment afforded by the Internal Revenue Code to the transaction based solely on the court’s ‘objective’

¹¹¹AICPA, “Report on Civil Tax Penalties: The Need for Reform,” *Doc 2009-22955*, 2009 TNT 199-103.

¹¹²*Id.*

¹¹³See Silverman et al., “Establishing Business Purpose in a Transparent World,” *supra* note 6.

¹¹⁴Petition for a Writ of Certiorari, *Coltec Industries Inc. v. United States*, No. 06-659, *Doc 2006-23232*, 2006 TNT 221-16. The Dow Chemical Co. filed a petition for a writ of certiorari relating to *Dow Chemical v. United States* on October 4, 2006. The questions presented were: (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,” and (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.” Petition for a Writ of Certiorari, *Dow Chemical Co. v. United States*, No. 06-478, *Doc 2006-21019*, 2006 TNT 197-15.

¹⁰⁹JCT report, *supra* note 107, at 49 n.130.

¹¹⁰H.R. 2419, 110th Cong., section 12521 (2007).

conclusion that a narrow part of the transaction lacked economic benefits for the taxpayer?

The second question presented for review asked:

In determining that a transaction may be disregarded for tax purposes, should a federal court of appeals review the trial court's findings that the transaction had economic substance *de novo* (as three courts of appeals have held), or for clear error (as five courts of appeals have held)?

If the Supreme Court does grant certiorari in an economic substance case (assuming a particular test has not yet been codified by Congress), it may wish to (1) adopt one of the circuit courts' tests as properly reflecting prior Supreme Court precedent, (2) reconcile prior case law into one unified doctrine, or (3) provide a new direction for the doctrine by articulating a new test. In deciding which approach to take, potentially relevant considerations include:

- What standard of review should courts of appeal use when reviewing trial court decisions in economic substance cases?
- As an initial matter, when should the test be applied? Is it relevant in every case, or only when the taxpayer's asserted tax results appear to conflict with congressional intent in enacting the provisions that allow for the favorable tax result?
- If the taxpayer has a valid nontax business purpose, is "objective economic substance" relevant?
- To what extent must a court evaluate an asserted business purpose? Should a court evaluate only whether an asserted business purpose was actually a purpose at the time of the transaction, or should a court evaluate the merits of the business purpose (that is, should courts defer to or second guess a "business judgment")?
- If objective economic substance is a relevant consideration, how should it be determined? How are risk, profit expectation, expenses, cost of funds, and nonfederal taxes relevant, if at all?

C. IRS Treatment of Economic Substance

The economic substance doctrine is a powerful tool for the IRS, and practitioners have expressed concern that it will use the doctrine to challenge more routine business transactions, especially if the doctrine is codified.¹¹⁵ IRS officials have answered that they do not intend to challenge routine transactions. For example, former IRS Chief Counsel Donald Korb said, "The sky is not fall-

¹¹⁵Silverman et al., "A New Form of Obscenity?" *supra* note 6; see also Amy S. Elliott, "IRS Office of Chief Counsel Previews Priorities for Coming Year," *Tax Notes*, Nov. 2, 2009, p. 511, *Doc 2009-23866*, or *2009 TNT 208-5* (stating that Louis Freeman, a tax partner at Skadden, Arps, Slate, Meagher & Flom LLP, asserted that it is the chief counsel's responsibility to exercise restraint in the economic substance codification process so normal corporate tax planning transactions are not affected).

ing. . . . The IRS will not assert the economic substance doctrine to challenge legitimate transactions."¹¹⁶

During his time as chief counsel, Korb said that the IRS should use discretion in invoking the economic substance doctrine:

It is very important for [the IRS] to exercise discretion in determining whether to utilize an economic substance argument in any particular case. The doctrine of economic substance is not [to] be used as a general antiabuse rule raised in every case where the taxpayer receives tax benefits that the IRS views as unintended or just because we do not like the transactions. Let me repeat that by saying it another way: the economic substance doctrine should be used only rarely and judiciously.¹¹⁷

Similarly, Korb said, "The IRS will not use the economic substance doctrine to challenge real transactions that are in accord with Congressional intent, simply because they generate tax benefits."¹¹⁸ However, *Schering-Plough* raises questions about how congressional intent in one area of the tax law should be weighed against an administrative pronouncement in another area of the tax law. Although one might respond that the transactions in *Schering-Plough* were not "real" transactions, the court apparently would have found for the government based only on its "assimilation with applicable tax laws" test, even if it determined that the transactions were "real" transactions properly treated as sales.¹¹⁹

The *Schering-Plough* "assimilation with applicable tax laws" test could be a powerful tool for the IRS. If the government promotes this test in litigation, as it has done with *Coltec*,¹²⁰ and courts adopt it, great uncertainty could be created regarding the vitality of administrative pronouncements and the treatment of transactions that appear to have clear consequences under the code, as

¹¹⁶Donald Korb, former IRS Chief Counsel, Remarks at the 2007 University of Southern California Tax Institute, "What a Difference Two Years Make!" (Jan. 23, 2007), *Doc 2007-1883*, *2007 TNT 16-65*.

¹¹⁷Korb, Remarks at the 2005 University of Southern California Tax Institute, "The Economic Substance Doctrine in the Current Tax Shelter Environment" (Jan. 25, 2005), *Doc 2005-1540*, *2005 TNT 16-22*. Korb cited favorably a coordinated issue paper on notional principal contracts, which instructs agents that "discretion must be exercised in determining whether to utilize an economic substance argument in any case . . . even in those cases when it is appropriate to raise the argument, economic substance should only be asserted as a secondary or tertiary argument, following any appropriate technical arguments." IRS Coordinated Issued Paper, Notional Principal Contracts (Jan. 6, 2005), *Doc 2005-708*, *2005 TNT 7-14*.

¹¹⁸Korb, "What a Difference Two Years Makes!" *supra* note 117.

¹¹⁹"To the extent the IRS previously determined that consideration received in exchange for the sale of income rights under a notional principal contract should be amortized over the life of the contract, it did not do so with the purpose of granting corporate taxpayers an 'out,' so to speak, from Subpart F taxation." *Schering-Plough*, note 1 *supra* at *89 (D.N.J. Aug. 28, 2009).

¹²⁰See *supra* note 12.

discussed above. One could argue that IRS agents and attorneys should, and are perhaps obligated, to zealously use every available argument to ensure that potentially noncompliant taxpayers pay their fair share. Still, by applying the economic substance doctrine rarely and judiciously, the IRS could better formulate its technical arguments and prevent inconsistent decisions and continued uncertainty in the application of antiabuse doctrine and the IRS's own administrative pronouncements.

D. Considerations for Taxpayers and Tax Advisers

Given IRS wins in many recent economic substance cases, the courts' apparent skepticism of taxpayers' motivations in these cases, and the likelihood of economic substance codification, tax advisers and taxpayers are well-advised to study current developments regarding the economic substance doctrine. Although recent trends raise several questions regarding how taxpayers and tax practitioners should proceed, considering some overall principles should help taxpayers and practitioners navigate the current environment.

1. Questions about tax practice. Courts in several recent economic substance cases could be criticized as substituting their own business judgment for that of the taxpayer. For example, in *Coltec* the court apparently accepted the taxpayer's argument that it had a business objective for using the subsidiary in the transaction but rejected the taxpayer's contention that the transfer of liabilities to the subsidiary was necessary to further these business objectives. When an outside tax adviser is considering opining on a transaction, to what extent should the adviser scrutinize the taxpayer's business purpose? Is a specific and reasonable business purpose enough, or, given the recent trend of skepticism by courts, should the practitioner accept only business purposes meeting some higher standard?¹²¹ Is it realistic for a tax practitioner to advise a taxpayer that all transactions must emerge from a nontax function of the business? If a transaction emerges from the tax function of a business but is supported by a nontax function and management of the business, is the business purpose for the transaction still somehow tainted?

It also is unclear whether, given recent trends in case law, tax practitioners must analyze whether every transaction, or even every step in every transaction, has economic substance and business purpose. *Schering-Plough's* "assimilation with applicable tax law" test raises further questions. For example, in a foreign-to-foreign all-cash D reorganization, is it enough that the taxpayer has a good business purpose for the transaction? Or must a practitioner analyze whether the transaction is incon-

sistent with the purposes of subpart F? Under *Coltec* and *Schering-Plough*, is the transfer of cash to the U.S. parent subject to extra scrutiny?

In light of the likely codification of the economic substance doctrine and the accompanying no-fault penalties, the future of opinions in tax practice also may be in question. It is unclear to what extent taxpayers will seek opinions for penalty protection when a transaction found to lack economic substance will be subject to an automatic 40 percent penalty, with no exception for reasonable cause and good faith. The reasonable cause and good faith exceptions would still be available, however, for some other accuracy-related penalties. As a result, a tax practitioner presumably could opine on whether a transaction had economic substance, and that opinion could be used for protection against, for example, the penalty for negligence or disregard of rules or regulations. But the practitioner's determination that the transaction had economic substance would have no effect on the imposition of a penalty on a transaction found to lack economic substance.

It also is unclear what effect the codification of a no-fault economic substance penalty will have on the standards of tax practice under Circular 230. For example, a tax practitioner "must inform a client of any penalties that are reasonably likely to apply to the client with respect to (i) a position taken on a tax return if (A) the practitioner advised the client with respect to the position; or (B) the practitioner prepared or signed the tax return."¹²² How does a practitioner determine if the penalty for transactions found to lack economic substance (or failing to meet "any other similar rule of law") is "reasonably likely to apply," especially given the varying interpretations of the economic substance doctrine? Must the practitioner apply *Coltec* or *Schering-Plough* or both?

2. Practical considerations for taxpayers and tax advisers. Several recent economic substance cases highlight the courts' skepticism about purported business purposes for tax-favorable transactions that are brought to the taxpayer by outside advisers. For example, in *Schering-Plough* the court emphasized the involvement of outside advisers in bringing the transaction to Schering-Plough, designing the transaction, and assisting Schering-Plough in implementing the transaction, including by liaising with swap counterparty ABN. Tax departments should be wary of marketed transactions, especially if the transaction is a "solution" looking for a problem for justification. If a transaction has an accompanying acronym (FLIPS, BLIPS, BOBS, etc.), taxpayers also should be wary. If considering a marketed or acronym transaction, tax departments should not rely solely on the legal analysis of a promoter and may wish to engage additional advisers to conduct an independent review of the transaction.

Tax departments should develop a standard routine for considering and analyzing transactions. This routine should include coordination with and between business

¹²¹See Circular 230 section 10.35(c)(ii). ("It is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits.") *Id.*, section 10.35(c)(iii). (A "practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete.")

¹²²*Id.* section 10.34(c)(1).

units, the general counsel, the chief tax officer, senior corporate officers, the executive committee, and, when appropriate, the board of directors. Minutes or notes documenting these proceedings should be routinely maintained.

Tax is a necessary business consideration. Tax considerations should not be hidden. Rather, corporate memoranda and correspondence, including e-mails, should consider and discuss both tax and nontax issues. Tax departments should approach transactions as if there were no privilege or doctrines protecting documents or personnel, and they should operate as if every relevant document is going to be turned over to the IRS. At the same time, however, tax departments should be familiar with document protection doctrines and how they are established and waived. Tax departments should consider involving in their tax planning a person with tax controversy/litigation expertise to advise on possible litigation and document protection issues.

When preparing opinions and memoranda in connection with a transaction, tax practitioners must carefully consider the tax and nontax reasons for the transactions. Facts should be fully developed. Further, written documents should address the business purposes of the transaction and analyze the possible economic substance issues raised by the transaction.

IV. Conclusion

The novel “assimilation with applicable tax laws” test offered by the U.S. District Court For the District of New Jersey in *Schering-Plough* raises questions about the ability of the IRS and courts to recharacterize transactions to fulfill a “purpose” of the tax law. Further, the court’s application of the economic substance doctrine, while purporting to apply Third Circuit precedent that looks at both business purpose and objective economic substance, appears to ignore the transfer of benefits and burdens and downplays several real business purposes, representing a further reach of the economic substance doctrine.

The “assimilation with applicable tax laws” test should not follow the path of *Coltec*. Transactions clearly

authorized by the code and regulations and supported by Supreme Court precedent should withstand IRS scrutiny, despite the questions raised by *Schering-Plough*. These transactions include, for example, section 304 transactions, reorganizations (undertaken for a valid business purpose) involving the application of section 356 and the “boot within gain” rule, choosing entity classification in accordance with the check-the-box regulations, and sales of property at a loss.¹²³ Even if some transactions are done exclusively or predominantly for tax reasons but there are real economic changes resulting from those transactions, they should be respected.¹²⁴

When deliberating codification of the economic substance doctrine, Congress should consider clarifying its proposals so that novel antiabuse tests, such as *Schering-Plough*’s “assimilation with applicable tax laws” test, are not read into the legislation by the IRS or by courts as relevant to when the economic substance doctrine is applied or read as “any similar rule of law” that, if found to be violated, can lead to a no-fault penalty. Congress should also consider the potentially negative tax administration and compliance issues that may result from codification of the economic substance doctrine. In particular, Congress should consider whether it is appropriate to impose a substantial no-fault penalty for transactions that do not satisfy the vagaries of the economic substance doctrine or the undefined “any similar rule of law.” If a taxpayer has acted in good faith and reasonably attempted to comply with the tax law, the taxpayer should not automatically be subject to a 40 percent penalty for failing to anticipate the novel tests of the next *Coltec* or *Schering-Plough*.

¹²³See Silverman et al., “A New Form of Obscenity?” *supra* note 6, for a discussion of various transactions which should withstand IRS challenge.

¹²⁴For example, these transactions might include a corporation increasing its stock ownership in a subsidiary to 80 percent to fall within section 332 or using a partnership to avoid the unified loss rules of the consolidated return regulations.