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ECONOMIC SUBSTANCE

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Table of Contents

Economic Substance Codification

- On March 30, 2010, the Health Care and Education Reconciliation Act of 2010, H.R. 4872 (the "Health Care Reconciliation Act") was signed by President Obama.
  - Section 1409 of the Health Care Reconciliation Act "codified" the economic substance doctrine (the "ES doctrine").
  - The statute adds new subsection 7701(o), "Clarification of Economic Substance Doctrine."
  - The statute provides for a strict liability penalty for transactions that lack ES.
- The statute generally applies to transactions entered into after the date of enactment. See section 1409(e) of the Health Care Reconciliation Act.

Economic Substance Codification

- The Health Care Reconciliation Act does not as a technical matter codify the ES doctrine but rather codifies standards for the ES doctrine, if the doctrine is first determined to be "relevant." Further, the provision imposes penalties, which is a critical feature of the enactment.
- The codification ultimately results from a combination of influences: (1) it carries a $4.5B revenue estimate (over 10 years) and so was used to help offset the cost of the health care bill, of which it was a part; (2) eliminates differences among courts in applying the ES standard; (3) politically it is viewed as part of a crack down on abusive taxpayers; and (4) it was a political football, first in favor during the last days of the Clinton administration, then out of favor during the Bush administration, then Senator Obama co-sponsored one of the earlier bills in 2007, then it passed during the Obama administration, after having been included in the President's 2010 Budget proposal.
- The most thorough official review of the ES doctrine and codification proposals is in JCS-3-09 (Sept. 2009) Description of Revenue Provisions in 2010 Budget, Part Two, pp. 34-72 ("JCT 9/09").
- The JCT explanation was continuously refashioned as various bills were introduced, ultimately resulting in JCX-18-10 (3/21/2010), with the final bill; see also H. Rep. No. 111-443 (3/17/2010) (describing a prior version of the ES provision, and less detailed, but containing a "reasons for change" section).

Economic Substance Codification

The JCT 9/09 Description stated the goals of codification as follows:

- provide partial certainty by resolving the lack of uniformity in different judicial versions of the tests;
- possibly lead to more IRS success in asserting ES doctrine by overruling courts that require taxpayers to satisfy only one "prong" of test;
- increase level of profit and business purpose required relative to some tests stated by courts;
- not change the "existing judicial framework" under which applicability of ES doctrine is determined;
- no intent to modify the application or development of other interpretive rules or prevent the IRS from proceeding on multiple grounds;
- change taxpayers' cost-benefit analysis and deter some aggressive taxpayer behavior; and
- not displace the common law ES doctrine in cases to which the statute is inapplicable (such as individual non business/investment activities).

Economic Substance Codification

- The statute does not contain certain provisions that were included in prior versions:
  - A statement that other common law doctrines are not affected by codification of the ES doctrine,
  - A grant of general authority to issue regulations to carry out the purposes of the codified ES doctrine,
  - A revision of the penalty rules for certain large and publicly-traded corporations,
  - A prerequisite that a court determine that the ES doctrine is relevant, and
  - A requirement that IRS Chief Counsel assert the strict-liability penalty (which applied to understatements rather than underpayments).

Economic Substance – Section 7701(o)

New Section 7701(o)

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—

(1) APPLICATION OF DOCTRINE.—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.

(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—

(A) IN GENERAL.—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) TREATMENT OF FEES AND FOREIGN TAXES.— Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.

New Section 7701(o)

(3) STATE AND LOCAL TAX BENEFITS.—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS.—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

> (A) ECONOMIC SUBSTANCE DOCTRINE.— The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.
>
> (B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.
>
> (C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.
>
> (D) TRANSACTION.—The term 'transaction' includes a series of transactions.

Notice 2010-62

Notice 2010-62

- On September 13, 2010, the IRS issued Notice 2010-62, which provides interim guidance under section 7701(o).

IRS Position on Section 7701(o) Guidance

- Notwithstanding concerns regarding the need for guidance on section 7701(o), the IRS and Treasury "do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply."
- Further, the IRS will not issue a private letter ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o).
- Notice 2010-62 provides that "the IRS will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o)."
  - Thus, according to the IRS, if authorities provided that the economic substance doctrine was not relevant to whether certain tax benefits were allowable prior to the enactment of section 7701(o), the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.
  - However, an IRS official recently warned that the economic substance doctrine may be relevant in cases in which the IRS has not previously raised economic substance or considered it in a private letter ruling.
- The IRS anticipates that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop, and states that the codification of the economic substance doctrine should not affect the ongoing development of authorities on this issue.

Application of Conjunctive Test

- In Notice 2010-62, the IRS states that it will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1).
- The IRS will challenge taxpayers who seek to rely on prior case law for the proposition that a transaction will be treated as having economic substance because it satisfies either prong of the two-prong test.

Notice 2010-62

Reasonably Expected Pre-Tax Profit

- Under section 7701(o)(2)(A), a transaction's profit potential is taken into account in determining whether the two-prong economic substance test is met if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected for tax purposes.
  - According to Notice 2010-62, the IRS will apply existing relevant case law and other published guidance in performing this calculation.
- The IRS and Treasury also intend to issue regulations pursuant to section 7701(o)(2)(B) on the treatment of foreign taxes as expenses in determining pre-tax profit in appropriate cases.
  - In the interim, the IRS notes in Notice 2010-62 that the enactment of section 7701(o) does not restrict the ability of courts to consider the appropriate treatment of foreign taxes in economic substance cases.

Accuracy-Related Penalties

- Notice 2010-62 provides details on what constitutes adequate disclosure under section 6662(i) for purposes of reducing the no-fault penalty from 40 to 20 percent.
- The disclosure will be considered adequate under section 6662(i) if made on a Form 8275 or 8275-R, or in a manner consistent with Rev. Proc. 94-69.
- If a transaction lacking economic substance is a reportable transaction, the adequate disclosure requirement under section 6662(i)(2) will be satisfied only if (i) the taxpayer meets the disclosure requirements described above, and (ii) the disclosure requirements under the section 6011 regulations.

When Does the Doctrine Apply -- In General

- A number of considerations must be taken into account in applying the ES doctrine –
  - Whether the ES doctrine is relevant
    - Does the transaction tested satisfy the terms of the Code and Treasury regulations
    - Whether the benefits claimed are consistent with a Congressional purpose or plan
    - What step(s) of the transaction are to be tested
    - Whether any “safe harbors” can be applied
    - Whether the transaction has been respected under longstanding judicial and administrative practice, based on meaningful economic alternatives based on comparative tax advantages
    - Whether the transaction falls under the exception for individual transactions
  - How the IRS will audit transactions and assert the ES doctrine in light of codification
  - Where the burden of proof will fall on the taxpayers and the IRS
  - Whether it is the ES doctrine that may be relevant (as, for example, compared to other judicial doctrines)

- If the ES doctrine is determined to be relevant, then it must be decided whether the transaction satisfies the codified ES statute:
  - The taxpayer’s economic position must change in a meaningful way
  - The taxpayer must have a substantial non-tax purpose

When Does the Doctrine Apply -- In General

- Definition of ES doctrine
  - The statute defines the ES doctrine as the "common law doctrine" under which benefits "under subtitle A" are not allowable if the transaction does not have "economic substance or lacks a business purpose." (emphasis added.) See section 7701(o)(5)(A).
  - What is the purpose of this definition? The statute says that the determination of whether the ES doctrine is relevant shall be made as if the statute was never enacted. See section 7701(o)(5)(C).

When Does the Doctrine Apply – Congressional Plan or Purpose

- The statute does not define when the doctrine will be treated as relevant.
- Statute and JCT report (JCX-18-10) states that "[t]he determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted."
  - The JCT report further confirms that the provision "does not change present law standards in determining when to utilize an economic substance analysis."
- Footnote 344 in the JCT report states that "[i]f the realization of the tax benefits of a transaction <u>is consistent</u> with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed." (emphasis added.)
  - JCT reports for prior versions of ES codification used the term "clearly consistent."
  - In effect, the "safe harbor" defines the ES doctrine as applying to tax benefits that IRS perceives not to be consistent with purposes of the particular Code provision the taxpayer relies on for the tax benefits.

When Does the Doctrine Apply – Congressional Plan or Purpose

- What does being consistent with Congressional purpose or plan mean?
  - Congress may not use language that reflects its intent and purpose.
  - Without an explicit statement by Congress, its intent and purpose may be defined narrowly or broadly.
  - Will the IRS view all benefits that are “unintended” or even “not contemplated” by Congress to be inconsistent with Congressional purpose and intent and subject to the ES doctrine?
  - If a taxpayer satisfies the technical requirements of the Code and regulations, should the ES doctrine apply if no clear statutory purpose or plan is circumvented?
- How does the IRS agent determine the intent or plan?
  - Rev. Proc. 64-22, 1964-1 C.B. 689: “It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is “protecting the revenue.” The revenue is properly protected only when we ascertain and apply the true meaning of the statute.”
  - “The proper method for conveying the positions of the Office and the policies of the Service is through published guidance. In contrast, litigation should be used as an enforcement tool to advance and defend established positions, not as a vehicle for making policy.” I.R.M. 31.1.1.1.3(1).

When Does the Doctrine Apply – Congressional Plan or Purpose

Application of the ES doctrine to landmark cases won by taxpayers:

- *Cottage Savings Assn. v. Commissioner,* 499 U.S. 554 (1991): Overall transaction of mortgage pool interest swaps had no possible economic profit and no business purpose; motivated entirely by desire for tax benefit of loss recognition, and losses were not booked for accounting purposes. [may be an allowed "longstanding choice" discussed below]
- *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), aff'd 886 F.2d 1318 (7th Cir. 1989): Overall transaction had business purpose and economic effect, but arguably not the steps by which Mobil purchased Esmark stock from public, followed by stock's redemption for stock of Vickers subsidiary of Esmark; not economically different from sale of Vickers by Esmark.
- *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953): No business purpose to distribute preferred pro rata on common, with plan for preferred to be bought by friendly insurance company. Ruled for taxpayer; Congress had to change law (section 306).
- *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950): Same overall business purpose as in *Gregory v. Helvering*, but no business purpose for step of distributing assets before their sale, allegedly by shareholders; no economic impact of steps on either corporation or shareholders other than tax reduction.
- *Frank Lyon v. United States*, 435 U.S. 561 (1978): Business purpose for Lyon's seller/lessee (the bank) not to have borrowed the money and built its own building; alleged lease economically similar to that result; no economic savings but tax savings.
- *Gitlitz v. Commissioner*, 531 U.S. 206 (2001): Taxpayer allowed to deduct presumably real losses on account of phantom income providing basis; is this protected from ES doctrine simply because taxpayer and S corp. did not engage in any "transaction" that they could control in the year at issue? Should the timing of the discharge of indebtedness of the S corp in that year have been questioned?

<u>When Does the Doctrine Apply - Certain Credits</u>

- The JCT report (JCX-18-10) footnote 344 further provides that “it is not intended” that certain tax credits (*e.g.*, section 42, 45, 45D, 47, and 48 credits) be disallowed in a transaction “pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.”
  - The footnote does not cite, but is similar to Rev. Rul. 79-300 (section 183 not applicable to low income housing partnership even though cannot make any money, but depends on tax benefit of losses).
- Does the structure of the investment or the taxpayer’s intent matter if an investment encouraged by Congress is made?
- Does the same standard for credits apply for deductions and other tax benefits?

When Does the Doctrine Apply – “Safe Harbors”

- According to the JCT report: “The provision 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 advantages. Among these basic transactions are[:]

  (1) the choice between capitalizing a business enterprise with debt or equity;

  (2) a U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;

  (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and

  (4) the choice to utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied.”

- What does the choice between <u>meaningful economic alternatives</u> require?
- Will the IRS expand the list of “safe harbor” transactions?
- Noteworthy that these four “safe harbors” provide taxpayers with the ability to avoid or defer US tax.
- Often, these “safe harbors” may form part of a larger transaction that will (or will not) pass the two prong test in the codified ES statute.

When Does the Doctrine Apply – “Safe Harbors”

1. The choice between capitalizing a business enterprise with debt or equity --
   - The use of debt is the biggest “tax shelter” there is, due to the interest deduction; why is it excluded? What does this say about perceived Congressional view of debt? Will this be useful in future debt/equity disputes? Does it matter that the creditor is related (not according to later “safe harbor”)?
   - Note that the “safe harbor” applies to using debt to capitalize an entity rather than the use of debt in transactions that the IRS has viewed as “tax shelters” – e.g., *Knetsch*; *Rice’s Toyota*; *ACM*.
   - What is a “business enterprise”? Is the term limited to entities or does it include sole proprietorship -- what if the undertaking being financed is an investment and not a business?
   - Does this “safe harbor” support the disaggregation approach since capitalizing a business enterprise may form part of an integrated transaction that passes the two prong test?
2. A U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
   - Once again, this “safe harbor” shows the ES doctrine dodging the 2nd biggest “tax shelter”: the ability to defer tax on foreign income.
   - Does this mean that the “reality” of foreign corporations will be unquestioned?
     - JCX-18-10 fn. 347 indicates *Bollinger* applies to prevent subsidiary from being parent’s agent except for specific cases.

When Does the Doctrine Apply – "Safe Harbors"

3. The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;
   - How does this square with IRS position when it cites *Caruth*, 688 F. Supp. 1189, for "business purpose" requirement for section 351?
   - How about Mrs. Gregory, cited in footnote 348 in JCX-18-10?
   - JCX-18-10 justifies this "safe harbor" by fact that IRS Chief Counsel will not give comfort rulings on these transactions.
   - Does the "choice" for tax-free treatment include transactions structured to avoid such treatment?
   - Are the reasons for protecting reorganizations and organizations the same? Corporate reorganizations are subject to several case law and regulatory anti-abuse rules, and could be viewed as exempt from the economic substance doctrine for that reason. Conversely, a thin set of authority purports to require business purpose for section 351 exchanges and the Treas. Reg. § 1.701-2 anti-abuse rule applies to partnership formation.
   - What about Treas. Reg. § 1.1002-1 strict construction for nonrecognition rules?

When Does the Doctrine Apply – "Safe Harbors"

4. The choice to "utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied."
   - Why are not all related party transactions particularly suspect?
     - This "safe harbor" appears inconsistent with *Coltec* analysis.
   - Is a related party partnership safer to use than a related party corporation?
   - Doesn't section 482 rule for intangibles assume that arm's length prices cannot be trusted between related parties?
   - Does ES doctrine defer totally to section 482?
   - Who determines whether the arm's length standard and the applicable concepts are satisfied – the IRS, a court?
   - Footnote 349 in JCX-18-10 cites to *National Carbide* and *Moline Properties* and contrasts *Aiken Industries* (back-to-back loans); section 7701(l) and the conduit regulations; and *Bollinger* (losses imputed to shareholder from nominee corporation).
     - Are these examples of the "other applicable concepts" referred to in the footnote?
     - <u>Note</u> Reg. 1.881-3(a)(4) (being related is primary way to trigger conduit financing regs)
     - How about *Gregory*, *Higgins v. Smith* (sale of loss property to wholly-owned corporation), *McWilliams* ("indirect" sales of loss shares between related parties)?

When Does the Doctrine Apply -- Disaggregation

- The statute defines the "transaction" as including a series of transactions.
- The JCT report supports not only the aggregation of a series of steps but also a disaggregation of multiple steps to an isolated step.
- According to the JCT report: "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."
  - The statute as enacted does <u>not</u> provide for a disaggregation approach.
  - The JCT report endorses the *Coltec* approach to disaggregating a transaction in contrast to other authorities. <u>Cf</u>. Notice 98-5; <u>but see</u> *Shell Petroleum* 2008-2 USTC ¶ 50,422 (S.D. Tex. 2008) (refused "slicing and dicing").
  - Does the JCT report accurately summarize how courts have historically applied the ES doctrine?
    - If not, can the disaggregation approach be squared with the general principle that "present law standards" of applying the ES doctrine not be changed?
    - The IRS will likely assert a narrow definition of the transaction.
    - Will the IRS approach and legislative history lead courts to shift toward a disaggregate approach (<u>i.e.</u>, will a court be more likely to disaggregate post-codification as compared to prior periods)?
    - <u>See</u> *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010) (only the portion of the transaction that gave rise to the loss should be evaluated for economic substance; this is the first appellate case after codification but did not refer to the statute).

If the ES Doctrine is Determined to be Relevant The Two Prong Test -- The Objective Component

- The transaction must change the taxpayer's economic position in a meaningful way (apart from Federal income tax effects). See section 7701(o)(1)(A).
- The taxpayer can rely on profit potential to satisfy the objective prong only if the "present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." See section 7701(o)(2)(A).
  - Satisfaction of the substantial net profit standard in section 7701(o)(2)(A) does not ensure that objective component is met.
  - Note that can rely on profit potential if profit is "reasonably expected" but need to show "actual" economic change to satisfy the objective prong.
  - What else would a taxpayer be required to show? Can a taxpayer satisfy the prong without actual profit?
  - See *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010) (1:50 profit potential to tax savings not enough on relative basis; this is the first appellate case after codification but did not refer to the statute).

The Two Prong Test -- The Objective Component

- A taxpayer may rely on measures other than profit potential to establish that the objective prong is satisfied.
  - When would a taxpayer need to rely on an alternative measure to show meaningful change in economic position?
    - Examples given in JCS-3-09, but not in the final JCT explanation: financial transactions and reorganizations may not have quantifiable profit aims.
      - A tax free-reorganization should already fall within the “safe harbor” in the JCT report.
      - What about “financial transactions”? Wouldn’t this normally refer to straddles, hedges, notional principal contracts?
    - Transactions designed to claim tax credits may also present difficulties in proving a pre-tax profit.
      - Like tax-free reorganizations, however, these transactions may have another basis to avoid ES analysis (*i.e.*, consistent with statutory intent and plan).
  - If necessary, how would a taxpayer show a meaningful change in economic position absent profit potential?

The Two Prong Test -- The Objective Component

- Reliance on pre-tax profit
  - How much profit is required?
    - There is no absolute minimum dollar amount of profit required.
    - However, a small amount of profit may not be treated as substantial in relation to the tax benefits claimed.
  - What does "reasonably expected" mean?
    - JCS-3-09, p. 45, indicates intended to be higher standard than "reasonable possibility," used in Rice's Toyota;
    - Note: "reasonable possibility" is too high a standard for section 183, which requires only "objective to make a profit"
  - How to calculate present value amounts?
    - What is the appropriate discount rate?
    - Can the taxpayer rely on its normal internal method?
  - What does it mean for net profit to be "substantial" relative to net Federal tax benefits?
    - Treas. Reg. § 1.170A-9(f) defines substantial as 1:3.
    - Notice 98-5 – 1:12 and ~ 1:8 deemed insubstantial.
    - Old "tax shelter" cases in 1980s – any amount of profit may be sufficient
    - *Con Ed* decided on relatively small profit.

<u>The Two Prong Test -- The Objective Component</u>

- <u>Reliance on pre-tax profit (con't)</u>
  - Fees and transaction expenses must be counted in determining net pre tax profit. <u>See</u> section 7701(o)(2)(B).
    - Consistent with historic approach to ES doctrine.
  - Statute provides that the Secretary "shall" issue regulations to treat foreign taxes as expenses and transaction fees in "appropriate cases."
    - Treatment of foreign taxes changed repeatedly during days up to codification: "shall be" treated as expenses, to no reference, to "shall" treat in appropriate cases.
    - JCT explanation (JCX-18-10) indicates belief that foreign taxes should be treated as expenses.
      - However, there is no clarity as to what the "appropriate cases" will be. Transactions described in Notice 98-5?
      - The "shall" delegation in the statute should not be treated as self-executing. <u>But</u> <u>see</u> footnote 357 in JCX-18-10.
    - <u>Cf</u>. Notice 98-5: proposed to deny foreign tax credits to transactions that were not entered into for profit and to deduct foreign taxes as an expense in that analysis; withdrawn by Notice 2004-19.
    - <u>Contra</u> *Compaq* and *IES*, which applied ES doctrine to pre-foreign tax profits.
      - Theory is that US taxes are not counted, and so neither should foreign taxes that are creditable.

The Two Prong Test --
The Subjective Component

- The taxpayer must have a substantial purpose (apart from Federal income tax effects) for entering into such transaction. See section 7701(o)(1)(B).
  - What was original purpose of this prong in the caselaw? (likely to protect transactions such as incorporation that could not logically be related to profit motive?) Has this purpose been lost?
  - Do courts treat the subjective prong as equal to the objective prong?
  - JCT viewed this as the "dominant issue" and an "absolute requirement." JCT 9/09
- The taxpayer can rely on the substantial net profit standard to satisfy the subjective prong as well as the objective prong. See section 7701(o)(2)(A).
  - Can the two prongs be collapsed into a single prong? See *Coltec Industries Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006); *Consolidated Edison Co. v. United States*, 90 Fed. Cl. 228 (2009).
  - Note that, as with the objective prong, the satisfaction of the substantial net profit standard technically does not ensure that the subjective prong is satisfied.
    - Is anything else needed to be shown?
  - If there is no substantial non-tax purpose for the transaction, but the transactions results in a substantial profit, is the subjective prong satisfied?
- Who is the taxpayer tested for subjective intent?
  - For example, a partner in a partnership should be the taxpayer. What if the activities or motive in question relate to the other partner or the partnership?

The Two Prong Test -- The Subjective Component

- What does “substantial” mean?
    - Compare Reg. section 1.701-2(a)(1), the partnership anti-abuse rule, requires a transaction be entered into for a substantial business purpose;
    - Cf. Reg. section 1.355-2(b)(1), which in effect requires a substantial business purpose for a spin-off: a “substantial part” business purpose is thought not to require either a primary or more than 50% purpose; 1/3 purpose seems sufficient.
    - Cf. Reg. section 1.355-2(b)(2), as to non Federal tax benefits.
- Financial accounting benefits derived from Federal income tax savings and state tax benefits that are related to the Federal tax benefits will not be accepted.
  - Accounting benefit concern derived from Enron usage of accounting profits attributable to additions to deferred tax asset account for future expected acquisition of depreciable property, for example.
- Closer to core business the better?
  - Compare *Consolidated Edison Co. v. United States*, 90 Fed. Cl. 228 (2009) (LILO case won where property leased was used in same business Con Ed was in); *Shell Petroleum, Inc. v. United States*, 2008-2 USTC ¶ 50,422 (S.D. Tex 2008) (property sold was business property)
  - But section 7701(o) says nothing about usual course of business transactions.
    - Query: does not fact that Congress chose to make the test a profits test, and to allow it to satisfy both prongs indicate that Congress understands all businesses and investors intend to make money any way they can, and so there should be no “regular course of business” test? Cf. section 162.

ES Doctrine
Individual Exception

- The statute carves out transactions of individuals unless “entered into in connection with a trade or business or an activity engaged in for the production of income.”
  - As a technical matter, section 7701(o)(5)(B) only excludes “personal transactions” from the two prong test set forth in section 7701(o)(1).
  - Thus, the ES doctrine, as codified, technically can still apply to these transactions. What is the effect?
- The exception presumably would not cover transactions where there is an expectation of gross income (as in section 212)
  - Thus, section 212, the section 183 hobby loss rule, and ES doctrine can all apply to activity expected to produce gross income
  - Note that section 183 is much easier for taxpayer to prove out of than ES doctrine (need not even have reasonable expectation of profit)
- Does the exception cover transactions designed to reduce taxes?
  - Charitable contribution planning
  - Estate planning

Economic Substance –
Strict Liability Penalty

ES Codification -- Penalties

Section 6662(b)(6) (20% accuracy-related penalty)

Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

Section 6662(i) -- INCREASE IN PENALTY IN CASE OF NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTION

(1) IN GENERAL.—In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.—For purposes of this subsection, the term 'nondisclosed noneconomic substance transaction' means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

(3) SPECIAL RULE FOR AMENDED RETURNS.—In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.

ES Codification -- Penalties

Section 6664(c)(2):

Paragraph (1) [reasonable cause exception for underpayments] shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).

Section 6664(d):

(2) EXCEPTION.—Paragraph (1) [reasonable cause exception for reportable transaction understatements] shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6)

Section 6676(c) (erroneous claim for refund penalty):

(c) NONECONOMIC SUBSTANCE TRANSACTIONS TREATED AS LACKING REASONABLE BASIS.—For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.

Section 6662A(e)(2) (coordination of section 6662A penalty with 40% nondisclosed noneconomic substance transaction penalty)

This section [section 6662A] shall not apply to any portion of an understatement on which a penalty is imposed under section 6662 if the rate of the penalty is determined under subsections (h) or (i) of section 6662.

<u>ES Codification -- Penalties</u>

- The 20% penalty for noneconomic substance transaction applies to any underpayment attributable to the disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or *failing to meet the requirements of any similar rule of law*.
  - What is "any similar rule of law"? Not defined in the statute.
  - <u>See</u> JCX-18-10, fn 359: "It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar 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."
    - Prior JCT reports did not contain this clarification.
    - Based on JCT report, a "similar rule of law" must mean the disallowance of tax benefits through application of the ES doctrine but not in name (e.g., where the court referred to the ES doctrine incorrectly (perhaps "sham transaction doctrine" or "business purpose doctrine").
    - The phrase "similar rule of law" should not mean "sham transaction doctrine" or even lack of "economic substance," when those terms actually refer to fact finding (for example, the business was not actually operated in the corporation), or if they refer to interpreting a requirement into the statute ("business purpose doctrine") as in case of *Gregory v. Helvering*.
    - Beware of tendency of IRS to view all fact finding methods (step transaction doctrine, etc.) and interpretive methods as "similar rule of law."

ES Codification -- Penalties

- 20% Strict Liability Penalty
  – An opinion from an outside tax advisor does not provide protection.
- Calculation of the Penalty
  – The strict liability penalty applies to the underpayment attributable to a disallowance of claimed tax benefits by reason of a transaction lacking economic substance.
    - What is the connection between the assessment and disallowance required? "But for" standard?

  – Prior versions of ES contained penalties based on understatement (i.e., under section 6662A).

  – The section 6662A penalty may apply to a non-ES transaction if it is a listed transaction or reportable transaction with significant purpose of tax avoidance or evasion. See section 6662A(b)(2).
    - The section 6662 penalty normally only applies to the excess of the substantial understatement over the reportable transaction understatement. See section 6662A(e)(1).
    - If the transaction is not disclosed and the 40% strict liability penalty applies, then the section 6662A penalty will not apply to that portion of the understatement. See section 6662A(e)(2)(B).

ES Codification -- Penalties

- Coordination with the fraud penalty
  - The strict liability penalty does not replace the fraud penalty (a 75% penalty on the underpayment). See section 6663.
  - The ES penalty will not apply to the extent the fraud penalty applies. See section 6662(b) (flush language)
- Coordination with the gross valuation misstatement penalty
  - Does the section 6662(h) gross valuation misstatement penalty apply in economic substance cases?
- Amended returns
  - Coordination with section 6676
    - The 20% strict liability penalty applies equally if the taxpayer claims benefits on an amended return.
    - Compare treatment of "tax shelters" – reasonable basis to avoid penalty on amended return but MLTN to reduce understatement under section 6662.
  - Cannot disclose a transaction to reduce the strict liability penalty to 20% after first contact.
    - Limitation applies even if examination has not raised the issue of ES.
  - What happens if a taxpayer files an amended return after first contact to claim no tax benefits?

ES Codification -- Penalties

- 40% penalty
  - Reduced to 20% if taxpayer makes adequate disclosure on return or in statement attached to return.
  - This is same language as used in section 6664(d)(2)(A) with respect to reportable transactions.
    - Under section 6664(d)(2)(A), the relevant facts affecting the tax treatment of the item must be adequately disclosed in accordance with the regulations prescribed under section 6011.
    - The section 6011 regulations provide a form for disclosure of (a) the expected tax treatment and all potential tax benefits, (b) any tax result protection, and (c) describe the transaction in sufficient detail for the IRS to be able to understand the structure and identify the parties.
- IRS assertion of the strict liability penalty
  - Can the IRS assert the ES doctrine and not assert the strict liability penalty?
    - If so, can the IRS then assert the substantial understatement penalty?
  - Can the IRS abate the penalty proportionately to the abatement of the tax? No indication in the bill.
  - What is the last point at which IRS can assert the strict liability penalty? Does it inevitably follow assertion of the ES doctrine and not have to be separately assessed?

Economic Substance – LMSB Directive on Imposition of Penalty

LMSB Directive

- LMSB directive on penalty imposition
  - On September 14, 2010, the IRS Large and Mid Size Business Division issued a directive on the imposition of a penalty on a transaction lacking economic substance.
  - According to the directive, “[t]o ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6), any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.”

Economic Substance – LB&I Directive

LB&I Directive

- On July 15, 2011, the IRS issued an LB&I directive to instruct examiners on how to determine when it is appropriate to seek the approval of the appropriate Director of Field Operations in asserting the codified economic substance doctrine.
- The directive provides that the examiner must develop and analyze a series of inquiries in order to seek approval for the ultimate application of the doctrine in the examination.
  - As a first inquiry, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate.
    - The directive provides a list of facts and circumstances that tend to show that application of the doctrine is likely not appropriate.
  - Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate.
    - The directive provides a list of facts and circumstances that tend to show that application of the doctrine may be appropriate.
  - Third, if an examiner determines that the application of the doctrine may be appropriate, the directive provides a series of inquiries an examiner must make before seeking approval to apply the doctrine.
  - Fourth, if an examiner and his or her manager and territory manager determine that application of the economic substance doctrine is merited, guidance is provided on how to request approval of the appropriate Director of Field Operations.

LB&I Directive

- The directive provides that, until further guidance is issued, the penalties in sections 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed with respect to the application of any other “similar rule of law” or judicial doctrine, such as step transaction, substance over form, or sham transaction.
- The directive indicates that the examiner should notify the taxpayer that he or she is planning to perform an economic substance analysis before commencing that analysis, and that if the Director of Field Operations decides to proceed, the taxpayer should be given an opportunity to be heard regarding whether the doctrine should apply.
- Depending on the nature of the transaction, the directive provides for various levels of review of an examiner’s decisions before assertion of the doctrine may proceed.
- In applying the directive, when a transaction involves a series of interconnected steps with a common objective, the term “transaction” generally refers to all of the steps taken together.
  - The directive indicates that in certain circumstances it may be appropriate to analyze separately one or more steps that are included within a series of interconnected steps, such as situations where an integrated transaction includes one or more tax-motivated steps that bear a minor or incidental relationship to a single common business or financial transaction.

Economic Substance – Practice and Procedure

When Does the Doctrine Apply -- Practice and Procedure

- Does the IRS have to assert the doctrine?
  - The statute only states that the ES doctrine will apply when relevant.
  - Can a court apply the ES doctrine if the IRS does not raise the issue?
    - "..if economic substance as such is not explicitly stated as one of the grounds for disallowance of tax benefits, the application of the companion penalty provisions may be in doubt." JCS 9/09 at p. 47.
  - Will a court be likely to independently raise the ES doctrine given the strict liability penalty?
- What is the proper time to raise the doctrine?
  - Can the doctrine be raised for the first time in litigation? In appeals?
  - Is RAR expected to be the proper place for assertion of ES doctrine?
  - What legal consequences hinge on timely assertion?
    - Applicability vel non – will the doctrine apply?
    - The burden of proof shifts to IRS in Tax Court if the doctrine is raised after the petition is filed.   See Tax Court Rule 142(a).
    - The ES doctrine or any similar rule of law must be asserted in order to apply the 40% penalty (even though a 20% penalty may be applied for a substantial understatement apart from a non-ES transaction).

<u>When Does the Doctrine Apply -- Practice and Procedure</u>

- <u>How will the IRS administer the ES doctrine?</u>
  - What role will LB&I / Chief Counsel have in determinations as to whether tax benefits are (i) consistent with Congressional plan or purpose, (ii) respected under longstanding practice, or (iii) permitted under specified safe-harbors?
    - Should IRS exam make these decisions? Must these decisions be confirmed with LB&I / Chief Counsel?
    - Will LB&I / Chief Counsel provide guidelines to IRS exam?
  - Will taxpayers be able to obtain advance certainty on transactions?
    - There will be a strict liability penalty that cannot be avoided by obtaining opinions from counsel.
    - Will the IRS entertain PLRs? Pre-filing agreements? Technical advice? <u>See</u> Notice 2010-62.

When Does the Doctrine Apply -- Practice and Procedure

- IRS guidance on ES doctrine
  - Definition of critical terms (e.g., substantial profit, calculation of pre-tax profit, substantial purpose)
  - Clarification of the scope of the ES doctrine –
    - Confirmation that deductions and other benefits treated as credits cited in JCT report
    - Expansion of the four “safe harbors” listed in the JCT report
    - List of general criteria that will not cause the ES doctrine to apply
    - Reliance on anti-abuse rules
      - Should the doctrine be applied when anti-abuse applies and ES doctrine not traditionally at issue?

When Does the Doctrine Apply -- Practice and Procedure

- How will the IRS audit transactions in practice under the ES doctrine?
  - Assert the doctrine any time the two prong test is viewed as failed
  - Assert the doctrine any time it is relevant
- Default Possibility # 1 -- Assert the doctrine any time the two prong test is viewed as failed
  - Example: IRS auditor concludes transaction (a) resulted in favorable tax reporting; (b) did not have business purpose; (c) was not expected to make much money.
    - Isn’t that likely to be the end of the auditor’s analysis?
    - Isn’t the “relevance” issue likely to be skipped or assumed?
    - Once the deficiency is set up, what realistic opportunity will taxpayer have to prove satisfaction of law as written and prove facts as occurred, or to contest ES doctrine relevance short of court?
    - JCS 9/09 and 2007 S. Rep. say flunking 2 prong test not dispositive, but isn’t it likely to work out that way in practice?

When Does the Doctrine Apply -- Practice and Procedure

- Default Possibility # 1 -- Assert the doctrine any time the two prong test is viewed as failed (con't)
  - In fact, courts do not necessarily determine that the taxpayer's facts satisfy the law as written before applying the ES doctrine, nor do they spend much time analyzing the relevance of the ES doctrine.
    - *Country Pine Finance LLC v. Commissioner*, T.C. Memo. 2009-251 (CARDS case; analysis portion of opinion only involved application of ES doctrine, citing *Am. Elec. Power*)
    - *Am. Elec. Power Co. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003) (rejected trial court "sham in fact" finding, while applying 6th Cir. version ES doctrine).
    - Two recent BLISS cases analyze and decide only ES doctrine: *Palm Canyon*, T.C. Memo. 2009-228; *New Phoenix Sunrise Corp*., 132 T.C. No. 9 (2009).
- Default Possibility # 2 -- Assert the doctrine any time it is relevant
  - Assuming the IRS agent will not tend to assert the ES doctrine unless the agent perceives a tax motivated transaction (which is not hard to perceive), is it likely as a practical matter that the dispute may be over once the "relevance" issue is resolved by the agent/LB&I?
  - IRS Chief Counsel cannot advise agent on the factual analysis specifically.
  - Chief Counsel, or LB&I, or agent, or Appeals determination of relevance will be determinative absent litigation?
- Isn't the threshold decision made by the agent to assert the ES doctrine likely to go unchanged absent litigation?

When Does the Doctrine Apply -- Practice and Procedure

- Venue
  - Does the choice of circuit matter?
    - The mechanics of the test have been standardized – e.g., conjunctive test.
    - Will judicial application of the codified statute lead to differences between circuits?
      - Will some courts be more reluctant to apply the doctrine given the strict liability penalties?
    - Different circuits treat economic substance as issue of fact or issue or law, which impacts the scope of appeal. See *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010) (question of law; citing contrary circuits).
  - Will taxpayers choose Tax Court to avoid paying heavy penalties first?
    - Note that, if not raising separate grounds to challenge the penalty, prepayment of the penalty may not be required. See *Shore v. United States*, 9 F.3d 1524 (Fed. Cir. 1993).
    - What grounds are there to challenge the penalty?

When Does the Doctrine Apply -- Practice and Procedure

- Burden of Proof
  - As to the “consistent with” purposes of the Code, this is a legal issue, not a factual issue.
  - The IRS is asserting a rule contrary to statute and regulations and so should have some sort of burden to justify that.
  - Will *Chevron* deference play a role in the application of the ES doctrine?
  - Even if taxpayer has normal burden of proof as to the two prong test if ES doctrine is asserted, the taxpayer should not be tasked with any burden to counter the IRS’s assertion of the generally applicability of the ES doctrine, but rather the court should carry out its duty to determine the true meaning of the law.

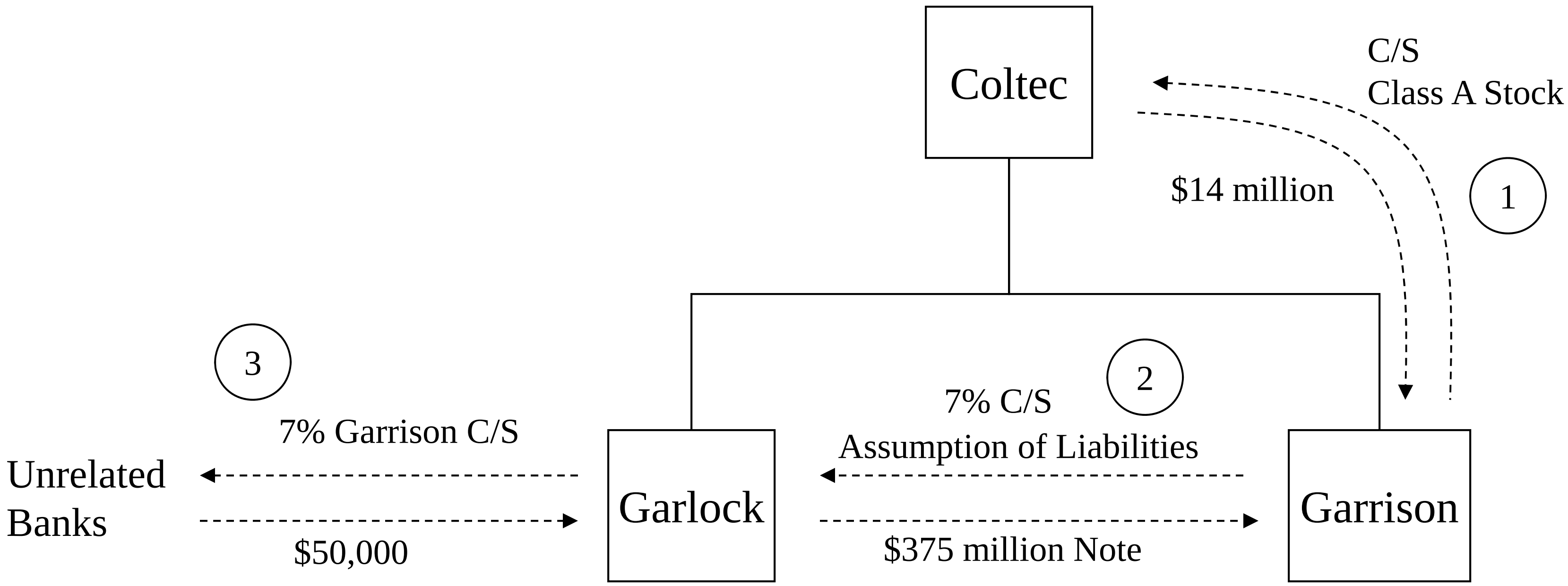
Economic Substance Doctrine – Summary

ES Doctrine – Summary

- The economic substance doctrine is the conflation of statutory interpretation and common law fact finding into a court-made rule of law that, regardless of whether a taxpayer meets all the requirements of the Code and all facts are developed applying relevant common law doctrines, the taxpayer will not prevail if the taxpayer cannot satisfy the subjective and objective standards applied by the courts
- The codified ES doctrine requires that the ES doctrine be relevant
- The legislative history identifies two exceptions to the application of the ES doctrine --
  - Whether the benefits claimed are consistent with a Congressional purpose or plan
  - Whether the transaction has been respected under longstanding judicial and administrative practice, based on meaningful economic alternatives based on comparative tax advantages
    - A safe-harbor may be available
- Will the IRS adopt other approaches to determine when the ES doctrine is relevant
  - Adopt a similar approach as under 355(e) regulations – general safe-harbor, specific safe-harbors, factors indicating plan / non-plan
  - What characteristics can be used –
    - Reliance on significantly detailed statute or regulations (e.g., consolidated return regs)
    - Anti-abuse rules that are relevant but satisfied (e.g., Treas. Reg. § 1.701-2; section 269)
    - Involving an area that has been well considered (e.g., election for taxable treatment)
    - Electivity permitted under the law (e.g., a section 332 liquidation, COBE regulations).
- Early guidance from the IRS
  - The IRS must issue early guidance to provide some certainty for taxpayers entering into transactions post-codification – Rev. Rul., Rev. Proc., Announcement
  - The IRS will continue to issue private letter rulings on substantive issues in transactions
    - What level of confidence will these rulings provide for taxpayers on the risk of ES doctrine?

Recent Economic Substance Cases

Coltec Transaction



Facts: Coltec, a publicly traded company with numerous subsidiaries, sold the stock of one of its businesses in 1996 and recognized a gain of approximately $240.9 million. Garlock, a subsidiary of Coltec, and its own subsidiary had both previously manufactured or distributed asbestos products and faced substantial asbestos-related litigation claims. Coltec caused another one of its subsidiaries, Garrison, to issue common stock and Class A stock to Coltec in exchange for approximately $14 million. In a separate transaction, Garrison issued common stock to Garlock that represented approximately a 6.6% interest in Garrison and assumed all liabilities incurred in connection with asbestos related claims against Garlock, as well as the managerial responsibility for handling such claims. In return, Garlock transferred the stock of its subsidiary, certain relevant records to the asbestos-related claims, and a promissory note (from one of its other subsidiaries) in the amount of $375 million. Garlock then sold its recently acquired Garrison stock to unrelated banks for $500,000. As a condition of sale, Coltec agreed to indemnify the banks against any veil-piercing claims for asbestos liabilities. On its 1996 tax return, Coltec's consolidated group claimed a $378.7 million capital loss on the sale of Garrison stock, which equaled the difference between Garlock's basis in the stock ($379.2 million) and the sale proceeds ($500,000).

Coltec Decision – Court of Federal Claims

- The Court of Federal Claims entered a decision after trial in favor of Coltec, upholding the capital loss claimed by Coltec from the contingent liability transaction at issue in this tax refund litigation. See *Coltec Industries, Inc. v. United States*, 63 Fed. Cl. 716 (2004).

- The Court of Federal Claims relied on the District Court analysis in *Black & Decker* (discussed below) to hold that the operation of the applicable code sections justified a capital loss.

  - The contribution of assets in exchange for stock and the assumption of the liabilities qualified as a nontaxable exchange under section 351.

  - Under section 358, the transferor received a basis in the stock equal to the basis of the assets contributed. Ordinarily, when a transferee in a section 351 exchange assumes liabilities of the transferor, the transferor's basis in the transferee's stock is reduced by the amount of the liabilities. However, under sections 358(d)(2) and 357(c)(3), if the satisfaction of the liabilities would have given rise to a deduction to the transferor, the assumption of such liabilities does not reduce basis. Because satisfaction of the liabilities assumed by the transferee would have given rise to a deduction to the transferors (had the liabilities not been transferred), the basis of the stock is not reduced by the liabilities assumed under section 358(d)(2). After the transfer, payment of the liabilities would give rise to a deduction by the transferee. See Rev. Rul. 95-74, 1995-2 C.B. 36 (1995). The government argued that section 357(c)(3) requires that payment of the liabilities would give rise to a deduction by the *transferor*. The court held that this interpretation was incorrect.

  - In addition, the court held that section 357(b) did not require basis to be reduced because there was a bona fide business purpose for the assumption of the liabilities.

Coltec Decision – Court of Federal Claims

- The Court of Federal Claims rejected the government's argument that the capital loss should nonetheless be disallowed under the economic substance doctrine.
- The court refused to apply the economic substance doctrine to the transaction because the transaction satisfied the statutory requirements of the Code. The court stated: "[I]t is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare…. Where the taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers."

Coltec on Appeal – Federal Circuit

- The Federal Circuit (Judges Bryson, Gajarsa and Dyk) reversed the opinion of the Court of Federal Claims and held that the taxpayer was not entitled to a capital loss because the assumption of the contingent liabilities in exchange for the note lacked economic substance. See *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).

- The Federal Circuit upheld the technical analysis of the Court of Federal Claims in favor of the taxpayer.

- The court concluded that section 357(c)(3) applies because payment of the liability would give rise to a deduction. The court stated that the government's interpretation that the liabilities must be transferred with the underlying business was plainly inconsistent with the statute.

- The court concluded that if a liability was excluded by section 357(c)(3), then section 357(b)(1) was not relevant. The court reasoned that the exception in section 358(d)(2) for liabilities excluded under section 357(c)(3) does not contain any reference to section 357(b), nor does section 357(b) contain any reference to the basis provisions in section 358.

Coltec on Appeal – Federal Circuit

- However, the Federal Circuit reversed the Court of Federal Claims decision with respect to economic substance and held that the transfer of liabilities in exchange for the note should be disregarded.

- The Federal Circuit identified five (5) principles of economic substance.

  – The law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality;

  – It is the taxpayer that has the burden of proving economic substance;

  – The economic substance of a transaction must be viewed objectively rather than subjectively;

  – The transaction to be analyzed is the one that gave rise to the alleged tax benefit;

  – Arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

Coltec on Appeal – Federal Circuit

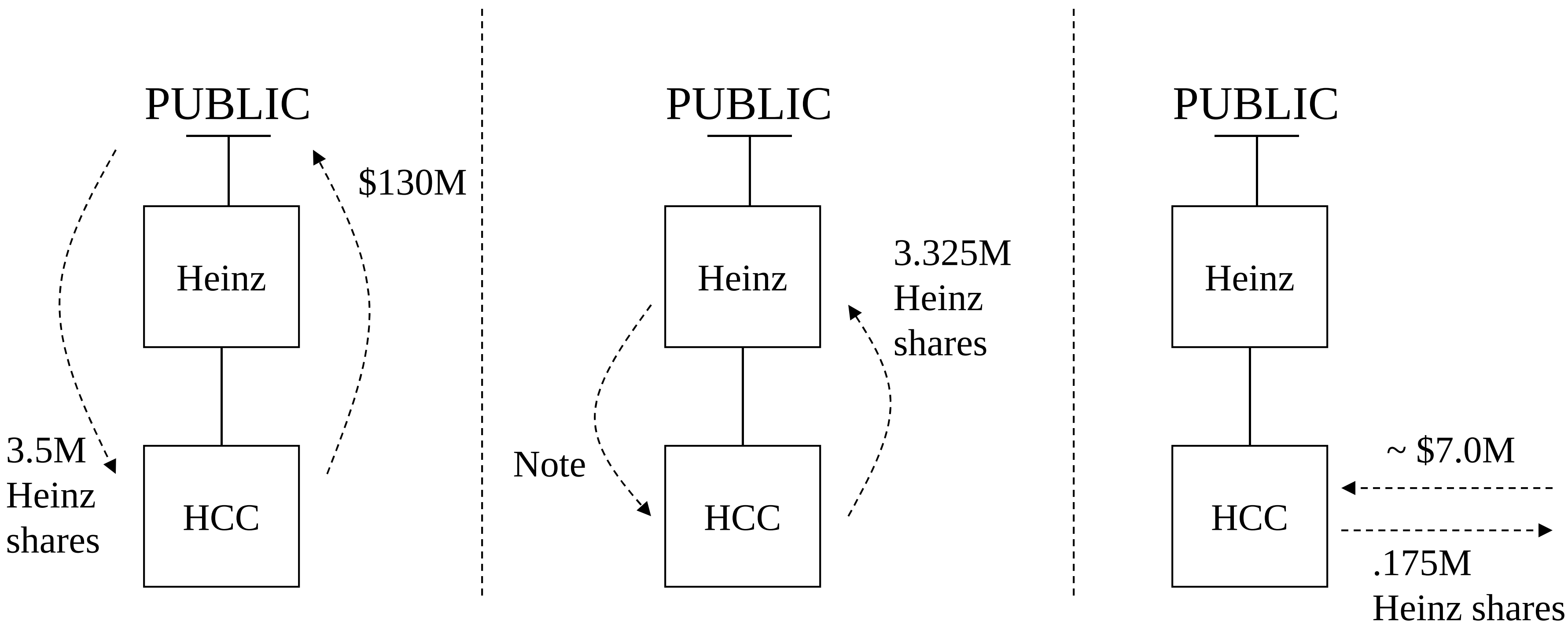
- In applying the economic substance test, the Federal Circuit focused solely on the transaction giving Coltec the high stock basis (i.e., the assumption of the liabilities in exchange for the note) and concluded that Coltec had not demonstrated any business purpose for that transaction.

- The court rejected Coltec's claim that it would strengthen its position against potential veil-piercing claims, since it only affected relations among Coltec and its own subsidiaries and had no effect on third parties.

Coltec Certiorari Petition

- Coltec filed a petition requesting certiorari with the Supreme Court.
- One of the two questions presented for review in the cert petition relates to the disjunctive vs. conjunctive nature of the economic substance test and the current circuit split.
  - The cert petition stated the question as follows: "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 court 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" conclusion that a narrow part of the transaction lacked economic benefits for the taxpayer?"
- The other question presented for review in the cert petition relates to the standard of review in economic substance cases.
  - The cert petition stated the question as follows: "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)?"
- Dow Chemical Co. filed a cert petition on October 4, 2006 that presented similar questions.
- On February 16, 2007, the Supreme Court denied certiorari in *Coltec* and *Dow Chemical*.

Heinz Transaction



Facts: Between August 11, 1994, and November 15, 1994, H.J. Heinz Credit Company ("HCC"), a subsidiary of the H.J. Heinz Company ("Heinz"), purchased 3.5 million shares of Heinz common stock in the public market for $130 million. In January of 1995, HCC transferred 3.325 million of the 3.5 million shares to Heinz in exchange for a zero coupon convertible note issued by Heinz. In May of 1995, HCC sold the remaining 175,000 shares to AT&T Investment Management Corp. ("AT&T"), an unrelated party, for a discounted rate of $39.80 per share, or $6,966,120, in cash. As a result of this sale, HCC claimed a capital loss and carried this loss back to 1994, 1993, and 1992. The IRS disallowed Heinz's claimed capital loss arguing, among other things, that the transaction lacked economic substance and a business purpose. Heinz paid the tax and filed a $42.6 million refund action with the Court of Federal Claims.

Heinz – Court of Federal Claims

- *H. J. Heinz Company and Subsidiaries v. United States*, United States Court of Federal Claims, 76 Fed. Cl. 570 (2007).
- All parties agreed that HCC had a basis of $124 million in the 3.325 million shares that were transferred to Heinz.
- Heinz asserted that the redemption qualified as a redemption under section 317(b), that the redemption should be taxed as a dividend, and that HCC's basis in the redeemed stock should be added to its basis in the 175,000 shares which it retained. Accordingly, Heinz claimed that, when HCC sold its remaining 175,000 shares, it should recognize a large capital loss. Heinz then claimed it was entitled to carry back HCC's capital loss to reduce the consolidated group's taxes in 1994, 1993 and 1992.
- The IRS asserted that the Heinz acquisition was not a redemption because: (i) Heinz did not exchange property for the stock within the meaning of section 317(b); (ii) the transaction lacked economic substance and had no bona fide business purpose other than to produce tax benefits; and (iii) under the "step transaction doctrine," HCC's purchase and exchange of the stock for the note should be viewed as a direct purchase of the stock by Heinz.

Heinz – Court of Federal Claims

- The Court of Federal Claims dismissed the IRS's first argument that no redemption occurred, but held that the acquisition and redemption of Heinz shares lacked economic substance and that the step transaction doctrine applied.
- The court followed the economic substance analysis set forth *Coltec* in addressing the IRS's second argument, quoting the following language from *Coltec* – "the transaction to be analyzed is the one that gave rise to the alleged tax benefit."
- Accordingly, the court stated that transaction in question is the purchase of Heinz shares from the public and the subsequent redemption. The court did not analyze the entire transaction (including the disposition) when applying the economic substance doctrine.
- The court in *Heinz* held that the acquisition and subsequent redemption of Heinz shares lacked economic substance.

Heinz – Court of Federal Claims

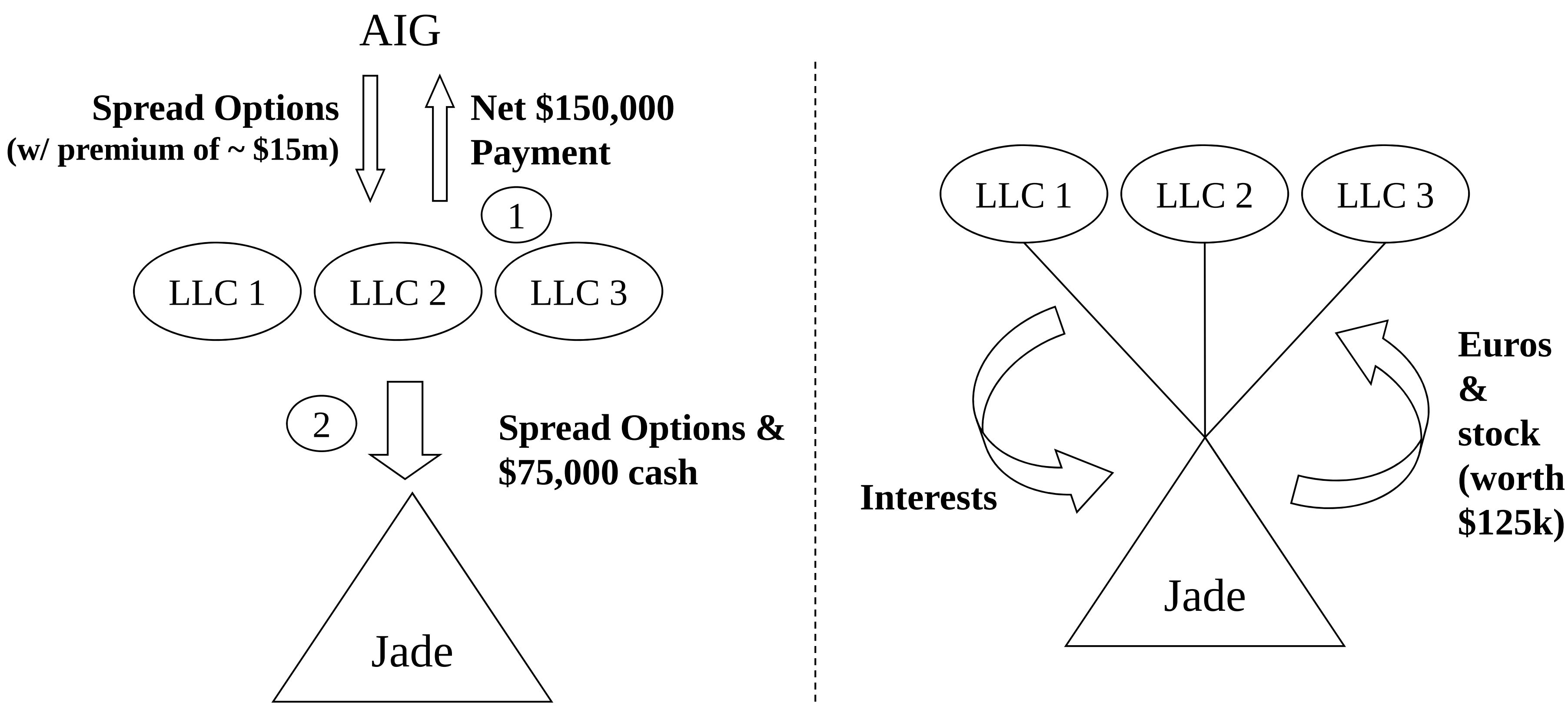
- The Court of Federal Claims was not persuaded by the taxpayer's assertion that HCC acquired the Heinz stock for non-tax, business purposes: as an investment and to add "substance" to HCC's operations for state tax purposes.

- In the eyes of the court, the taxpayer's claim of an investment purpose was undercut by the factual record, as evidenced by the following factors. First, the convertible notes were contemplated and, in fact, were in the process of being drafted well before HCC purchased the Heinz stock. Second, because the acquired stock was not registered, HCC purchased the stock at full price in the market and sold the Heinz stock at a deep discount. Third, the purpose of the stock purchase program -- the funding of stock option programs – could not be achieved so long as HCC held the Heinz stock.

- The court also found the factual record to be inconsistent with the taxpayer's second claim of business purpose, which was to bolster the taxpayer's tax return position that HCC should be respected as a Delaware holding company. The court cited three factors in support of its position. First, the record did not suggest that the taxpayer was motivated by this non-tax purpose. Second, internal communications indicated that any tax return exposure could not be limited at the time of the stock acquisition or on a going forward basis. Third, the record indicated that, at the time of the stock acquisition, Heinz was considering eliminating HCC's lending operations, which raised the very issue that the taxpayer sought to mitigate through the stock acquisition.

- The taxpayer has appealed to the Court of Appeals for the Federal Circuit.

Jade Trading – Son-of-Boss Transaction



Facts: In March 1999, three taxpayers sold their cable business and realized an aggregate $40.2 million capital gain. Each of the three taxpayers created a single-member LLC on September 17, 1999. On September 23, 1999, Jade Trading LLC was formed by Sentinel Advisors, LLC ("Sentinel") and a foreign financial institution. [Sentinel pitched the transaction to BDO Seidman, which marketed the transaction.] On September 29, 1999, each of the three LLCs purchased offsetting currency options for net premium paid of $150,000 to AIG. For each LLC, the options purchased and sold had a premium of $15 million and $14.85 million, respectively. On October 6, 1999, the LLCs contributed their spread options and $75,000 cash to Jade Trading LLC ("Jade"), in exchange for membership interests. About 60 days after the contribution, the three LLCs exited Jade with each receiving euros and Xerox stock (with a market value of approximately $125,000) in exchange for their interests.

Jade Trading – Taxpayer's Position

- Each taxpayer claimed that the LLCs' basis in the interest in Jade was increased by the value of the option purchased ($15 million), but not decreased by the value of the options sold ($14.85 million). Accordingly, each taxpayer claimed a large capital loss upon exiting the partnership (approximately $14.9 million).

- The primary Code sections at issue in *Jade Trading* were section 752(b) and section 722.

  – Section 752(b) provides that a decrease in a partner's liabilities by reason of a partnership's assumption of those liabilities will be treated as a distribution of money to the partner by the partnership (with the effect of reducing the partner's basis).

  – Under section 722, a partner's basis acquired by a contribution of property, including money, is equal to the amount of money and basis of such property contributed.

- The taxpayers relied principally on *Helmer v. Commissioner*, T.C. Memo. 1975-60, which provided that a contingent obligation (such as an option) was not a liability for purposes of section 752.

- At the time of the transaction, the principle set forth in *Helmer* was good law.

  – The IRS subsequently issued temporary regulations on June 24, 2003, which would have treated the sold option as a liability for purposes of section 752. <u>See</u> Treas. Reg. § 1.752-6T.

  – The temporary regulations had retroactive effect to October 18, 1999 (the LLCs contributed the spread options on October 6, 1999).

  – The Preamble to the temporary regulations explicitly states that the regulations do not follow *Helmer*.

<u>*Jade Trading*</u> <u>– Court of Federal Claims</u>

- The Court of Federal Claims held that the transaction creating the basis increase lacked economic substance. <u>See</u> *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007).
- The court found that basis increase claimed by each LLC satisfied the technical provisions of the Code.
- The court then analyzed the transaction under the economic substance doctrine.
  - The court stated that *Coltec* unequivocally reaffirmed the vitality of the economic substance doctrine in the Federal Circuit.
  - The court found that –
    1. The transaction lacked economic reality because (i) the losses claimed were not tied to any economic loss (<u>i.e.</u>, the LLCs did not incur a $15 million loss) and (ii) the use of the partnership structure had no real economic purpose.
    2. The taxpayer had the burden of proving that the transaction had economic substance.
    3. The objective reality of the transaction was the relevant criterion rather than any subjective intent of the taxpayer.
    4. The transaction to be analyzed was the spread transaction that gave rise to the inflated basis (rather than any hypothetical transactions that could have occurred and/or any other trades).
       - The court found that there was no objective profit potential, because the maximum profit potential on the spread ($140,000) was exceeded by the high fees ($934,100).
       - The court also noted that transaction was marketed as a tax avoidance mechanism.
       - The court also noted that the options had to be viewed together rather than as two distinct legal entitlements because of the economic realities of the transaction.
    5. The transaction did not alter the economic interests of independent third parties (<u>i.e.</u>, the other partners in Jade).
  - The court held that the transaction lacked economic substance on the basis of the above conclusions, which the court viewed as relevant based upon its interpretation of *Coltec.*

Jade Trading - Court of Appeals for the Federal Circuit

- The U.S. Court of Appeals for the Federal Circuit affirmed the Court of Federal Claim's finding that the contributions to the spread transactions to the Jade partnership lacked economic substance and should be disregarded for tax purposes. See *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010).
- The court relied on the principles established in *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006) for purposes of conducting its economic substance analysis.
  - The court agreed with the determinations made by the Court of Federal Claims, noting that the loss generated was "purely fictional," the formation of the Jade partnership had no economic purpose, the spread transaction was virtually guaranteed to be unprofitable, and the transaction was developed as a tax avoidance scheme and not an investment strategy.
  - The court also rejected the argument that the contribution of the spread transactions to the Jade partnership had economic substance because the spread strategy options were separate assets with separate documentation that were owned by unrelated parties.
  - The court agreed with the finding by the Court of Federal Claims that the transactions could not be separated because they were totally dependent on one another from an economic and pragmatic standpoint.

Sala v. United States

- The District Court of Colorado recently held in favor of a taxpayer that entered into a transaction similar to the transaction described in *Jade Trading.* See *Sala v. United States*, 552 F. Supp. 2d 1167 (D.C. Co. 2008).

- The IRS has referred to the *Sala* decision as an "anomaly" in the government's continued litigation of "Son-of-Boss" transactions.

- Relevant Facts

  – The taxpayer in *Sala* realized $60 million of income in 2000 in connection with the exercise of stock options.

  – In 2000, the taxpayer invested approximately $9 million in a foreign currency investment program (the "Deerhurst Program").

  – In connection with the "Deerhurst Program," the investment manager acquired long and short options on foreign currencies for a net cost of approximately $730,000.

  – On November 8, 2000, the taxpayer formed an S corporation as its sole shareholder ("Solid"). On November 28, 2000, the taxpayer transferred the long and short options and approximately $8 million of cash to Solid. On the same date, Solid transferred the options and cash to a general partnership ("Deerhurst GP").

  – Deerhurst GP liquidated prior to December 31, 2000. In the liquidation, Solid received approximately $8 million in cash and two foreign currency contracts.

  – Solid subsequently sold the foreign currency contracts prior to December 31, 2000.

  – Solid reinvested the liquidation proceeds into Deerhurst LLC for a minimum of five years.

Sala v. United States

- Taxpayer Position
  - Solid claimed a basis in Deerhurst GP equal to the value of the cash plus the long options, or approximately $69 million. See *Helmer v. Commissioner*, T.C. Memo 1975-60.
  - Solid claimed a basis in the two foreign currency contracts received in liquidation of Deerhurst GP equal to its partnership basis (~ $69 million) less the cash received in liquidation (~ $8 million), or approximately $61 million.
  - Upon the sale of the two foreign currency contracts, Solid claimed a loss equal to approximately $60 million.
  - The taxpayer claimed the $60 million loss on its original 2000 tax return, but filed a subsequent amended return that did not claim the $60 million loss and paid tax, interest, and penalties of over $26 million in connection with the amended return. The taxpayer subsequently filed a second amended return that claimed the $60 million loss. The taxpayer sued in District Court to claim a tax refund on the basis of the second amended return.
- The Deerhurst Program
  - The District Court found the facts of the Deerhurst Program particularly persuasive.
  - In the program, investors place a minimum of $500,000 in an account for an initial trial period. The account was managed by Deerhurst Management Company, Inc., which was owned and operated by a well-known foreign currency trader.
  - Investors that were interested in remaining in the Deerhurst Program were then required to place additional funds into the program equal to at least 15% of the expected tax loss (for the taxpayer, 15% of ~ $60 million, or ~ $9 million).
  - If the account was profitable after the liquidation in late 2000, investors had to reinvest their liquidation proceeds in Deerhurst LLC for a minimum of five years or be subject to a withdrawal penalty.

Sala v. United States – District Court Decision

The District Court made the following rulings with respect to the Deerhurst Program:

1. The transactions entered into in connection with the Deerhurst Program satisfied the sham transaction / economic substance standard --

   – The court refused to focus its inquiry on the “Son-of-Boss” aspect of the Deerhurst Program and considered the entire investment program.

   – The court found that taxpayer had a potential (albeit small) of obtaining an economic return in excess of the $60 million loss and that the taxpayer entered into the transaction for profit.

   – The court found that the transaction had a good faith business purpose other than tax avoidance, concluding that –

     – The taxpayer’s stated purpose of creating Solid to reduce liability exposure was a valid purpose;

     – The creation of Deerhurst GP had the valid purpose of investing in currency options and its liquidation had the valid purpose of “easier accounting and redistribution of the partnership assets”;

     – The investment “test period” in the Deerhurst Program had a valid purpose since it permitted taxpayers to gauge their interest in the program at little cost;

     – The fact that “digital options” were not purchased (that would not have created the large tax loss) was immaterial; and

     – The Deerhurst Program, as a whole, had a legitimate business purpose – a good faith and reasonable belief in profitability beyond mere tax benefits.

   – <u>Compare</u> *Klamath Strategic Inv. Fund, LLC v. United States,* 568 F.3d 537 (5th Cir. 2009) (held that the transaction did not have economic substance; court applied a conjunctive economic substance test)

Sala v. United States – District Court Decision

2. The tax loss was permitted under the Code and applicable regulations --

   – The basis obtained in Solid and Deerhurst GP was equal to the value of long options and contributed cash and was not decreased by liabilities associated with the short options.

   – The at-risk rules of section 465 and the loss limitation rule of section 1366(d) did not apply.

   – Each of the 24 options contributed to Solid and Deerhurst GP were separate financial instruments. Accordingly, offsetting options were not offset against each other for purposes of determining the "net" value of property contributed to Solid and Deerhurst GP.

   – The two foreign currency contracts received by Solid upon liquidation of Deerhurst GP constituted "property" within the meaning of section 732. As a result, Solid obtained a basis in such property equal to Solid's basis in the partnership reduced by any money distributed.

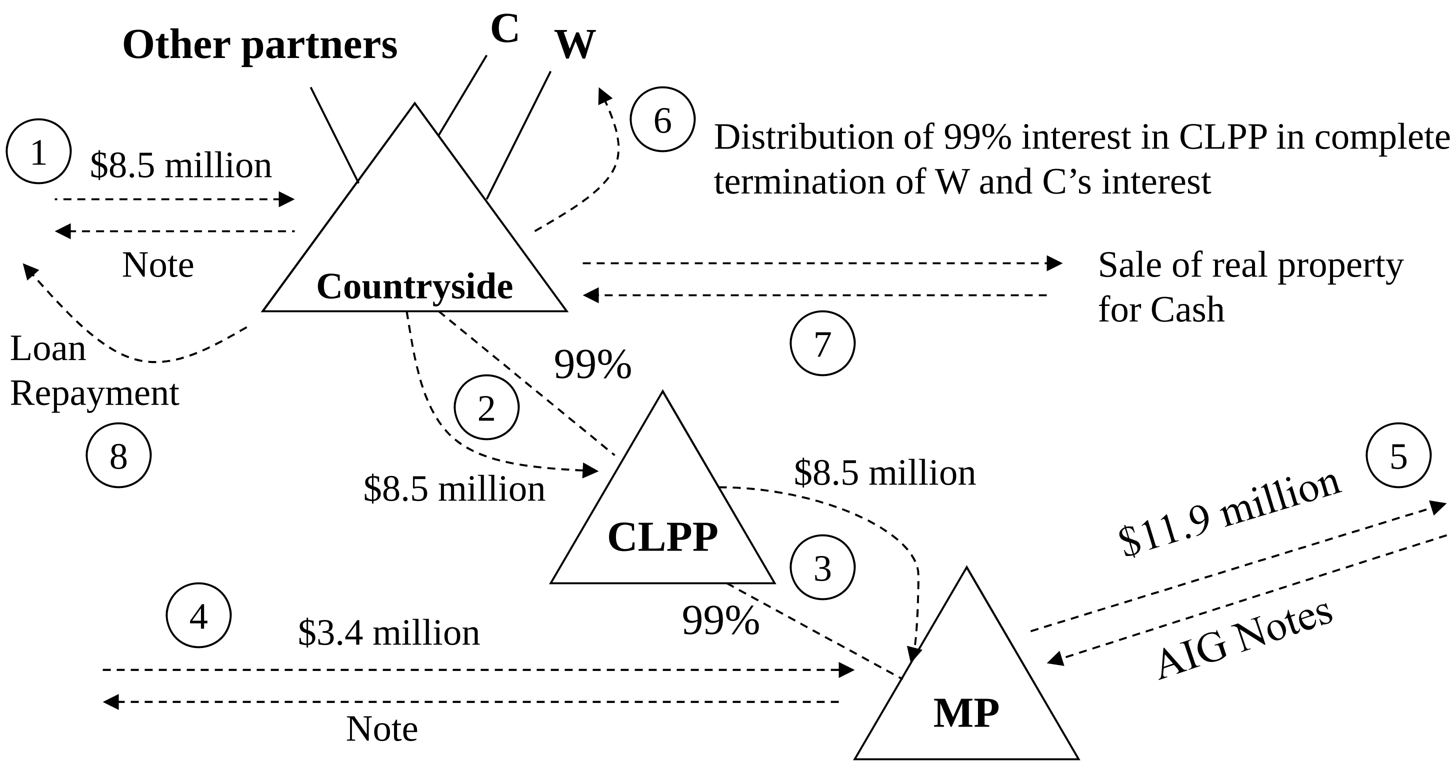
3. Treasury exceeded its authority when issuing Treas. Reg. § 1.752-6(b)(2) and when making the regulations retroactive. Compare *Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006) with *Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008).

4. The taxpayer filed a valid qualified amended return, and the IRS was not entitled to offset excess interest payments made by the taxpayer with an accuracy-related penalty.

Sala v. United States – Tenth Circuit Decision

- On appeal, the Tenth Circuit Court of Appeals reversed the district court's decision. See *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010).
- The Court focused its economic substance analysis on Deerhurst GP, unlike the district court, which had reviewed the entire Deerhurst Program as a single transaction.
  - According to the Court, the Deerhurst GP phase could not be legitimized merely because it was on the "periphery of some legitimate transactions," as a "loss-generating transaction must stand or fall on its own merit."
- In setting out the applicable standard for its economic substance analysis, the Court noted that transactions lacking an appreciable effect aside from tax benefits will be not be respected for tax purposes, that a transaction having some profit potential does not necessarily require the finding that a transaction has economic substance, and that tax benefits must be linked to actual losses.
- The Court determined that Sala's participation in Deerhurst GP lacked economic substance, relying on the following findings:
  - The claimed loss generated by the program was structured from the outset to be a complete fiction and was designed primarily to create a reportable tax loss with little actual economic risk.
  - Deerhurst GP was designed to exist for only a short time, as its liquidation before the end of 2000 was pre-determined in order to generate a tax loss to offset Sala's income.
  - The expected tax benefit of around $24 million dwarfed the potential gain from Sala's participation in Deerhurst GP (projected to earn profits of $550,000 over the course of one year), making the economic realities of the transaction insignificant in relation to the tax benefits.
  - The court disregarded the business explanations for the various components of the Deerhurst GP stage, stating that any anticipated economic benefit from the brief participation in Deerhurst GP was negligible in comparison to the asserted tax benefit.
  - The district court's finding that Sala entered into the Deerhurst Program primarily for profit did not alter the Court's conclusion. The Court stated that the presence of an individual's profit objective did not require it to recognize a transaction lacking economic substance. The Court also discounted the district court's findings on this issue, as they were based on the Deerhurst Program as a whole.

Countryside – Facts of Transaction



Facts: W and C are individual partners in a partnership ("Countryside"). W possessed a 70% interest and C possessed a 25% interest in Countryside. Two other partners held the remaining interests. On or about September 18, 2000, W, acting as president of two separate corporations, formed two separate LLCs ("CLPP" and "MP"). On October 27, 2000, each of the corporations contributed cash to obtain a 1% interest in the LLCs. Countryside borrowed $8.5 million from a third-party bank. On October 30, 2000, Countryside contributed the cash to CLPP in exchange for a 99% interest and CLPP contributed the borrowed funds to MP for a 99% interest. On or about that day, MP borrowed an additional $3.4 million from the third-party bank. On or about October 31, 2000, MP used the borrowed proceeds to acquire four privately issued notes (the "AIG Notes") in the aggregate principal amount of $11.9 million. On December 26, 2000, Countryside distributed its 99-percent interest in CLPP to W and C in complete liquidation of their respective partnership interests. As a result of the distribution, both W and C were relieved of their share of Countryside's liabilities, although each retained a share of MP's liabilities. In April 2001, Countryside sold real property and used the sale proceeds to repay the $8.5 million obligation to the third-party bank. In 2003, the AIG Notes were redeemed from MP by AIG. In 2004, MP repaid the $3.4 million loan.

Countryside – Tax Issues

- The IRS issued a notice of final partnership administrative adjustment (the FPAA) on October 8, 2004. The FPAA contained the following adjustments –
  - The distribution in liquidation of W and C's interest in Countryside constituted a taxable event resulting in a large capital gain,
  - A denial of Countrywide's election to receive a basis step-up under section 734(b)(1)(B) for the property remaining after the liquidating distribution (including the real property sold in 2001), and
  - A basis reduction in the AIG Notes held by MP.
- W filed a partial motion for summary judgment in the Tax Court to resolve the first of the above issues raised by the IRS in the FPAA.
- The IRS argued that Countryside's distribution of its 99% interest in CLPP constituted a distribution of marketable securities for purposes of section 731(a)(1) or, alternatively, it should be treated as such under the economic substance doctrine.
  - Section 731(a) provides that a partner does not recognize gain on a partnership distribution, except to the extent that money distributed (including "marketable securities") exceeds the partner's adjusted basis in the partnership.
  - If the distribution was treated as a distribution of money, then W and C would recognize substantial gain because both would have a low basis in their interests in Countryside (in part, because the relief of Countryside liabilities assumed by W and C would be treated as a distribution under section 752 that would reduce W and C's outside basis).
  - Note that W and C claimed that the $3.4 million borrowing by MP increased their outside basis and thus offset potential gain on the liquidating distribution.
- The Tax Court decided this issue in favor of the taxpayer. See *Countryside Limited Partners v. Commissioner*, T.C. Memo. 2008-3.

Countryside – Economic Substance

- The Tax Court rejected that IRS argument that the distribution of the 99% interest in CLPP constituted a distribution of marketable securities under section 731(a)(1).
- The Tax Court also rejected the IRS argument that the economic substance doctrine should apply to treat the distribution as a distribution of money for purposes of section 731(a)(1).
- The crux of the IRS position was that W and C effectively permanently deferred the recognition of gain on their share of the sale proceeds Countryside received in the 2001 sale of real property.
- The IRS unsuccessfully argued that Countryside had no potential for profit in the transaction because of interest and transaction costs and, thus, the transaction lacked a business purpose and should be recast under the economic substance doctrine.
  - The Tax Court rejected this IRS argument because it focused on Countryside's pre-tax profit rather than the partners, W and C, who were the focus of the motion before the court.
  - At most, the Tax Court stated that this argument could support a challenge to any interest deductions claimed by Countryside with respect to the $8.5 million loan.
- The Tax Court concluded that the means of the transaction (i.e., the liquidation of W and C's interest in Countryside) were designed to avoid recognition of gain, but that these means also served "a genuine, nontax, business purpose" – to convert W and C's investments in Countryside into a 10-year promissory note.
- The Tax Court observed that these two forms of investment were economically distinct and therefore, in form and substance, the transaction constituted a redemption of W and C's interest for non-marketable securities.
- The Tax Court clearly viewed the tax benefits of the transaction as being incidental to the legitimate business purpose of the transaction. Accordingly, the Tax Court found no harm in structuring the transaction in a manner to minimize the tax burden of W and C

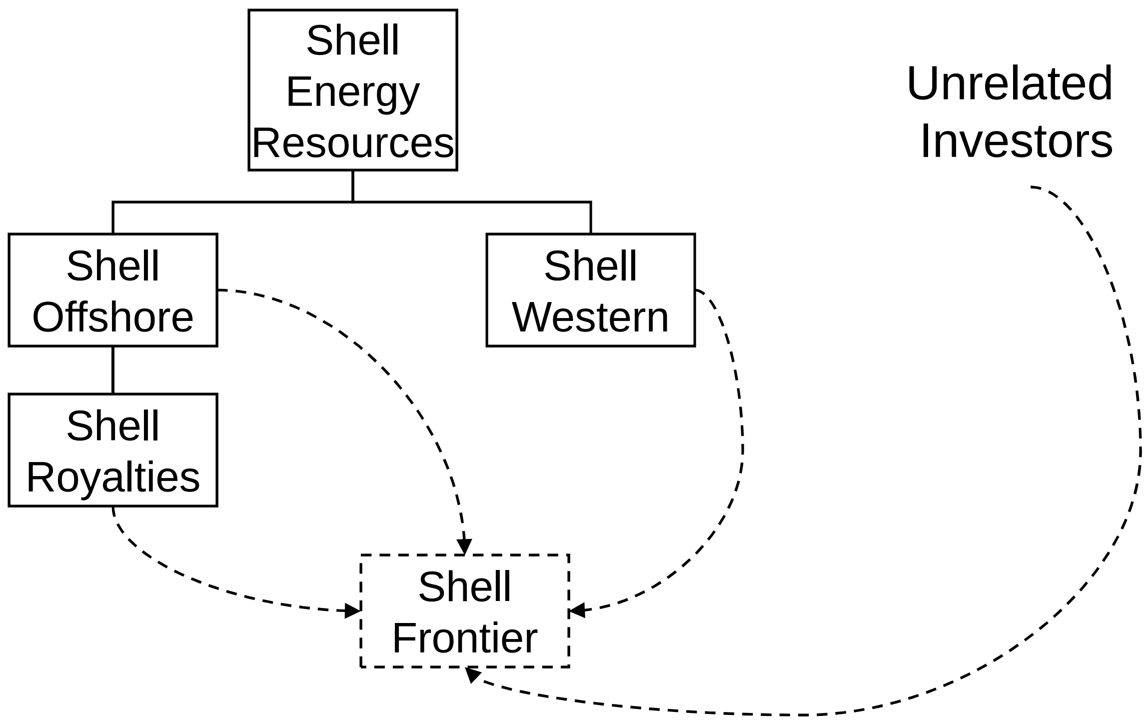
Countryside – Effect of Continued Litigation?

- The Tax Court only resolved the issue addressed by the partial motion for summary judgment.
- The Tax Court did not resolve the remaining issues raised by the FPAA, and it is uncertain whether W, C, Countryside or MP will retain any tax benefits claimed in connection with the transaction if and when the remaining issues are addressed.
- A footnote in the decision suggests that the Tax Court believes that the tax benefits claimed may not be warranted.
- Footnote 29 states that, given the totality of the circumstances, including (i) the formation of CLPP and MP and (ii) the section 754 elections made by Countryside and CLPP (but not by MP), there may be grounds to invoke the partnership anti-abuse rule of Treas. Reg. § 1.701-2 and/or the economic substance doctrine in order to determine –
  - Whether Countryside should obtain a basis step-up in the retained assets and/or
  - Disregard CLPP and MP as sham entities, and/or
  - Require a basis step-down in the AIG Notes held by MP.
- The remaining issues have been consolidated before the Tax Court judge.

Countryside and *Valero* – Section 7525

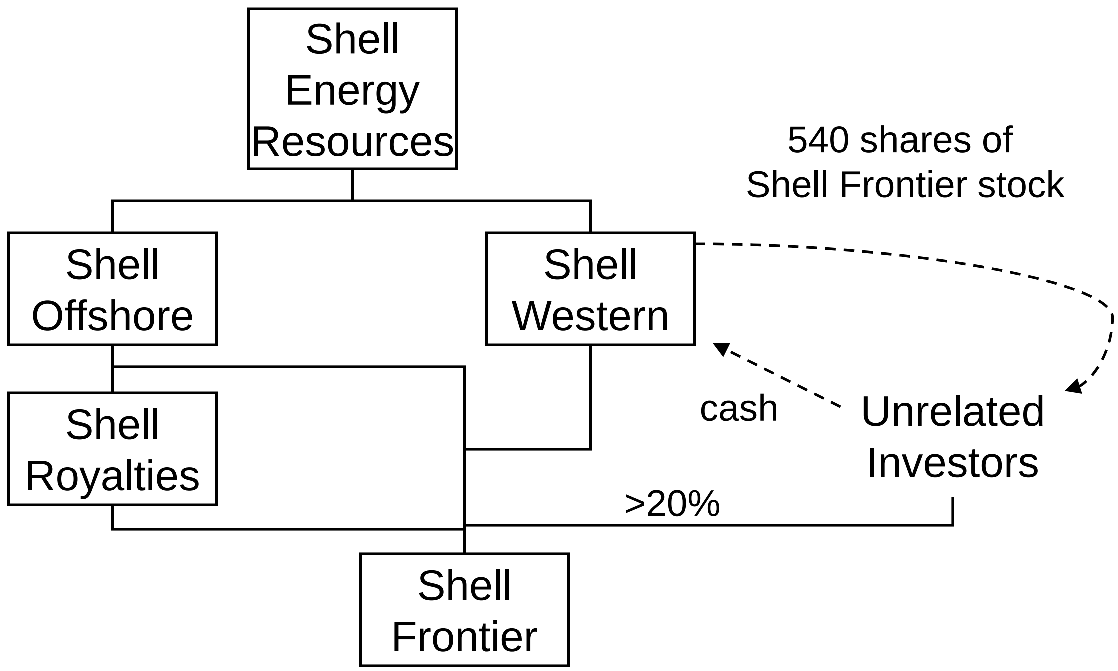
- On June 8, 2009, the Tax Court in *Countryside* denied an IRS motion to compel the production of “meeting minutes” and handwritten notes that memorialized conversations between the partnership (*Countryside)* and its outside tax advisor in respect of the transaction.
  - The documents were generally protected under section 7525.
  - However, the IRS argued that the section 7525 privilege did not apply because the underlying advice constituted “written communication” in connection with the “promotion” of a “tax shelter.” <u>See</u> section 7525(b).
  - The Tax Court held that the IRS did not meet its burden in establishing the elements of the “tax shelter” exception since (i) the handwritten notes, which were not communicated with anyone, did not constitute a “written communication” for purposes of section 7525(b) and (ii) the minutes were not prepared in connection with the “promotion” of a tax shelter for purposes of section 7525(b) since the tax advisor provided advice as part of a long-standing and ongoing relationship with the partnership. <u>See</u> *Countryside v. Commissioner*, 132 T.C. 347 (2009).
- In *Valero Energy Corp. v. United States*, 569 F.3d 626 (7th Cir. 2009), the 7th Circuit also recently addressed the tax shelter exception to the section 7525 privilege.
  - In *Valero*, the taxpayer raised the section 7525 privilege in respect of a summons issued to Arthur Andersen in connection with a transaction recommended to the taxpayer by Ernst & Young and reviewed by and supplemented by the taxpayer’s long-time advisors at Arthur Andersen.
  - The recommended transaction was specific to the taxpayer, and was neither “prepackaged” nor marketed to other taxpayers.
  - The 7th Circuit refused to limit the tax shelter exception in section 7525(b) to only “actively marketed tax shelters or prepackaged products” and upheld the District Court decision in favor of the government.
  - Thus, the 7th Circuit’s interpretation would extend the tax shelter exception to instances where a taxpayer receives specific advice (rather than marketed or “one-size-fits-all” advice) in connection with a transaction that qualifies as a tax shelter (i.e., there is a significant purpose of tax avoidance or evasion).

Shell Petroleum – Facts of Transaction



- Facts: Step 1 – Formation of Shell Frontier. In August 1992, three lower-tier subsidiaries of Shell Petroleum transferred assets to newly formed Shell Frontier in exchange for voting common stock and nonvoting preferred stock. The assets consisted of producing and nonproducing properties. In addition, unrelated investors purchased 1100 shares of auction-rate preferred stock in exchange for $110 million. The auction-rate preferred stock entitled the unrelated investors to 25.88% of the vote in Shell Frontier. One of the three lower-tier Shell Petroleum subsidiaries, Shell Western, also transferred additional assets to Shell Frontier in exchange for 900 shares of auction-rate preferred stock. The assets transferred by Shell Western consisted of non-producing Colorado oil shale properties and offshore oil leases in California and Alaska. Shell Western had an aggregate basis in these assets of $679,335,936. (Continued on next slide.)

Shell Petroleum - Facts of Transaction



- Facts: Step 2 – Sale of stock. In December 1992, Shell Western sold 540 shares of Shell Frontier stock to unrelated investors for $54 million. Shell Frontier was not a member of the Shell consolidated group for tax purposes because more 20% of the voting power in Shell Frontier was owned by outside investors. Accordingly, this transaction caused the Shell Group to recognize a capital loss of approximately $354 million and created a consolidated net operating loss of approximately $320 million. The carryback of a portion of this net operating loss to 1990 resulted in a refund of approximately $19 million. In addition, a portion of the NOL was carried back to 1989 and 1991 and a portion was carried forward to years after 1992.

Shell Petroleum - IRS Challenge

- The IRS challenged the capital loss claimed by the Shell Group as a result of Shell Western's sale of auction rate preferred stock in Shell Frontier to the unrelated investors.

- The IRS argued that the auction rate preferred stock was not issued in exchange for property under section 351 because the nonproducing real estate properties did not earn income and therefore were without value.

- In addition, the IRS argued that the transaction should be disregarded because it lacked economic substance. In making this argument, the IRS relied heavily on the Federal Circuit's decision in *Coltec*.

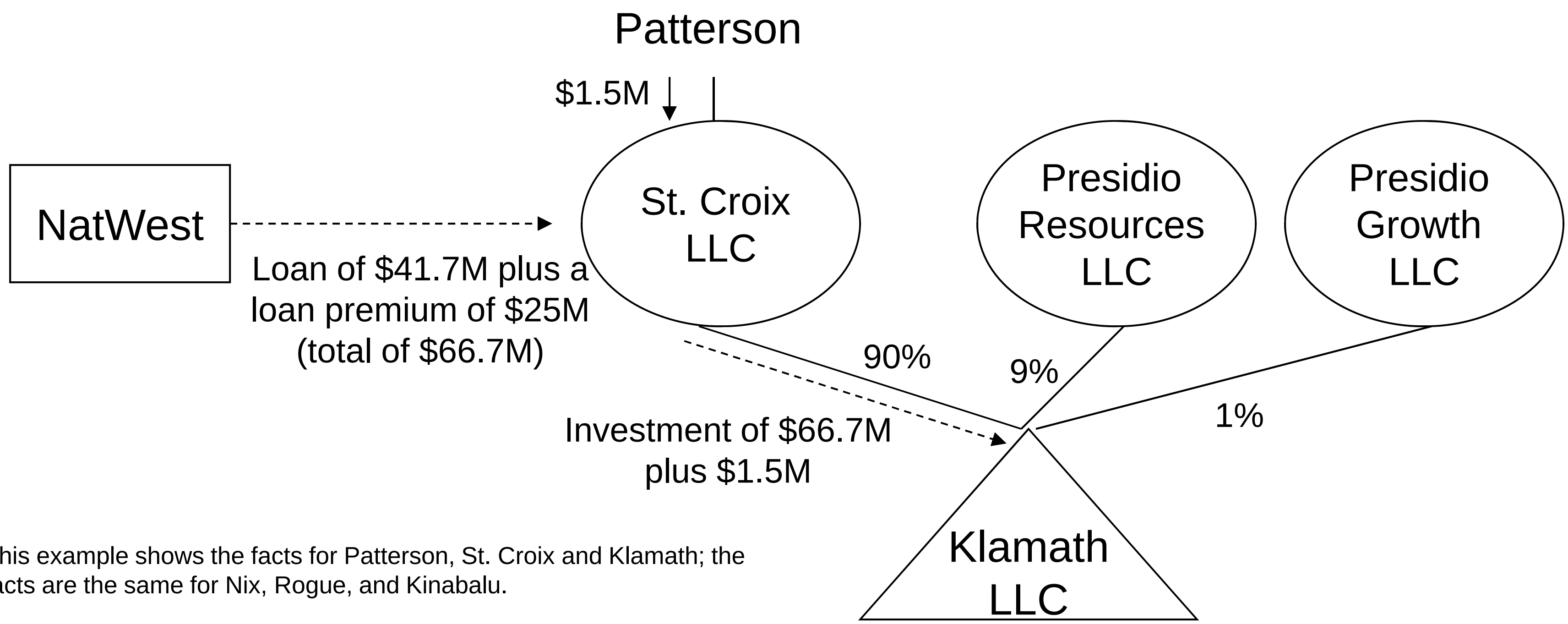
- Note that this transaction would not result in a capital loss today because of section 362(e)(2). Section 362(e)(2) requires taxpayers that transfer built-in loss property in a section 351 exchange to take a fair market basis in such property. Section 362(e)(2), however, was not enacted at the time of the transactions in *Shell Petroleum*.

Shell Petroleum – District Court Decision

- The United States District Court for the Southern District of Texas rejected the IRS argument and upheld the taxpayer's capital loss. See *Shell Petroleum Inc. v. United States*, 2008-2 USTC ¶ 50,422 (S.D. Tex. 2008).
- The court determined that the transfer of property to Shell Frontier qualified as a tax-free section 351 transaction and therefore Shell Western obtained a basis in the stock received in the exchange equal to its basis in the transferred assets.
  - The court determined that the nonproducing real estate properties transferred to Shell Frontier had value, even though they weren't earning income, and therefore such properties were "property" under section 351.
- The court rejected the government's economic substance argument.
  - The court noted that different courts apply different versions of the economic substance test and that some require both objective economic substance and business purpose and others require only one or the other. The court did not identify which standard it was applying, but determined that the transaction had both economic substance and business purpose. The court concluded that the transaction allowed Shell to monetize certain assets and also established a better management structure by containing the assets at issue within a single subsidiary. The court acknowledged that the structure of the transaction was motivated in part by the tax consequences and that the use of Shell Frontier was proposed by Shell's tax department. However, the court determined that the overall transaction was not proposed by the tax department, but rather by Shell business people. Further the court determined that the overall transaction had a legitimate business purpose and economic substance.
- The court criticized and declined to follow the step-by-step approach to economic substance analysis applied in *Coltec*:

  "Moreover, 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."
- The government has appealed to the Fifth Circuit Court of Appeals.

Klamath Strategic Investment Fund v. United States – Facts



This example shows the facts for Patterson, St. Croix and Klamath; the facts are the same for Nix, Rogue, and Kinabalu.

Facts: On January 20, 2000, St. Croix LLC ("St. Croix") and Rogue Ventures LLC ("Rogue") were formed as single-member Delaware LLCs. Individuals Patterson and Nix each contributed $1.5M to St. Croix and Rogue, respectively. On March 29, 2000, St. Croix and Rogue each borrowed $41.7M from National Westminster Bank plc ("NatWest") for seven years at a fixed interest rate. St. Croix and Rogue opted to pay an increased interest rate (17.97%) on their loans in return for NatWest paying St. Croix and Rogue premiums of $25M each. On April 6, 2000, St. Croix and Rogue each invested $68.2M to Klamath and Kinabalu, respectively, in exchange for a 90% partnership interest. Klamath and Kinabalu used these funds to purchase very low risk contracts on U.S. dollars and Euros and short 60- to 90-day term forward contract trades in foreign currencies. The investments involved three stages – I, II, and II – with the risk increasing with each stage.

Klamath Strategic Investment Fund v. United States – District Court Decision

Taxpayer's Position

- On their income tax returns for 2000, 2001, and 2002, Patterson claimed total losses of $25,277,202 arising from Klamath's activities and Nix claimed total losses of $25,272,344 arising from Kinabalu's activities.
- Patterson and Nix calculated their basis in the partnership as the $66.7M plus $1.5M, minus the liability assumption of $41.7M and, thus, were able to deduct over $25M from their taxable income.

Government's Position

- The IRS disagreed with the basis calculation and stated that under Section 752, the partners should have treated the entire $66.7M as a liability.
- Alternatively, the IRS argued that the transactions were shams or lacked economic substance and should be disregarded for tax purposes.

District Court

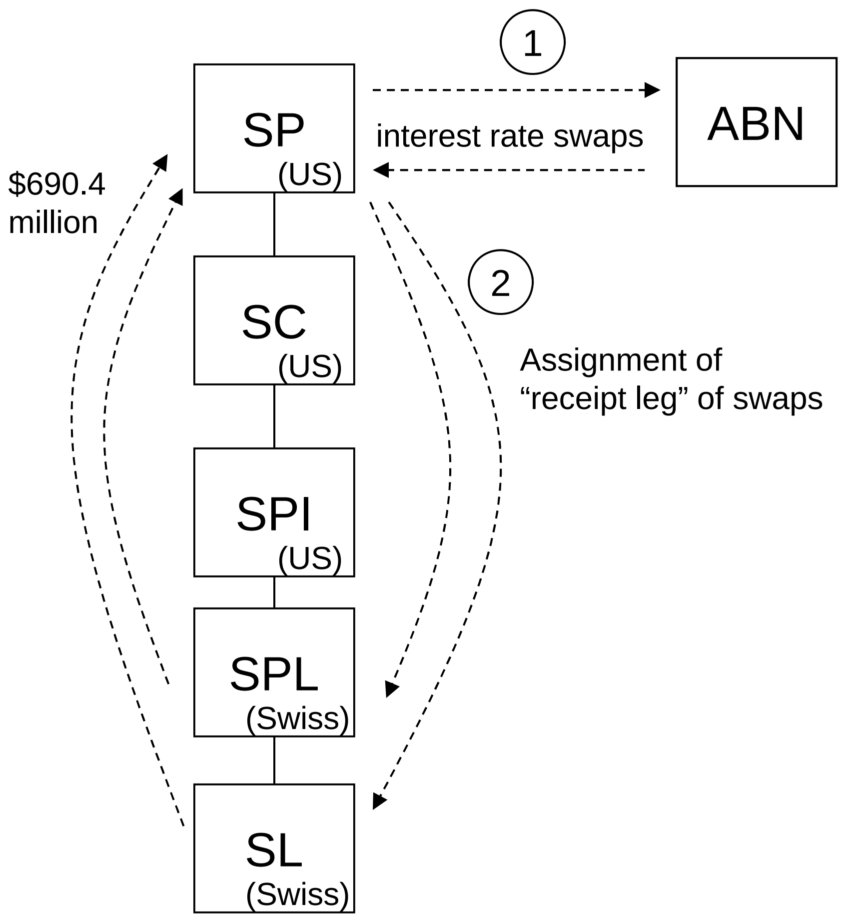
- The Partnership filed suit against the Government under section 6226 for readjustment of partnership items. The Partnerships moved for partial summary judgment, and the Government cross-moved for summary judgment on the issue of whether the partners' tax bases were properly calculated; specifically whether the loan premiums constituted liabilities under section 752 of the Code.
- The district court granted the Partnership's motion and denied the Government's, holding that the loan premiums were not liabilities under section 752 and therefore the partners' bases were properly calculated.
- However, following a bench trial the district court held that the loan transactions must nonetheless be disregarded for Federal tax purposes because they lacked economic substance.
- The Government appealed the district court's partial summary judgment in favor of the Partnerships, arguing that the "loan premiums" constitute liabilities under section 752.

Klamath Strategic Investment Fund v. United States – Fifth Circuit Decision

Fifth Circuit

- The Fifth Circuit applied the majority view of the economic substance doctrine – that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance (i.e., the conjunctive test).
- The court went on to explain that the Supreme Court in *Frank Lyon* set up a multi-factor test for when a transaction must be honored as legitimate for tax purposes. These factors include
  - Whether the transaction has economic substance compelled by business or regulatory realities,
  - Whether the transaction is imbued with tax-independent considerations, and
  - Whether the transaction is not shaped totally by tax avoidance features.
- The Fifth Circuit found that the evidence supported the district court's conclusion that the loan transactions lacked economic substance.
  - Numerous bank documents stated that despite the purported seven-year term, the loans would only be outstanding for about 70 days.
  - NatWest's profit in the loan transaction was calculated based on a 72-day period.
  - In the event that the investors wanted to remain with the plan beyond 72 days, NatWest would force them out.
  - The Partnerships contend that the loan funds were critical to the high-risk foreign currency transactions; however, the structure of the plan shows that these high-risk transactions could not occur until Stage III, which was never intended to be reached.
- The Fifth Circuit noted that 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.
  - In this case, the transactions that provided the tax benefits at issue were the loans from NatWest. Therefore, the court found that the proper focus is on whether the loan transactions presented a reasonable possibility of profit.
  - The Fifth Circuit found that the evidence clearly shows that Presidio and NatWest designed the loan transactions and the investment strategy so that no reasonable possibility of profit existed and so that the funding amount would create massive tax benefits but would never actually be at risk.
- The Fifth Circuit also held that the Government lacked standing to appeal the district court's partial summary judgment ruling that Section 752 operates to eliminate the claimed tax benefits arising from the Partnerships' participation in the loan transactions.

Schering-Plough Corp. v. United States



Facts: Schering-Plough Corporation (“SP”) owned all of the stock of Schering Corporation (“SC”), which owned all of the stock of Schering Plough-International (“SPI”). SP, SC, and SPI were U.S. corporations.

SPI owned a majority of the voting stock of Schering-Plough Ltd. (“SPL”), which owned a majority share in Scherico, Ltd. (“SL”). SPL and SL were Swiss corporations.

SP entered into 20-year interest rate swaps with ABN, a Dutch investment bank, in 1991 and 1992. The swap agreements obligated SP to make payments to ABN based on LIBOR and for ABN to make payments to SP based on the federal funds rate for the 1991 swap and on a 30-day commercial paper rate (plus .05%) for the 1992 swap.

The swap agreements permitted SP to assign its right to receive payments under the swaps (the “receipt leg” of the swap). Upon an assignment, SP’s payment to ABN and ABN’s payment to the assignee could not be offset against each other.

SP assigned substantially all of its rights to receive interest payments to SPL and SL in exchange for lump-sum payments totaling $690.4 million.

<u>*Schering-Plough Corp. v. United States*</u>

- <u>Taxpayer Position</u>
  - SP relied on Notice 89-21 to treat the swap and assignment transaction as a <u>sale</u> of the receipt leg of the swap to its foreign subsidiaries (SPL and SL) for a non-periodic payment that could be accrued over the life of the swap.
  - The IRS issued Notice 89-21 to provide guidance on the treatment of lump-sum payments received in connection with certain notional principal contracts in advance of issuing final regulations.
    - Notice 89-21 required that a lump-sum payment be recognized over the life of a swap in order to clearly reflect income.
    - Notice 89-21 stated that regulations would provide the precise manner in which a taxpayer must account for a lump-sum payment over the life of a swap and that similar rules would apply to the assignment of a "receipt leg" of a swap transaction in exchange for a lump-sum payment.
    - Notice 89-21 permitted taxpayers to use a reasonable method of allocation over the life of a swap prior to the effective date of the regulations.
    - Notice 89-21 cautioned that no inference should be drawn as to the treatment of "transactions that are not properly characterized as notional principal contracts, for instance, to the extent that such transactions are in substance properly characterized as loans."
  - The IRS issued final regulations in 1993 that reversed the basic conclusion of Notice 89-21 and provided that an assignment of the "receipt leg" of a swap for an up-front payment (when the other leg remained substantially unperformed) could be treated as a loan. <u>See</u> Treas. Reg. 1.446-3(h)(4) and (5), ex. 4.
- <u>IRS position</u>
  - The IRS argued that the swap and assignment transaction should be treated as a <u>loan</u> from the foreign subsidiaries to SP, which would trigger a deemed dividend under section 956.

Schering-Plough Corp. v. United States

- Court Decision
  - The District Court found in favor of the government on four separate grounds that, in the court's view, would be sufficient to deny the taxpayer's claim for tax-deferred treatment under Notice 89-21. See *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D.C. N.J. 2009).

  1. Substance Over Form
     - The court noted that the integrated transaction had the effect of a loan in which SP borrowed an amount from its foreign subsidiaries in exchange for principal and interest payments that were routed through ABN.
     - The court discounted SP's arguments (i) that there was an absence of customary loan documentation, (ii) that SP did not directly owe an amount to the foreign subsidiaries (even if ABN failed to fulfill its obligations), and (iii) that the amount of interest paid by SP to ABN would not equal the amount received by its foreign subsidiaries because of the different interest rate bases used under the swap.
     - The court determined that SP's efforts to structure the transactions as sales failed to overcome the parties' contemporaneous intent and the objective indicia of a loan.
       - The court stated that the foreign subsidiaries received the "economic equivalent" of interest and noted that SP "consistently, materially, and timely made repayments" to its foreign subsidiaries.
       - The court found that SP officials considered the transaction to be a loan.
       - The court observed that SP did not use customary loan documentation for intercompany loans.
     - The court also concluded that ABN was a mere conduit for the transactions which, according to the court, further supported its holding that the transactions were, in substance, loans.
       - ABN faced no material risk since it entered into "mirror swaps" to eliminate interest rate risk (but not the credit risk of SP).
       - The court found that ABN did not have a bona fide participatory role in the transactions, operating merely as a pass-through that routed SP's repayments to the Swiss subsidiaries.

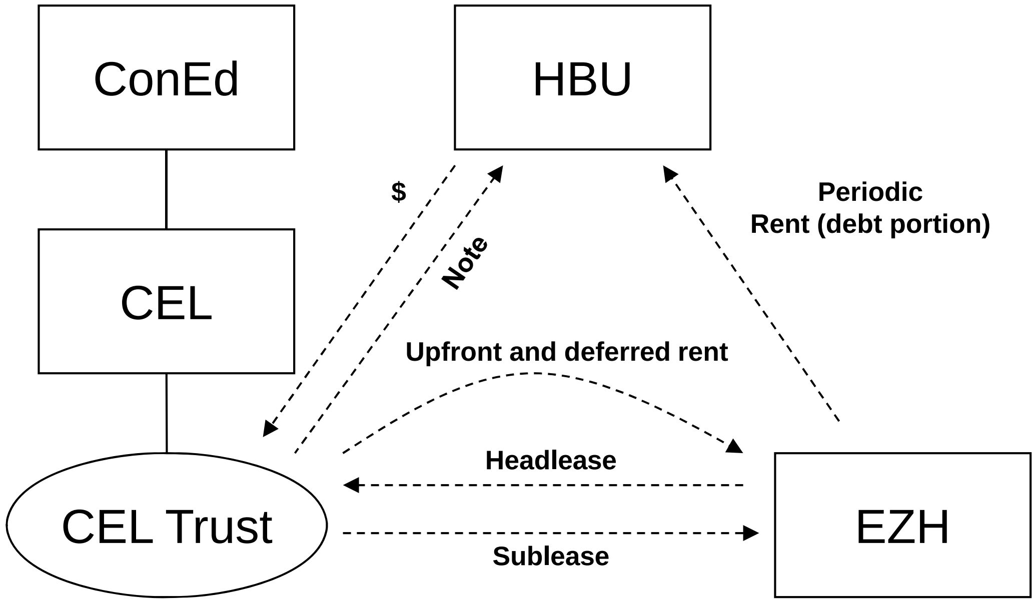
Schering-Plough Corp. v. United States

- Court Decision (con't)
  2. Step Transaction
     - The court also applied the step transaction doctrine as part of its substance over form analysis to treat the swap and assignment transaction as a loan.
     - In applying the "end-result test," the court determined that the steps of the swap and assignment transaction could be collapsed because they all functioned to achieve the underlying goal of repatriating funds from the foreign subsidiaries (SPL and SL).
       – In the court's view, the evidence established that the swaps and subsequent assignments were pre-arranged and indispensible parts of a "broader initiative" of repatriating earnings from the foreign subsidiaries.
     - The court also concluded the steps of the swap-and-assign transactions to be interdependent under the "interdependence test."
       – The court found that the goal of the interlocking transactions was to repatriate foreign-earned funds, and the interest rate swaps would have been pointless had SP not subsequently entered into the assignments with its subsidiaries.
     - The court rejected SP's argument that, in applying the step transaction doctrine, the IRS created the fictitious steps that (i) the foreign subsidiaries loaned funds to SP, (ii) SP entered into an interest rate swap for less than the full notional amount with ABN, and (iii) SP satisfied its obligation under the imaginary loans by directing ABN to make future payments under the swap to its foreign subsidiaries.
     - The court also rejected SP's argument that the step transaction doctrine should not apply because the IRS failed to identify any meaningless or unnecessary steps.

Schering-Plough Corp. v. United States

- Court Decision (con't)
  3. Economic Substance
     - The court concluded that the swap and assignment transaction failed the economic substance doctrine and, thus, SP was not entitled to tax-deferred treatment.
     - The court followed 3rd Circuit precedent, *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), which treats the "objective" and "subjective" elements of the doctrine as relevant factors (rather than applying a rigid conjunctive or disjunctive standard).
     - The court rejected the taxpayer's position that the repatriation proceeds represented "profit" from the transaction. The court also noted that any interest rate risk due to the swaps was hedged and that SP incurred significant costs in executing the transaction. In sum, the court found that there was little, if any, possibility of a pre-tax profit.
     - The court concluded that both the swap and assignment lacked a business motive.
       – SP contended that it entered into both swaps for cash management and financial reporting objectives, the 1991 swap for hedging purposes, and the 1992 swap for a yield enhancement function. The court rejected each of these non-tax motivations.
       – Notably, the court avoided the difficult legal determination of whether the court must examine the whole transaction or, as the government argued, just the component part that gave rise to the tax benefit (here, the assignment step of the transaction).
  4. Subpart F Principles
     - The court determined that permitting the repatriation of $690 million in offshore earnings without at least a portion of those earnings being captured under subpart F would contradict Congressional intent.
     - The court noted that Notice 89-21 did not supplant, qualify, or displace subpart F, nor was the notice intended to permit U.S. shareholders of controlled foreign corporations to repatriate offshore revenues without incurring an immediate tax.
     - In the court's view, the notice only dealt with the timing of income recognition.
- Third Circuit Decision
  – On appeal, the Court of Appeals for the Third Circuit upheld the District Court's decision. See *Merck & Co., Inc. v. United States*, 2011-1 USTC ¶ 50,461 (3d Cir. 2011).
  – The Third Circuit held that the District Court correctly found that the transactions were in substance loans, not sales.
  – Because the Third Circuit upheld the District Court's characterization of the transactions as loans, it did not address the District Court's alternative conclusion that the transactions lacked economic substance.

ConEd v. United States



Facts: ConEd, a U.S.-based utility, entered into a leveraged lease with EZH, a Dutch utility, on December 15, 1997. The lease property was an undivided 47.7% interest in a gas fired cogeneration power plant located in the Netherlands (the "RoCa3 Facility"). Under the "Headlease," ERZ leased the interest in the RoCa3 Facility to CEL Trust, a trust formed by a subsidiary of ConEd, for a period of 43.2 years. CEL Trust leased the interest back to EZH under the "Sublease" for a period of 20.1 years. CEL Trust was required under the Headlease to make an upfront rental payment ($120.1m), which was financed by an equity commitment of $39.3 million and a nonrecourse loan ($80.8m) from a third-party bank ("HBU"), and a deferred rent payment ($831.5m) due at the end of the Headlease term. Pursuant to the Sublease, EZH was required to make periodic rent payments, exclusive of certain payments, directly to HBU in satisfaction of CEL Trust's obligations under the non-recourse loan. At the end of the Sublease term, three options could be exercised: (1) EZH could exercise the Sublease Purchase Option for the price of $215.4 million, (2) CEL Trust could exercise the Sublease Renewal Option to extend the lease term for approximately 16.5 years, or (3) CEL Trust could exercise the Retention Option pursuant to which EZH would return its interest in the RoCa3 Facility to CEL Trust.

The parties entered into defeasance arrangements to finance their obligations under the LILO arrangement. EZH established a defeasance account with the upfront payment attributable to the nonrecourse financing ($80.8m) to fund the "debt portion" of the periodic rental payments under the Sublease. EZH also established a defeasance account with a portion of the upfront payment attributable to the equity commitment ($31.2m) to fund the "equity portion" of the periodic rental payments and the equity portion of the Sublease Purchase Option, if exercised by EZH. ConEd received a pledge of the equity and debt defeasance investments and re-pledged the debt defeasance to the nonrecourse lender, HBU, to secure its obligations under the nonrecourse note. For simplicity, the precise mechanics of the defeasance arrangements are not shown in the above diagram.

CED, as a subsidiary of ConEd, claimed deductions in 1997 for the prepaid rent transferred to EZH and for the interest attributable to the nonrecourse financing.

ConEd v. United States – Court of Federal Claims

- Spoliation Claim
  - The government alleged that, at the time of the change to a new email system in late 2000, ConEd had a duty to preserve evidence relevant to the LILO arrangement because it anticipated litigation starting in 1997.
    - The government's argument was based on the fact that Con Ed claimed work product protection for three memoranda drafted in 1997 that evaluated the tax consequences of the LILO arrangement.
    - In the alternative, the government argued that ConEd anticipated litigation in 1999 when Rev. Rul. 99-14 was issued.
    - The government sought an inference in its favor regarding open factual issues as to ConEd's intent and understanding of the LILO arrangement.
  - The Court of Federal Claims ruled in favor of ConEd.
    - The court already had concluded that the memoranda at issue were not work product.
    - The court also held that Rev. Rul. 99-14 by itself was not sufficient to give rise to an anticipation of litigation.
    - Accordingly, the court held that ConEd did not have a duty to preserve documents at the time of the email conversion.

ConEd v. United States – Court of Federal Claims

- Substance Over Form
  - The government argued that the taxpayer did not qualify as the “true owner” of the leasehold interest in the RoCa3 Facility such that it possessed the “benefits and burdens” of ownership.
  - The Court of Federal Claims rejected the government’s argument.
  - The court found that there was some risk of loss and some opportunity for profit.
    - The court acknowledged that, if EZH does not, or is not certain to, exercise the Sublease Purchase Option, then ConEd would likely satisfy the benefits and burdens standard due to the risk incurred during the retention period.
    - The court referred extensively to the record (using both taxpayer and government experts) and, on the totality of the factual circumstances, concluded that the purchase option was not compelled to be exercised.
      - From an economic perspective, the court relied on expert testimony that confirmed that the cost of exercising the purchase option would exceed the remaining value in the RoCa3 Facility interest at the end of the Sublease term.
      - In addition, the court found persuasive the fact that numerous conditions that may affect the decision to make the election could change over time (e.g., discount rates, inflation, market changes, technological evolution, state of Dutch utility industry) and, thus, it was unlikely that an election was “virtually certain” at the time of the transaction.
      - The court discounted government expert testimony (used in multiple LILO litigation cases) to the effect that the option would be exercised, in part, because it failed to address the specific facts at issue in the case.
    - The court relied on ConEd expert testimony regarding the various risks that may arise upon an early termination of the LILO arrangement.

ConEd v. United States – Court of Federal Claims

- Substance Over Form (continued)
  - The Court of Federal Claims rejected the government's argument that only a future interest was acquired because EZH held possession of the property during the Sublease period.
    - The court noted that possession is transferred in almost all true leases, including the lease in *Frank Lyon*.
  - The Court of Federal Claims also concluded that the nonrecourse debt was valid.
    - The court noted that all leveraged leases involve nonrecourse debt, that the nonrecourse loan permitted ConEd to acquire property, and that ConEd's property rights had substantial value such that ConEd would not walk away from the property and default on the loan.
    - The court rejected the government's circular funds argument and found that the defeasance arrangements, which only reduced risk, did not disqualify the debt as valid debt.
- Economic Substance
  - The Court of Federal Claims viewed the *Coltec* decision as consistent with past economic substance decisions that, in the aggregate, set forth the "general approach" to reviewing economic substance rather than "formulaic prescriptions" for determining which elements will result in a finding of economic substance.
  - The court stated that the *Coltec* decision reduced the relative weight afforded to subjective business motivations when applying the economic substance standard, although the court considered non-tax business purposes to remain relevant, if not necessary, for the economic substance analysis.
  - The court articulated the standard in the opinion's conclusion as follows –

    "*Coltec* expands on the guidance in *Frank Lyon*, offering a methodology to analyze economic substance by reviewing whether the taxpayer's sole motivation was tax avoidance, which party bears the burden of proof and, if the evidence does not demonstrate that the taxpayer's sole motive was tax avoidance, a requirement for objective evidence of economic substance in the transaction at issue."

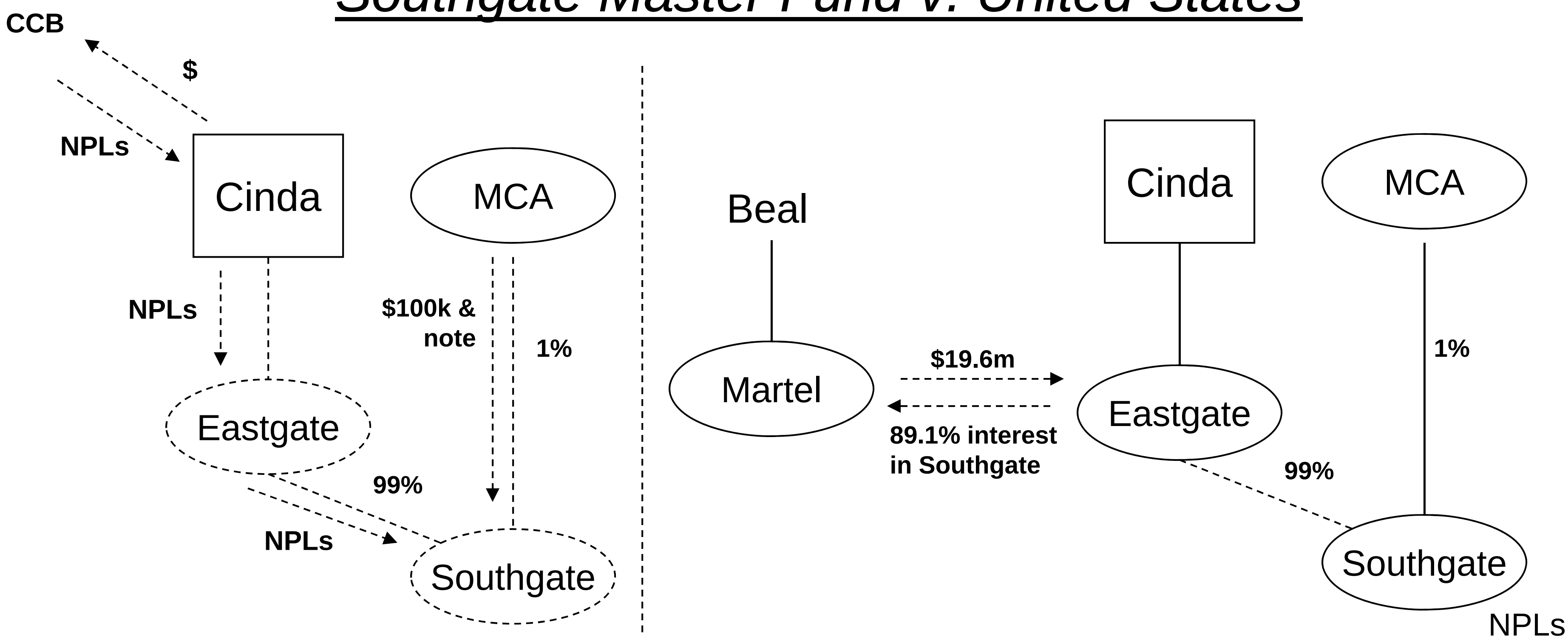
ConEd v. United States – Court of Federal Claims

- Economic Substance (continued)
  - Subjective Factors
    - The Court of Federal Claims lists numerous non-tax business reasons for entering into the LILO arrangement based on testimony offered by ConEd, including (i) the ability to pursue new opportunities and alternatives in the deregulated market, (ii) the expectation of making a pre-tax profit, (iii) ConEd's entry into Western European energy markets, (iv) potential to benefit from the residual value of the RoCa3 Facility, and (v) technical benefits from operating a high tech plant in its own field of expertise.
  - Objective Factors
    - The Court of Federal Claims states that a "significant consideration" in the economic substance analysis is whether there is a reasonable opportunity for profit at the time of the transaction.
    - The court concludes that Con Ed had a reasonable opportunity for profit under each of the possible scenarios at the end of the Sublease (i.e., purchase option, renewal, retention).
      - The court noted that other decisions have accepted relatively low percentage of pretax profit (e.g., 3% or more) for leasing transactions.
      - In determining the profit percentage, the court did not accept the government's position that a discount rate must be used.
- In sum, in applying the substance over form doctrine and the economic substance standard, the court reiterated that it was applying the judicial standards to unique set of facts and cited extensively to the record in this regard. On the basis of the totality of factual evidence, the court distinguished recent court decisions (*BB&T, Altria*, *Fifth Third*) involving LILO arrangements that were decided in favor of the government.

Wells Fargo v. United States – Court of Federal Claims

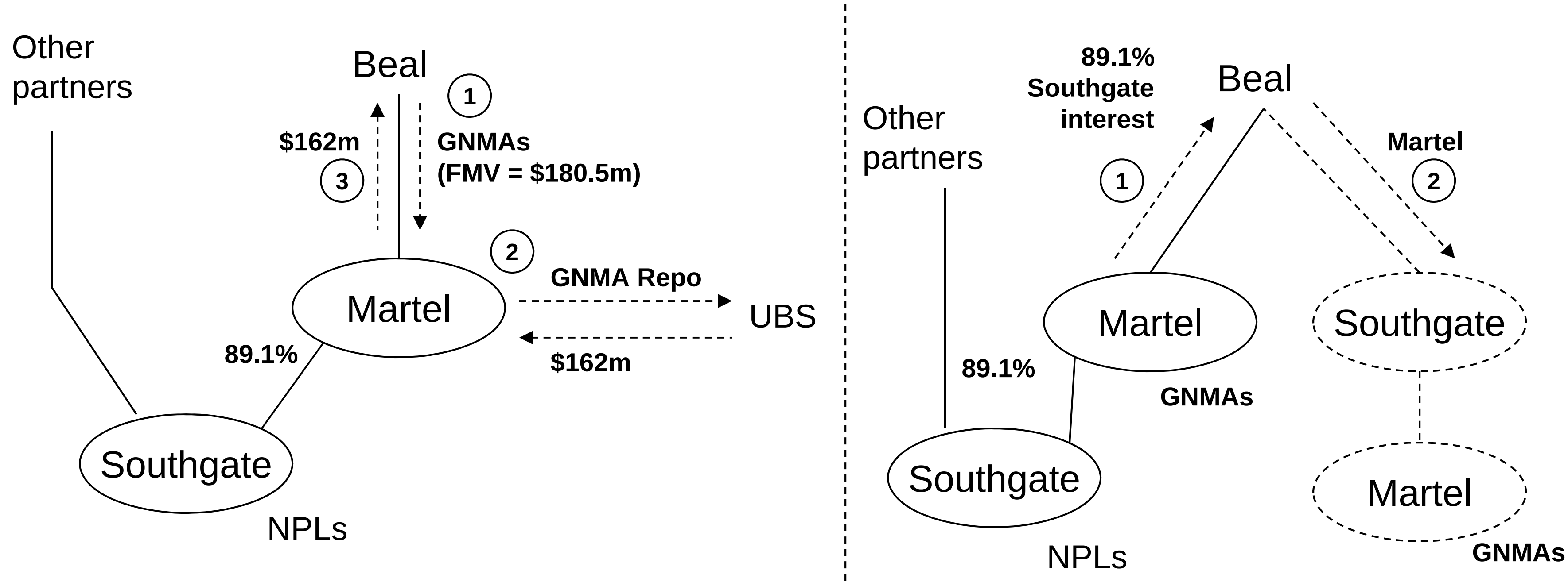
- In a subsequent decision, the Court of Federal Claims distinguished *ConEd* in *Wells Fargo v. United States*, 91 Fed. Cl. 35 (2010), holding that a similar SILO ("sale in/lease out") transaction failed a substance-over-form analysis and lacked economic substance.
- The court described *ConEd* as a "distinctly unique case" that was "easily distinguishable" from Wells Fargo's SILO transactions.
- The court noted that, in *ConEd*, it repeatedly emphasized the fact-dependent basis for its holding.
  - The court went so far as to list a series of quotations from its earlier *ConEd* opinion in which it stressed the uniqueness of the facts presented and the intended limited application of its holding.
- Accordingly, analyzing economic substance with respect to the specific SILO transactions at issue, the court determined that Wells Fargo's transactions were more similar to the SILO/LILO transactions disregarded in *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008), and *BB&T Corp. v. United States*, 2007-1 USTC ¶ 50,130 (M.D.N.C. 2007), aff'd 523 F.3d 461 (4th Cir. 2008).
  - Thus, the court denied Wells Fargo's refund claim for the tax deductions stemming from its SILO transactions.
- On appeal, the Court of Appeals for the Federal Circuit affirmed the decision by the Court of Federal Claims. *Wells Fargo v. United States*, 641 F.3d 1319 (Fed. Cir. 2011).
  - The Federal Circuit upheld the decision of the Court of Federal Claims based solely on the substance-over-form doctrine.

Southgate Master Fund v. United States



Facts: China Cinda, an entity owned and operated by the Chinese government ("Cinda"), paid face value (approx. $1.1 billion) for certain nonperforming loans ("NPLs") held by the state-owned Chinese Construction Bank (the "CCB"). On July 31, 2002, Cinda contributed these NPLs to Eastgate, a Delaware limited liability company, in exchange for 100% of the interests in Eastgate. On or about July 31, 2002, Eastgate contributed the NPLs to Southgate, a Delaware limited liability company, in exchange for a 99% membership interest. The remaining 1% membership interest was acquired for $100,000 cash and a note by Montgomery Capital Advisers, a Delaware limited liability company formed to pursue investment opportunities in China ("MCA"). D. Andrew Beal ("Beal") formed Martel Associates, LLC, a Delaware limited liability company ("Martel"), which purchased 90% of Eastgate's interests in Southgate for approximately $19.4 million on August 30, 2002. After the acquisition, Martel owned an 89.1% interest in Southgate, and Eastgate and MCA owned a 9.9% interest and a 1% interest, respectively.

Southgate Master Fund v. United States



Facts (continued): Southgate adopted a strategy to monetize the NPLs by selling a portion of low-quality NPLs to third parties and collecting on the remaining high-quality NPLs. Southgate planned to sell 20% to 25% of the NPLs in 2002, which would trigger a substantial amount of built-in losses to shelter Beal's personal income in 2002. In late 2002, Beal and Martel entered in a sale-repurchase transaction (a "repo" transaction) and a restructuring of Beal's interest in Martel (collectively, the "Repo/Restructuring") in order to increase Beal's outside basis in Southgate so that he could recognize the built-in losses that would be allocable to Beal (approx. $265 million).

The repo transaction consisted of the following steps: (i) Beal contributed Ginnie Mae securities ("GNMA" securities) with a basis and value of approximately $180.5 million to Martel, (ii) Martel entered into a repo transaction with UBS in exchange for $162 million and an agreement to repurchase identical GNMAs from UBS, and (iii) Martel distributed the $162 million to Beal and Beal guaranteed Martel's obligation to repurchase.

In the restructuring, (i) Martel distributed its interest in Southgate to Beal and (ii) Beal contributed his interest in Martel to Southgate. Beal became the sole manager of Martel under amended operating agreements and, in such capacity, held sole discretion *inter alia* to direct the purchase and sale of securities by Martel and the use of all proceeds from the repo transaction. After the restructuring, Beal's percentage interest in Southgate increased to approximately 93.3% while Eastgate's percentage interest decreased to 5%.

Southgate Master Fund v. United States

- Taxpayer's position
  - Allocation of Southgate Losses
    - Southgate incurred approximately $294.8 million in losses in 2002, of which approximately $292.8 million were built-in losses (within the meaning of section 704(c)) and $2.0 million were post-contribution losses.
    - Beal was allocated 90% of both the built-in losses and post-contribution losses in 2002 (approx. $265 million) pursuant to section 704(c) and Treas. Reg. § 1.704-3(a)(7) (as those provisions were in effect in 2002).
  - Beal's Outside Basis in Southgate
    - Beal's acquired a cost basis in Southgate upon acquisition from Eastgate (increased prior to the Repo/Restructuring by a payment of a placement fee on behalf of Southgate and a loan to Southgate).
    - Beal's contribution of the GNMAs to Southgate increased his outside basis in Southgate by his basis in the GNMAs, or $180 million.
    - The $162 million in repo liabilities assumed by Southgate in connection with the restructuring (through its ownership of Martel), and Beal's guarantee of such liabilities, resulted in offsetting basis adjustments.
    - Beal's basis in Southgate was approximately $210.5 million as of December 31, 2002, and he reported an ordinary deduction of approximately $216.3 million arising from his interest in Southgate.
- IRS position
  - The IRS argued that judicial doctrines (economic substance, sham partnership, and substance over form) prevented Beal's outside basis increase from the Repo/Restructuring.
  - The IRS also raised three separate so-called "basis killer" arguments that would require a step-down in the basis of the NPLs contributed to Southgate and, thus, deny all of built-in losses claimed by the partnership and allocated to Beal:
    - The IRS argued that Cinda was a dealer in securities and therefore Cinda would be required to mark-to-market the NPLs transferred to Southgate.
    - The IRS argued that section 482 should apply to reallocate income from the purchase of the NPLs by Cinda from the CCB at face value.
    - The IRS argued that NPLs were worthless at the time they were acquired by Cinda.

Southgate Master Fund v. United States

- Court Decision
  - The district court held that the judicial doctrines of economic substance, sham partnership, and substance over form applied to deny Beal the increase in basis from the Repo/Restructuring. See *Southgate Master Fund v. United States*, 651 F. Supp. 2d 596 (N.D. Tex. 2009).
  - Economic Substance
    - The district court stated that the transaction as a whole must be divided for purposes of the economic substance analysis: (i) the partnership between Cinda, MCA, and Beal in the Southgate acquisition of the NPLs and (ii) the Repo/Restructuring that increased Beal's basis in Southgate.
    - The district court held that Southgate itself had economic substance on the basis that the formation was not shaped solely by tax-avoidance features. In that regard, the district court found that there was a potential for profit (even though the venture turned out unprofitable) and noted that section 704(c), as it existed prior to 2004, arguably encouraged these types of transactions.
    - The district court held that the basis-increasing steps undertaken by Beal lacked economic substance. The court found that Southgate did not have a reasonable possibility for profit from the transaction (even though Southgate did in the original NPL transaction), in part, because Beal controlled the income streams from the GNMAs and had sole discretion to award gains or losses to the partnership. Furthermore, in the court's opinion, the taxpayer also did not establish a valid business purpose other than the tax benefits obtained by Beal.
  - Sham Partnership
    - The district court held that the Repo/Restructuring resulted in a sham partnership thereby denying Beal any resulting basis increase. Note that the district court did not disregard the partnership for all purposes.
    - The district court found, as described above, that there was no substantive non-tax business reason for structuring the Repo/Restructuring.
  - Substance Over Form
    - The district court also applied the substance over form doctrine to deny Beal the basis increase resulting from the Repo/Restructuring.
    - The district court appears to conclude that the Beal should be treated as entering into the repo transactions directly, thereby disregarding the use of Martel in the transaction.

Southgate Master Fund v. United States

- Court Decision (con't)
  - Basis-Killer Arguments
    - Dealer status of Cinda
      - The district court rejected the government's argument that Cinda should be treated as a dealer in securities required to mark-to-market the NPLs contributed to Southgate.
      - The district court noted that Cinda commonly entered into debt-to-equity swaps and other non-sale transactions in which it collected for its own account in the years preceding the transaction.
    - Section 482 adjustment
      - The district court rejected the government's argument that section 482 should apply to adjust the consideration paid by Cinda to acquire the NPLs from the CCB.
      - The district court concluded that section 482 could not apply to the sale between Cinda and the CCB because the adjustments contemplated by section 482 must be made to entities having a U.S. tax liability.
      - The district court also questioned whether Cinda and CCB could be viewed as related parties for purposes of section 482.
    - Worthlessness of NPLs
      - The district court rejected the government's argument that the NPLs were worthless when acquired by Cinda and therefore Southgate could not recognize a taxable loss on their disposition.
      - The district court cited evidence that the NPLs were sold for consideration.
  - The district court did not impose accuracy-related penalties asserted by the government, finding that Beal acted in good faith and with reasonable cause.

Southgate Master Fund v. United States

- On appeal, the Court of Appeals for the Fifth Circuit affirmed the district court's decision. *Southgate Master Fund, LLC v. United States*, No. 09-11166 (5th Cir. 2011).

Economic substance

- The court affirmed the district court's conclusion that Southgate's acquisition of the NPLs had economic substance, applying the standard adopted by the court in *Klamath Strategic Inv. Fund* – a transaction will be respected for tax purposes if it exhibits objective economic reality, a subjectively genuine business purpose, and some motivation other than tax avoidance.
  - The court found that the transaction had objective economic reality, noting that Southgate and its members entered into the NPL investment with a reasonable possibility of making a profit.
  - The court also agreed with the district court that Southgate and its members acquired the NPLs for legitimate purposes and that they believed they could earn a profit from the NPLs.
- The court rejected the government's argument that the transaction lacked economic substance because the profit potential of the transaction was insubstantial relative to its expected tax benefits.
  - The court noted that this was factually incorrect, as the district court had found that the NPLs had a more than de minimis potential for profit.
  - From a legal standpoint, the court stated that the government's argument conflated the court's analysis of the acquisition of the NPLs under the economic substance doctrine with the court's analysis of the formation of Southgate under the sham partnership doctrine.
  - According to the court, "The acquisition of the NPLs did not, by itself, generate any tax benefits. It was the funneling of that acquisition through the partnership structure that generated massive deductions for Beal. The fact that an economically substantial transaction comes wrapped in a dubious form is not reason to disregard the transaction; it is a reason to disregard the form."

Sham partnership

- The court agreed with the district court that Southgate was a sham partnership that must be disregarded for federal income tax purposes, finding that (i) Montgomery, Beal, and Cinda did not intend to come together jointly to conduct the business of collecting on the NPLs, and (ii) the parties lacked any genuine business purpose for their decision to form Southgate.

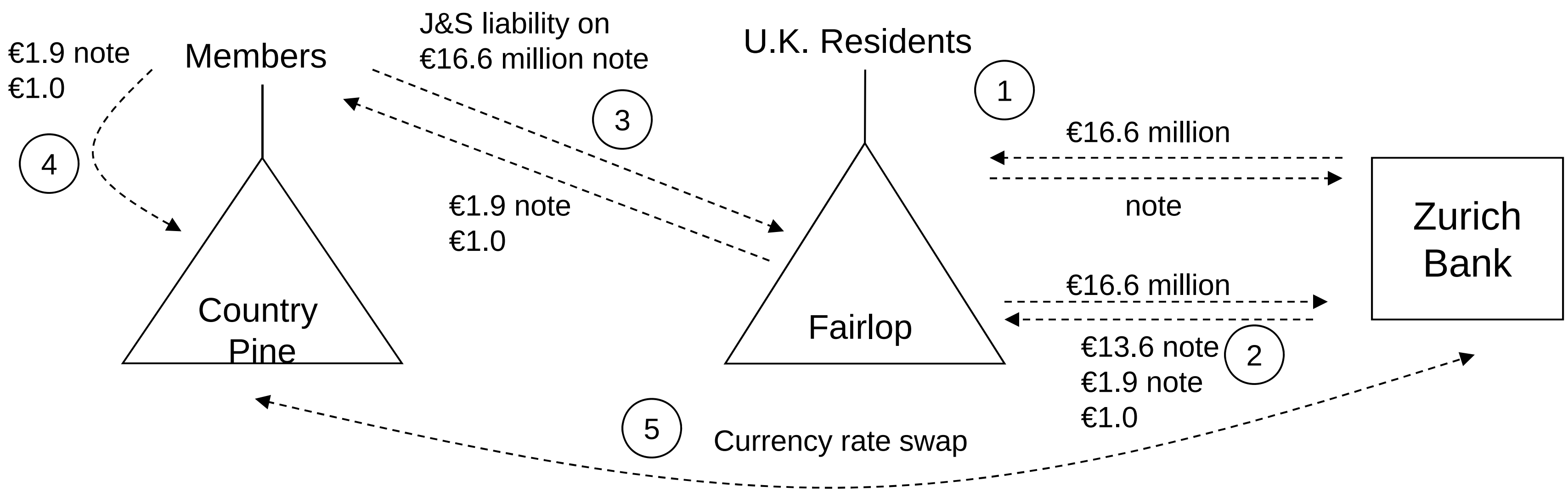
Substance over form

- The court stated that, because it had concluded that the acquisition of the NPLs had economic substance but that the formal partnership structure through which the acquisition took place was a sham, it had to determine what transactional form most closely followed the substance of that acquisition.
- The court held that Southgate's acquisition of the portfolio of NPLs should be recharacterized as a direct sale of the NPLs by Cinda to Beal.

Penalties

- The court affirmed the district court's decision to disallow the imposition of any accuracy-related penalties.

Country Pine Finance, LLC v. Commissioner



Facts: In 2001, several individual taxpayers sold stock in the Burnham Insurance Group ("BIG") to HUB International ("HUB") (referred to as the "Members"), recognizing gain on the exchange of BIG stock for HUB stock and cash.

In the CARDS transaction entered into in 2001, Fairlop Trading, LLC ("Fairlop"), an entity formed by two U.K. residents, borrowed €16.6 million from Zurich Bank. Fairlop used the loan proceeds to purchase two promissory notes from Zurich Bank to collateralize the loan: one for €13.6 million and another for €2.9 million. Fairlop later exchanged the €2.9 million note for a new note of €1.9 million and €1.0. [Note that this exchange not shown in diagram above.]

The Members formed Country Pine Finance, LLC ("Country Pine") to participate in the CARDS transaction. The Members purchased the €1.9 million note and €1.0 from Fairlop in exchange for an agreement to become jointly and severally liable for the entire €16.6 loan from Zurich Bank to Fairlop. The Members then contributed the €1.9 million note and €1.0 to Country Pine. In exchange, Country Pine guaranteed the loan to Fairlop. The Members and Country Pine pledged the contributed property as collateral for the loan.

Country Pine and Zurich Bank entered into a currency swap pursuant to which Country Pine exchanged the €1.9 million note and €1.0 for $2.6 million in cash. Country Pine claimed a $11,952,871 loss on the exchange (allocated between a short-term capital loss on the note and an ordinary loss on the euro) since it claimed a basis in the exchanged property equal to the full amount of the joint and several liability assumed by the Members -- €16.6 million or $14.6 million.

The amounts exchanged served as the notional amounts under the swap. The swap required Zurich Bank to pay interest on €2.9 million received from Country Pine (that equaled Country Pine's payments to Zurich Bank on the assumed loan) and Country Pine to pay interest on the $2.6 million received from Zurich Bank (that Country Pine used to obtain a promissory note from Zurich Bank, which was pledged back to Zurich Bank as collateral).

Country Pine Finance, LLC v. Commissioner

- IRS argued that the claimed losses should be denied because (i) the CARDS transaction lacked economic substance, (ii) substance-over-form principles should apply to disallow the loss, and (iii) neither Country Pine nor the Members could claim deductions under section 165, 465, or 988.
- The Tax Court held that the transaction did not have economic substance under either the standard applied in the 6th Circuit (no rigid test) or D.C. Circuit (disjunctive test), and denied the claims for losses in the CARDS transaction. See *Country Pine Finance, LLC v. Commissioner*, T.C. Memo. 2009-251.
  - The Tax Court did not address other arguments in the T.C. Memo. opinion raised by the government.
- The taxpayer argued that the CARDS transaction had economic substance and was entered into to permit Country Pine to finance real estate investments on the members' behalf.
  - Taxpayer argues that Country Pine and the Members were jointly and severally liable for the entire € 16.6 million, and that Fairlop, the Members and Country Pine were at risk for the loan proceeds.
  - Taxpayer also argues that there was profit potential since real estate could have been substituted for collateral on the loans.
- The IRS argued that transaction had no economic substance and no practical effect other than creating tax losses.

Country Pine Finance, LLC v. Commissioner

- The Tax Court held that the tax losses must be denied under both an objective and a subjective analysis.
- Objective Analysis
  - Tax Court concluded that the transaction did not have a profit potential.
    - None of the loan proceeds ever left Zurich Bank's control as loans acquired promissory notes that were pledged as collateral.
    - Expert testimony established that the transaction had a negative net present value and rate of return – fees of $700,000 paid in order to borrow €2.9 million for 1 year, the funds from which purchased investments that could never earn a profit (e.g., promissory notes from Zurich Bank).
  - Tax Court concluded that the transaction should not be analyzed as if real estate were substituted as collateral.
    - Country Pine could only earn a profit if it could substitute collateral and earn a return in excess of the cost of the initial loans.
    - However, the court found that Zurich Bank would not have permitted the substitution without imposing more onerous terms to account for its increased risk and that the Members knew prior to the transaction that real estate could not be substituted as collateral without a "haircut."
    - The Tax Court further held that any substitution would be viewed as a separate transaction so that the currency exchange creating the tax loss would still have no pre-tax profit, citing *Coltec*.
- Subjective Analysis
  - Tax Court held that the Members did not have a nontax business purpose for entering into the CARDS transaction.
  - Tax Court noted that the Members knew that real estate could not be substituted prior to the transaction, the petitioner testified that the decision to enter into the transaction was to take advantage of tax benefits, and that Members repeatedly testified that they did not read any of the relevant documents or otherwise engage in due diligence.

Fidelity International v. United States

- The District Court of Massachusetts recently held that certain Son-of-BOSS type transactions should be disregarded because they lacked economic substance. See *Fidelity Int'l Currency Advisor A Fund LLC v. United States*, 2010-1 USTC ¶ 50,418 (D.C. Mass. 2010).

Relevant Facts:

- Taxpayers owned approximately 25 million shares of EMC stock. In 2000, taxpayers' basis in the stock was extremely small in comparison to the stock's trading price, and the sale of any portion of the stock would have resulted in substantial capital gains. Taxpayers also owned options to purchase an additional 8 million shares of EMC stock at very low strike prices. The exercise of the options would generate significant amounts of ordinary income.
- To avoid the large tax liabilities that would result from a stock sale or exercise of the stock options, taxpayers invested in son-of-BOSS style tax shelters promoted by KPMG.
- The first transaction involved the contribution of offsetting options (in large notional amounts) and EMC stock to Fidelity High Tech Advisor A Fund, LLC, which was taxed as a partnership.
  – Taxpayers treated the purchased option as an asset, but the sold option was not treated as a liability. Thus, the taxpayers contributed assets to the partnership entity but not liabilities, creating an inflated basis in their membership interest of more than $163 million. In 2002, the taxpayers sold all of the stock in Fidelity High Tech and claimed a significant capital loss.
- Taxpayers used a second transaction, the Financial Derivatives Investment Strategy ("FDIS"), a variation of the scheme discussed above, to shelter ordinary income resulting from the exercise of their EMC stock options.
  – The FDIS transaction, executed through Fidelity International Currency Advisor A Fund, LLC, generated paper losses for taxpayers by assigning any offsetting "gains" offshore to one of two Irish confederates of the tax promoters (neither of whom filed U.S. tax returns).
  – The Fidelity International transaction resulted in the creation of artificial losses of $158.6 million in 2001, which the taxpayers used to offset the ordinary income of $162.9 million from the option exercise on their income tax return that year.

Fidelity International v. United States – District Court Decision

Taxpayer's Economic Substance Arguments:

- Taxpayers had a business purpose for the transactions.
  - The Fidelity High Tech transaction was to serve as a hedge against a downward movement in the price of EMC stock.
  - The Fidelity International transaction was to serve as a hedge against fluctuating interest rates and foreign currency exchange rates.
- The transactions possessed objective substance.
  - Both transactions were reasonably designed and implemented to serve a hedging function, and there was a reasonable possibility that the taxpayers could profit on the transactions.

Court's Decision:

- Economic Substance Analysis:
  - The court stated that the First Circuit appears to have adopted a version of the economic substance doctrine that looks to both the subjective and objective features of the transactions, without applying a rigid two-part test (citing *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989)).
  - Taxpayers relied on several other First Circuit opinions, including *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956), for the proposition that a transaction that is not fictitious should be upheld, without regard to the subjective intent of the taxpayer.
  - The court, however, stated that the *Dewees* opinion effectively overruled *Granite Trust* (as well the other cases cited by taxpayers), "at least as to the broad contours of the economic substance doctrine."
    - The court stated that *Dewees* is in accordance with the view shared by most circuits, that a court may take into account both objective and subjective factors in assessing whether a particular transaction had economic substance.
    - Accordingly, to the extent the cases cited by taxpayers may be read to support the proposition that a taxpayer's subjective intent is irrelevant, that proposition cannot survive the holding or the reasoning of *Dewees*.
  - The court concluded that, in making an economic substance determination, it considers both the objective features of the transactions and the subjective intent of the participants, including the overall features of the tax shelter scheme and the intentions of the promoters.
    - The court noted, however, that it was not necessary to decide whether the objective or subjective factors, standing alone, would be sufficient to support a finding of a lack of economic substance in this case, as the transactions at issue were without economic substance under either an objective or subjective analysis.

Fidelity International v. United States – District Court Decision

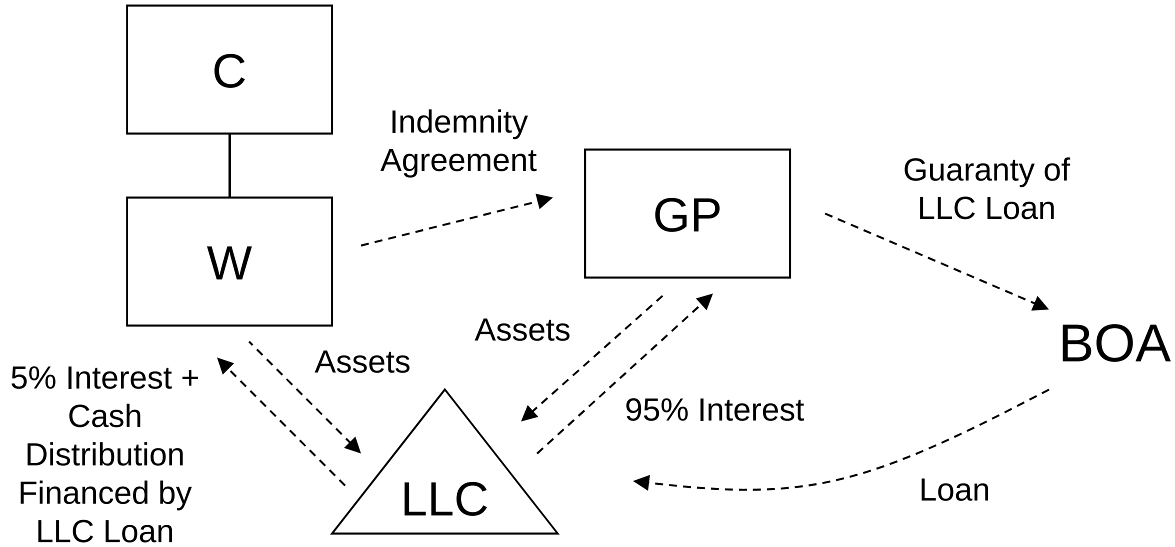
Overview of Court Analysis:

- From a subjective standpoint, the transactions had no business purpose of any kind. The taxpayers did not enter into the transactions for profit or to provide a hedge or other protection against economic risk, but to shelter capital gains and ordinary income from taxation.
- The transactions also had no economic substance from an objective standpoint.

Relevant Findings for Particular Transactions:

- Fidelity High Tech
  - The transaction served no reasonable hedging function
    - Option trades were not a rational economic hedge
    - Various components of the transaction served no hedging function
  - There was no reasonable possibility of profit
    - Transaction costs and fees were extremely high
    - Expected return on the transaction was negative
    - Net present value of the options was negative
    - One-option payout was not a real possibility
    - Options were not profitable
- Fidelity International
  - The transaction served no reasonable hedging function
    - Interest rate and currency option transactions were not rational economic hedges
    - Various components of the transaction served no hedging function
  - There was no reasonable possibility of profit
    - Capital structure was not rational
    - Costs and fees for the transaction were extremely high
    - Expected rate of return for the transaction was negative
    - One-option payout was not a real possibility
    - Transaction was intended to be profitless

Canal Corp. v. Commissioner



Facts: W, a wholly-owned subsidiary of C, proposed to transfer its assets and most of its liabilities to a newly-formed LLC in which W and GP, an unrelated corporation, would have ownership interests. In 1999, GP transferred assets valued at $376.4 million to the LLC in exchange for a 95-percent LLC interest. W contributed $775 million in assets to the LLC in exchange for a 5-percent LLC interest. On the same day it received the contributions from W and GP, the LLC borrowed $755.2 million from Bank of America and immediately transferred the loan proceeds to W as a special cash distribution. GP guaranteed payment of the Bank of America loan, and W agreed to indemnify GP for any principal payments made pursuant to its guaranty. W used a portion of the cash distribution it received to make a loan to C. W's only assets after the transaction were its LLC interest, a note from C, and a corporate jet. The LLC thereafter borrowed funds from a financial subsidiary of GP to retire the bank loan.

In 2001, GP entered into a separate transaction that required it to divest its entire interest in the LLC. W subsequently sold its LLC interest to GP, and GP then sold the entire interest in the LLC to an unrelated party. C reported gain from the sale on its consolidated income tax return for 2001. The IRS determined that the joint venture transaction was a disguised sale that resulted in capital gain includible in C's consolidated income for 1999. The IRS also asserted a substantial understatement penalty under section 6662(a).

Canal Corp. v. Commissioner

- The Tax Court found that the facts and circumstances evidenced a disguised sale, and held that W sold its business assets to GP in 1999, the year it contributed the assets to the LLC, not the year it sold its LLC interest. See *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010).
- Under Treas. Reg. 1.707-3(c)(1), W's transfer of assets to the LLC and simultaneous cash distribution were presumed to effect a sale unless the facts and circumstances clearly established otherwise.
- The taxpayer asserted that the LLC's special distribution of cash to W was not part of a disguised sale, but was a debt-financed transfer of consideration (an exception to the disguised sale rules).
  - The regulations except certain debt-financed distributions in determining whether a partner received money or other consideration for disguised sale purposes. See Treas. Reg. § 1.707-5. A distribution financed from the proceeds of a partnership liability may be taken into account for disguised sale purposes to the extent the distribution exceeds the distributee partner's applicable share of the partnership liability.
- The taxpayer further asserted that the transaction should not be recast as a sale because the anti-abuse rule under Treas. Reg. § 1.752-2(j) did not disregard W's agreement to indemnify GP, which, according to the taxpayer, imposed on W the economic risk of loss for the LLC debt.
  - Under the anti-abuse rule, a partner's obligation to make a payment may be disregarded if (i) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's risk of loss or to create a facade of the partner's bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation. See Treas. Reg. § 1.752-2(j)(1), (3).
- The IRS argued that the taxpayer structured the transaction to defer capital gain, contending that W did not bear any economic risk of loss when it entered the joint venture agreement because the anti-abuse rule under Treas. Reg. § 1.752-2(j) disregards W's obligation to indemnify GP. Thus, according to the IRS, the transaction should be treated as a disguised sale.

Tax Court's Disguised Sale Analysis

- Addressing the taxpayer's argument that the distribution was not part of a disguised sale because it was a debt-financed transfer of consideration, the court examined whether W had any allocable share of the LLC's liability to finance the distribution. To make this determination, the court focused on whether W bore any economic risk under its agreement to indemnify GP.

Canal Corp. v. Commissioner

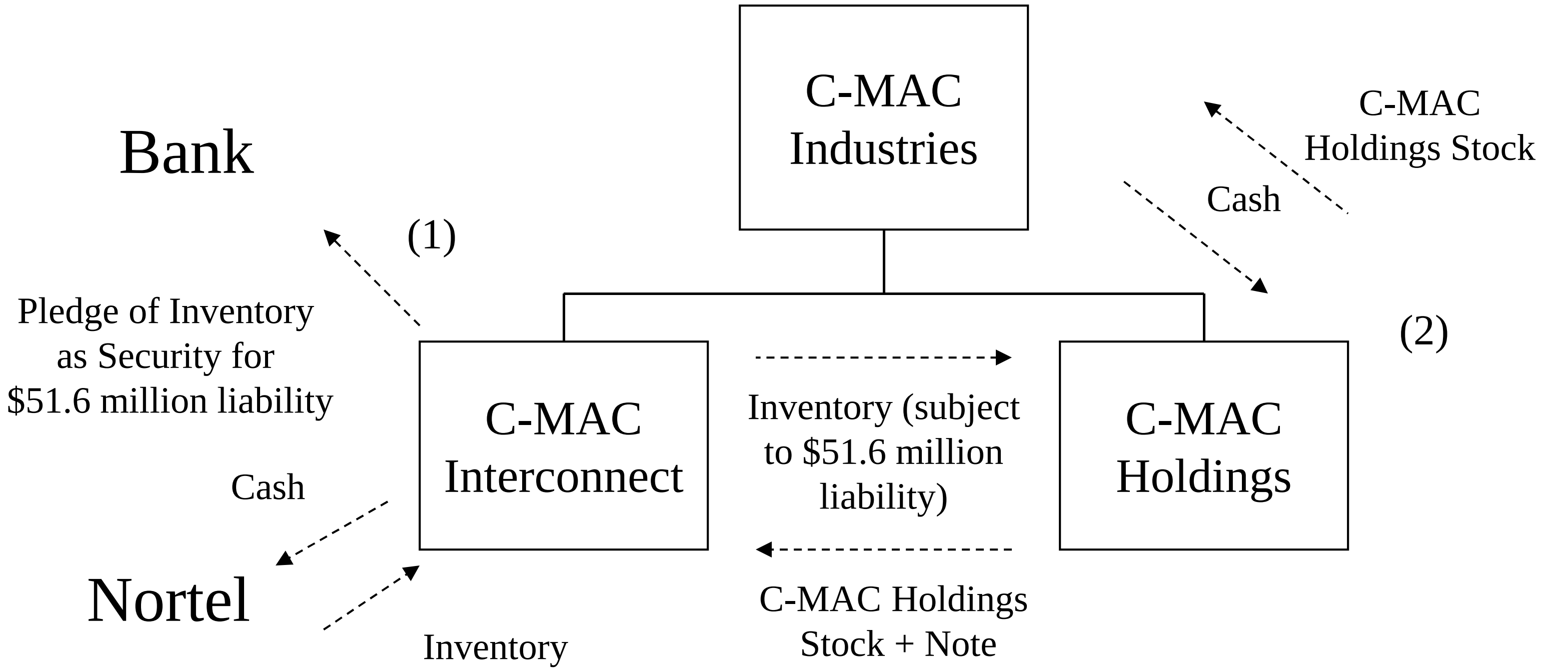
Disguised Sale Analysis (continued)

- The court found that the taxpayer crafted the indemnity agreement to limit any potential liability to W's assets.
  - GP did not require the indemnity, and the indemnity agreement did not require W to maintain a certain net worth.
  - W was chosen as the indemnitor because it would cause the economic risk of loss to be borne only by W's assets rather than C's.
  - Contractual provisions reduced the likelihood of GP invoking the indemnity against W.
- The court also noted that, regardless of how remote the possibility was that W would have to pay anything under the indemnity agreement, W lacked sufficient assets to cover the maximum exposure on the indemnity.
  - In particular, the court noted that C could remove W's main asset, the intercompany note, from W's books at any time.
- The court concluded that W's agreement to indemnify GP's guaranty lacked economic substance and afforded no real protection to GP.

Section 6662(a) Penalty

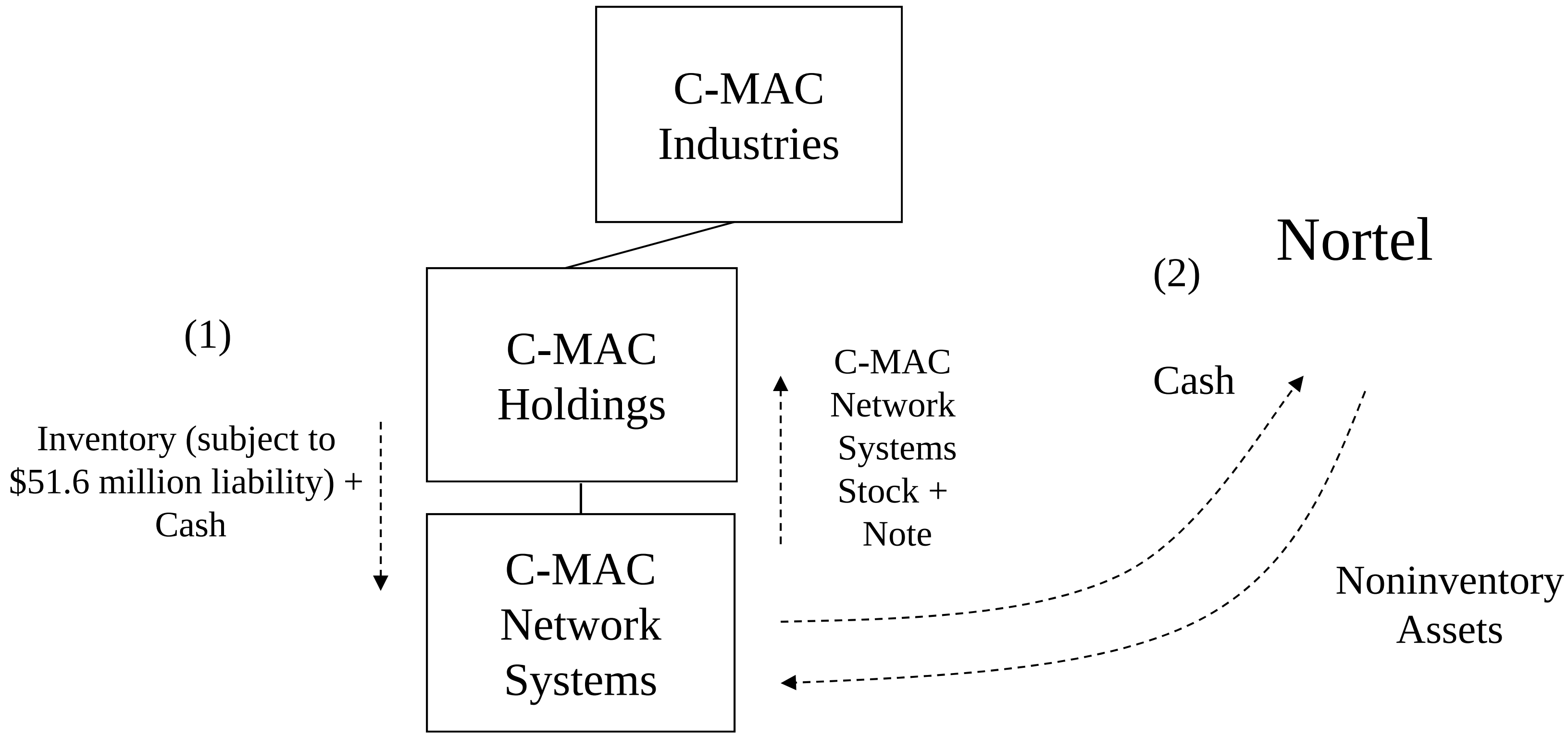
- The taxpayer claimed that it reasonably relied in good faith on tax advice from PwC, including legal analysis detailed in a "should" level PwC opinion, and that no penalty should be imposed.
- The court, however, determined that PwC based its advice on unreasonable assumptions, noting the following:
  - The draft opinion submitted into evidence was disorganized and incomplete.
  - The opinion was filled with questionable conclusions and unreasonable assumptions. The opinion assumed the indemnity would be effective and that W would hold assets sufficient to avoid the anti-abuse rule, failing to consider whether the indemnity lacked substance.
  - The rendering of a "should" level opinion was unreasonable given the dubious legal reasoning provided in the opinion.
  - It was unreasonable for the taxpayer to have relied on an analysis based on erroneous legal assumptions.
- The court also found that the taxpayer did not act with reasonable cause or in good faith in relying on PwC's advice, finding that any advice received was tainted by an inherent conflict of interest because a member of the PwC team helped plan the transaction.
  - The court also noted that the opinion was issued for an exorbitant fixed fee of $800,000, which was contingent on the closing of the transaction.

Flextronics America, LLC v. Commissioner



Facts: C-MAC Industries, a Canadian corporation and the parent company of all C-MAC entities (the "C-MAC group"), owned C-MAC Interconnect, a Canadian company, and C-MAC Holdings, a U.S. subsidiary. In 1998, C-MAC Industries agreed to acquire a manufacturing facility from Nortel, an unrelated party who was of the largest purchasers of the C-MAC group's products. Before closing, C-MAC Interconnect acquired the facility's inventory from Nortel for $12.1 million. C-MAC Interconnect and Nortel also executed a bailment agreement, which provided that the inventory was to be kept and maintained by Nortel at the facility pending the closing, but also provided that C-MAC Interconnect and its affiliates had the authority to pledge and encumber the inventory and transfer rights to, title to, and interest in the inventory. The acquisition was financed through loans totaling $51.6 million from a bank to various C-MAC entities, with the acquired inventory pledged by C-MAC Interconnect as security. Following its purchase of the inventory, C-MAC Interconnect sold a portion of the inventory to C-MAC Quartz, another member of the CMAC group that operated a facility in the United Kingdom, which transferred the purchased inventory to another facility maintained by Nortel. Subsequently, C-MAC Interconnect transferred the inventory to C-MAC Holdings in exchange for 10,107 shares of C-MAC Holdings stock and a $9.5 million promissory note. Concurrently, C-MAC Industries transferred $4 million to C-MAC Holdings in exchange for 17,124 shares of C-MAC Holdings stock.

Flextronics America, LLC v. Commissioner



Facts (cont'd): C-MAC Holdings transferred the inventory and $2.3 million to C-MAC Network Systems, a newly-formed U.S. subsidiary, in exchange for 10,107 shares of C-MAC Network System's stock and a $9.5 million promissory note. Another entity within the C-MAC group then loaned $42.2 million to C-MAC Network Systems, which purchased the remaining noninventory facility assets from Nortel. On its 1998 federal income tax return, Taxpayer claimed a $37.3 million loss on the disposal of the inventory. This amount was based on a $39.8 million increase in the inventory's basis under sections 357(c) and 362(a)(1). Under section 357(c), in a section 351 exchange, if the sum of the liabilities assumed by a transferee and the amount of the liabilities to which transferred property is subject exceeds the adjusted basis of the transferred property, the excess is recognized as gain to the transferor. Under section 362(a)(1), the basis of property transferred to the transferee in the section 351 transaction is equal to the basis of the transferred assets in the hands of the transferor, increased by the gain recognized by the transferor on the transfer.

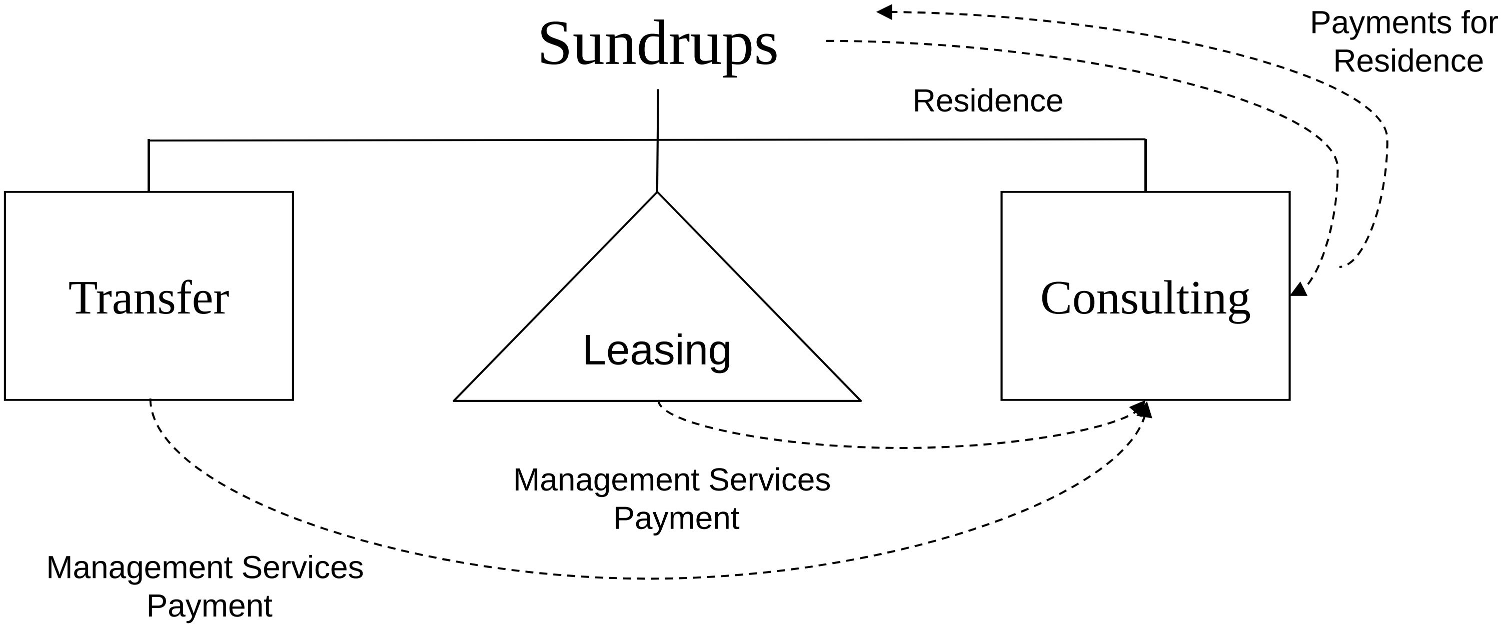
Flextronics America, LLC v. Commissioner

- Although the IRS agreed that the inventory transactions involving C-MAC Holdings and C-MAC Network Systems met the literal requirements of section 351, the IRS contended that the inventory transactions should be disregarded because they fell outside the statutory purpose of section 351, lacked section 351 business purpose, lacked economic substance, and were subject to disallowance under the step transaction doctrine.
- The Tax Court, however, held that the inventory transactions were valid transactions, and rejected each of the IRS's contentions, stating that it was "not inclined to stretch inapplicable judicial doctrines to corral a transaction that escaped before Congress closed the barn door." <u>See</u> *Flextronics America, LLC v. Commissioner*, T.C. Memo. 2010-245.
  - In 1999, Congress amended section 357(c) and added sections 357(d) and 362(d), which effectively provide that the bump-up in basis could not exceed the fair market value of the transferred property.
- <u>Scope of Section 351</u>
  - The IRS, citing *Wolf v. Commissioner*, 357 F.2d 483, and *Gregory v. Helvering*, 293 U.S. 465 (1935), asserted that the section 351 inventory transactions fell outside the statutory purpose of section 351 because the purpose of that section is the deferral of gain or loss recognition, not total avoidance.
    - The IRS focused on the fact that C-MAC Network Systems received the tax benefit of the loss, while C-MAC Interconnect was not subject to U.S. tax and did not incur a corresponding gain.
  - The Tax Court distinguished the case law relied on by the IRS, noting that, although the creation and use of entities and transactions that lack substance falls outside the purpose of section 351, the inventory transactions at issue were valid substantive transactions.
- <u>Business Purpose</u>
  - The IRS contended that the inventory transactions lacked a business purpose as required under section 351.
  - The Tax Court, while noting that the existence of a business purpose requirement under section 351 was unclear, found that there was a business purpose for the inventory transactions, which provided for part of the capitalization of C-MAC Network Systems and enabled the acquired facility to be operated as a separate subsidiary of C-MAC Industries' U.S. consolidated group.
  - The Court disregarded the role of the tax advisors who encouraged the use of the planning technique, noting that such advice did not nullify the Taxpayer's business purpose.

Flextronics America, LLC v. Commissioner

- Economic Substance
  - The Tax Court rejected the IRS's argument that the inventory transactions should be disregarded for lack of economic substance, holding that the inventory transactions had economic substance and were legally valid transactions that did what they purported to do.
    - According to the Court, C-MAC Interconnect purchased the inventory from Nortel, sold part of the inventory to C-MAC Quartz (which needed the inventory for its business), pledged the inventory as security for the bank loans needed to purchase the facility, and transferred the remaining inventory to C-MAC Holdings. C-MAC Holdings capitalized C-MAC Network Systems by contributing the inventory and other assets, which was legally transferred and subject to a valid lien.
  - The Court rejected the IRS's argument that C-MAC Interconnect's purchase of the inventory was in substance an advance deposit on the inventory acquired at closing, and that C-MAC Interconnect had no right to possession or control of, nor did it benefit from, the inventory until after closing.
    - According to the Court, upon the purchase of the inventory the C-MAC group had the right to pledge and encumber the inventory and transfer rights to, title to, and interest in the inventory. The C-MAC group also benefitted from the inventory purchase, as C-MAC Interconnect sold some of the inventory and made it available for use in its other operations.
    - The Court rejected the IRS's argument that C-MAC Interconnect's sale of the inventory to C-MAC Quartz was contrived or invalid.
    - The Court thus concluded that the advance inventory purchase had economic substance.
- Step Transaction Doctrine
  - The IRS argued that C-MAC Interconnect and C-MAC Holdings were mere conduits for C-MAC Network's purchase of the inventory and that the transfers were without economic effect because neither conducted any business with the inventory and their ownership of the inventory was transitory.
  - The Tax Court, however, found that C-MAC Interconnect and C-MAC Holdings were bona fide entities that used the inventory in their businesses.
    - C-MAC Interconnect sold part of the inventory to C-MAC Quartz for use in C-MAC Quartz's business, and C-MAC Holdings used the inventory to capitalize C-MAC Network Systems.
    - The inventory transactions also allowed the C-MAC group to create a separate U.S. subsidiary to operate the acquired facility and for that subsidiary to obtain the capital it needed.
  - The Tax Court thus concluded that the step transaction doctrine was inapplicable.

Sundrup v. Commissioner



Facts: Ronald and Helen Sundrup (the "Sundrups"), had operated a trucking business as a sole proprietorship since 1967. In 2000, the Sundrups formed three separate entities – Sundrup Transfer, Inc. ("Transfer"), Sundrup Leasing, LLC ("Leasing"), and Sundrup Consulting, Inc. ("Consulting"). The Sundrups were the sole owners of the entities and the only members of their boards. Transfer operated as a trucking business and engaged in the same types of business activities previously conducted by the Sundrups in their sole proprietorship. The Sundrups transferred to Leasing certain assets that had been used in the trucking business, which Leasing leased to Transfer for use in Transfer's trucking business. Consulting executed separate, but substantially similar, "management consulting agreements" with both Transfer and Leasing. Under these agreements, Consulting agreed to consult with Transfer and Leasing on matters related to the management and operation of their businesses. Transfer and Leasing made monthly payments to Consulting under the management consulting agreements. The Sundrups and Consulting also entered into a real estate contract whereby the Sundrups agreed to sell their residence to Consulting. The Sundrups, however, did not execute a deed in favor of Consulting with respect to their residence, and the Sundrups continued to live in their residence. Consulting paid to the Sundrups certain amounts described as interest and principal. Consulting also paid virtually all expenses relating to the Sundrups' residence, in addition to other personal expenses. The IRS issued notices of deficiency to the Sundrups, Transfer, and Consulting that disallowed various deductions arising from the transactions between the parties. The IRS also determined that the Sundrups, Transfer, and Consulting were liable for accuracy-related penalties under section 6662.

Sundrup v. Commissioner

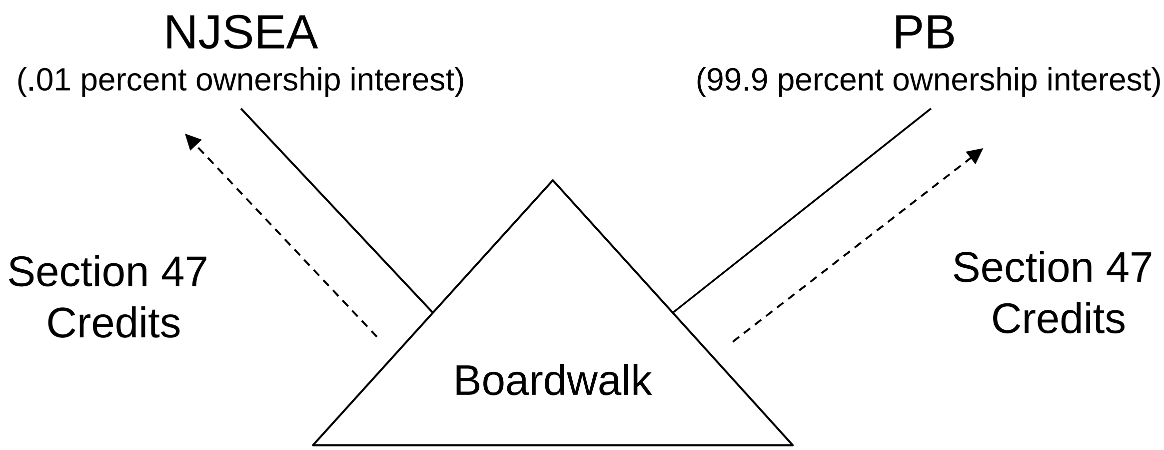
Parties' Arguments

- The IRS argued that the transactions between (i) Transfer and Consulting, and (ii) Leasing and Consulting, in which Consulting purported to provide services to each of these companies, should not be respected for tax purposes. The IRS also argued that the transaction between the Sundrups and Consulting, under which Consulting purported to agree to buy the Sundrups' residence, should not be respected for tax purposes.
  - According to the IRS, there was no non-tax business purpose for any of the transactions, and each of the transactions was without economic substance and a sham.
  - The IRS contended that Transfer and Leasing's payments to Consulting enabled the Sundrups to live a tax-free lifestyle through Consulting's payment of their personal living expenses, and that such payments were not deductible.
  - The IRS also argued that the Sundrups' sale of their residence was part of a scheme to deduct their personal living expenses.
- The petitioners contended that the transactions should be respected for tax purposes, arguing that Transfer, Leasing, and Consulting were created primarily for corporate protection in the form of premises liability, and that the companies were not part of a scheme to deduct the taxpayer's personal expenses.

Tax Court Holding

- The Tax Court agreed with the IRS and held that the transactions lacked economic substance. *Sundrup v. Commissioner*, T.C. Memo. 2010-249.
  - The court stated that it was unwilling to rely on the respective testimonies of Mr. and Mrs. Sundrup (the only witnesses at trial) as to why they incorporated Consulting.
  - According to the court, the only intended purpose of the respective transactions was the tax-avoidance objective of having Consulting pay the Sundrups' personal living expenses with the funds that Transfer and Leasing paid to Consulting and for which Transfer and Leasing claimed tax deductions.
  - Thus, the court found the transactions were entered into only for tax-avoidance reasons and did not have economic substance.
- Accordingly, the court concluded that the transactions should not be respected for tax purposes.
  - As a result, (i) Transfer was not entitled to deduct its payments to Consulting, (ii) Leasing was not entitled to deduct its payments to Consulting, and (iii) the Sundrups did not have interest income from the purported interest payments received from Consulting.
- The court also upheld the section 6662 accuracy-related penalties asserted against the Sundrups, Transfer, and Consulting, rejecting the petitioners' claim that they had reasonable cause and acted in good faith in taking their tax return positions.
  - The court repeated its conclusion that the transactions at issue should not be respected for tax purposes.
  - The court found that, based on the evidence in the record, the Sundrups, Transfer, and Consulting were negligent and disregarded rules or regulations, or otherwise did not do what a reasonable person would do, with respect to the items that resulted in their respective underpayments.
  - The court further held that there was not reasonable cause for, and that the Sundrups, Transfer, and Consulting did not do what a reasonable person would do, with respect to any portion of their underpayments of tax.

Historic Boardwalk Hall, LLC v. Commissioner



Facts: The New Jersey Sports and Exposition Authority ("NJSEA"), a State instrumentality, and PB Historic Renovations, LLC ("PB") formed Historic Boardwalk Hall, LLC ("Boardwalk"), which was treated as a partnership for federal tax purposes, to invest in the historic rehabilitation of East Hall, a convention center in Atlantic City, New Jersey. PB had a 99.9-percent ownership interest in Boardwalk, and NJSEA had the remaining .01-percent interest. Because it was a historic structure, the rehabilitation of East Hall had the potential to earn historic rehabilitation credits under section 47. The formation of Boardwalk was intended to allow PB, a private party, to earn these historic rehabilitation credits from the rehabilitation of the government-owned East Hall. PB lent funds to Boardwalk and made capital contributions totaling $18 million. PB was entitled to a preferred return equal to 3 percent of its adjusted capital contribution. The transaction documents also included various purchase options in favor of NJSEA and put options in favor of PB. East Hall underwent significant rehabilitation during the years at issue, and Boardwalk claimed qualified rehabilitation expenditures. Boardwalk allocated these expenditures to PB, and PB claimed historic rehabilitation tax credits under section 47. The IRS issued an FPAA in which it determined that (i) Boardwalk was created for the express purpose of improperly passing along tax benefits to PB and was a sham, (ii) that PB's interest in Boardwalk was not a bona fide partnership interest because it had no meaningful stake in the success or failure of Boardwalk, (iii) that East Hall was not sold to Boardwalk because the benefits and burdens of ownership did not pass to Boardwalk, and (iv) that Boardwalk should be disregarded under Treas. Reg. § 1.701-2(b). The IRS also imposed an accuracy-related penalty under section 6662.

Historic Boardwalk Hall, LLC v. Commissioner

Economic Substance

- The Tax Court held that Boardwalk was not a sham and did not lack economic substance. *Historic Boardwalk Hall, LLC v. Commissioner*, 136 T.C. No. 1 (2011).
- The Tax Court applied the economic substance doctrine as interpreted by the Third Circuit, which requires a court to "analyze two aspects of a transaction to determine if it has economic substance: its objective economic substance and the subjective motivation behind it."
  - The court further noted that these aspects do not constitute prongs of a rigid two-step analysis, but are related factors that inform the analysis of whether a transaction had sufficient substance apart from tax consequences.
  - Under this test, a transaction that affects a taxpayer's net economic position, legal relations, or non-tax business interests will not be disregarded merely because it was motivated by tax considerations.
- IRS Arguments:
  - The IRS argued that Boardwalk was a sham because it lacked objective economic substance.
    - According to the IRS, NJSEA and PB negotiated and executed a transaction in anticipation of a limited number of possible outcomes, none of which would appreciably affect PB's economic position aside from a reduction of its tax liabilities.
    - The IRS also argued that, even though PB was entitled to a 3-percent return on the transaction, such return was less than PB could have earned had it invested in other financial instruments.
  - The IRS also argued that Boardwalk served no subjective business purpose because it was intended solely to facilitate NJSEA's sale of rehabilitation tax credits to PB.
  - The IRS's arguments relied significantly on the conclusion that the rehabilitation credits were to be ignored in evaluating economic substance.
    - In support of this position, the IRS cited *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054 (1988), for the proposition that investment tax credits are never to be taken into account in determining the economic substance of a transaction.
- Petitioner's Arguments:
  - Petitioner argued that the economic substance doctrine was inapplicable because Congress intended section 47 to spur investment in historic rehabilitation projects that would otherwise not be economically feasible.
  - Relying on *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), petitioner also argued that the rehabilitation tax credits should be taken into account in determining whether the transaction had economic substance and provided a net economic benefit to PB.

Historic Boardwalk Hall, LLC v. Commissioner

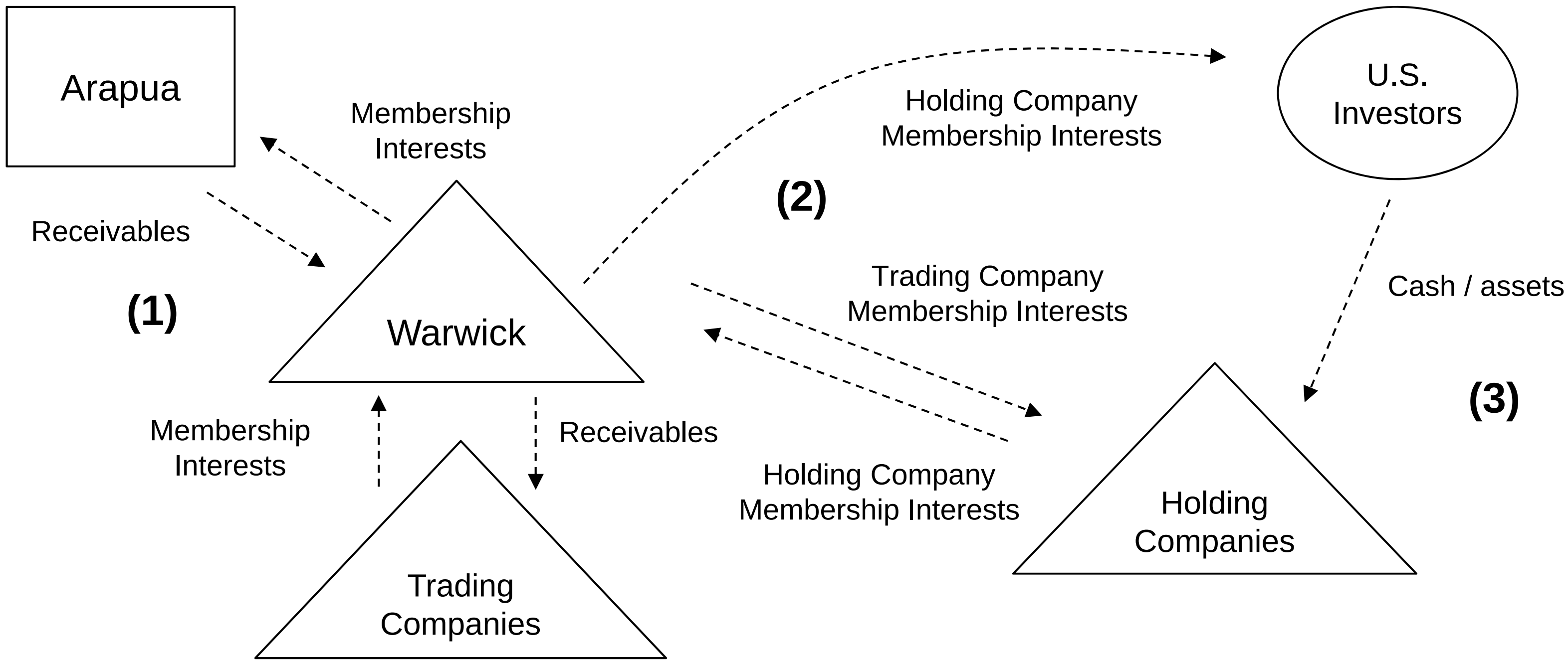
Economic Substance (cont'd)

- The Tax Court determined that PB did not invest in the Boardwalk transaction solely to earn rehabilitation tax credits.
    - The court stated that, taking into account both PB's 3-percent return and the expected tax credits, the transactions, when viewed as a whole, had economic substance.
    - The court also found that PB, NJSEA, and Boardwalk had a legitimate business purpose, to allow PB to invest in the rehabilitation of East Hall.
- The court rejected the IRS's argument that the structure of the transactions prevented the transactions from affecting NJSEA and PB's economic positions.
- The court pointed to the legislative history of section 47, which the court found indicated that section 47 was intended to encourage taxpayers to participate in what would otherwise be an unprofitable activity.
    - The court noted that, without the rehabilitation credit, PB would not have invested in the rehabilitation of East Hall, because it could not have earned a sufficient net economic benefit on its investment.
    - The court found that Congress intended the credit to address this very issue.
- The court rejected the IRS's attempt to read the Tax Court's holding in *Friendship Dairies* as establishing that the investment tax credit is never taken into account in considering the economic substance of a transaction.
    - The court stated that *Friendship Dairies* did not make such a broad holding.
    - The court also found that *Friendship Dairies* was distinguishable on its facts because the transaction at issue had no chance of profitability.

Other Holdings

- The Tax Court also held that (i) Boardwalk was a valid partnership, (ii) NJSEA transferred the benefits and burdens of ownership of East Hall to Boardwalk, and (iii) the IRS's attempt to recast the transaction under Treas. Reg. § 1.701-1(b) was inappropriate.
- The court also found that the section 6662 accuracy-related penalty asserted by the IRS was inapplicable.

Superior Trading, LLC v. Commissioner

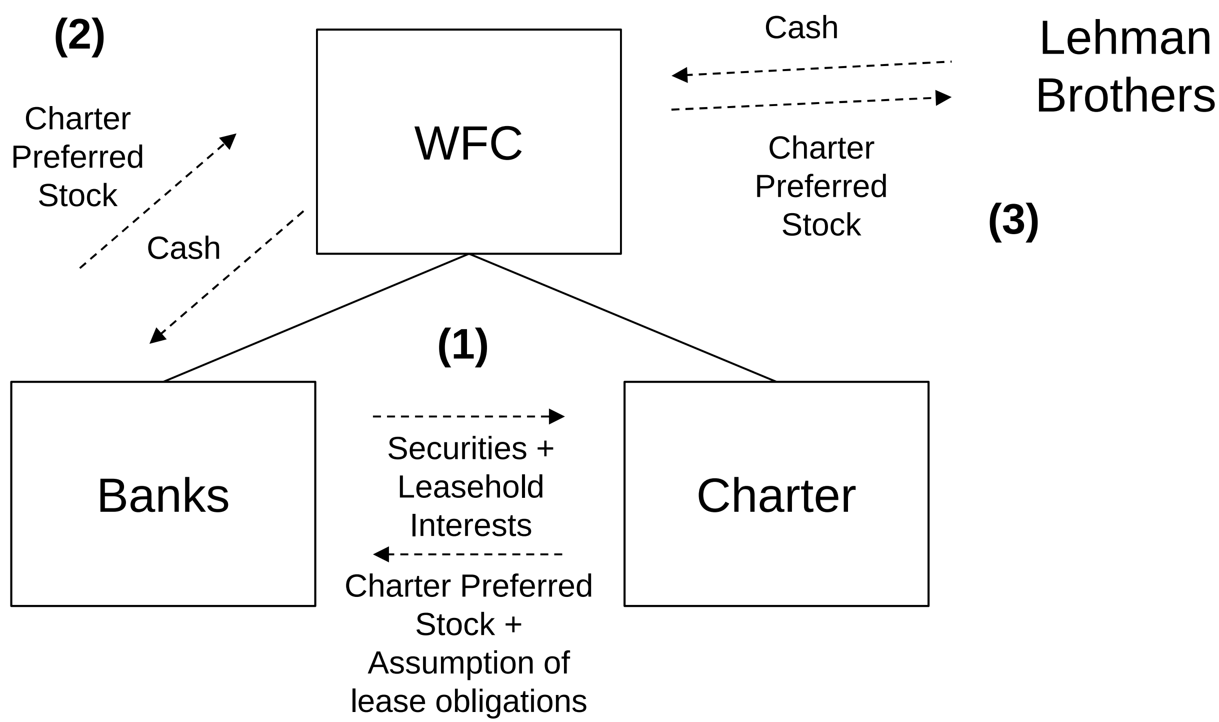


Facts: In 2003, Arapua, a retail company headquartered in Brazil, contributed past due consumer receivables to Warwick, an Illinois LLC, in exchange for 99 percent of the membership interests in Warwick. Warwick contributed portions of the consumer receivables to 14 different LLCs (trading companies) in exchange for 99 percent membership interests. Individual U.S. investors acquired membership interests in the trading companies through another set of LLCs (holding companies), to which Warwick had contributed most of its membership interests in each trading company in exchange for holding company membership interests. Each of the LLCs elected to be treated as a partnership for federal tax purposes, and Warwick and the trading companies claimed a carryover basis in the consumer receivables under section 723. During 2003 and 2004, the trading companies liquidated the distressed receivables for their FMV, with the resulting loss (the difference between the face amount and the FMV of the receivables) allocated to the individual U.S. investors owning membership interests in the holding companies. Each of the individual U.S. investors owning membership interests in a trading company through a holding company claimed the benefits of these deductions on their respective federal income tax return. The individual U.S. investors had to contribute significant cash or other assets to the holding companies to generate the needed outside basis in his/her holding company interest to claim his/her share of the loss. Warwick also claimed losses on the sale of membership interests in the holding companies to the individual U.S. investors. The IRS issued FPAAs attacking the characterization of the transactions by Warwick and the trading companies on several grounds, including lack of economic substance.

Superior Trading, LLC v. Commissioner

- The Tax Court held for the IRS, but declined to apply the economic substance doctrine. *Superior Trading, LLC v. Commissioner*, 137 T.C. No. 6 (2011).
- The Tax Court stated that the tax benefits produced by the transaction were confined to timing gains (each individual U.S. investor's outside basis was reduced by the amount of the loss resulting from the distressed receivables, so that the U.S. investor would later have gain on the redemption of his/her partnership interest), and that the claiming of the tax benefits required sufficient outside basis, which necessitated an investment of real assets.
  - The court found that it could "safely address [the transaction's] sought-after tax characterization without resorting to sweeping economic substance arguments."
  - According to the court, "[the transaction] requires a minimum of two parties, with one willing to give up something of substantive value. In an arm's length world, this would happen only if adequate compensation changed hands. Consequently, we need only look at the substance lurking behind the posited form, and where appropriate, step together artificially separated transactions, to get to the proper tax characterization."
- The Tax Court noted the IRS's argument that the transactions had no independent economic substance.
  - The court stated that it was not convinced by the IRS's argument that the trading companies had no chance of earning a pre-tax profit.
  - However, the court found that it did not need to resolve these fact-intensive issues to rule on the losses claimed by Warwick and the trading companies.
- The Tax Court ultimately held that Warwick was not a valid partnership and that a sale, rather than a contribution to such partnership, had taken place, and applied the substance-over-form and step transaction doctrines.

WFC Holdings Corp. v. United States



Facts: WFC was the parent corporation of an affiliated group of corporations, including Wells Fargo Bank, N.A. and Wells Fargo Bank (Texas), N.A. ("Banks"), and Charter Holdings, Inc. ("Charter"). On December 17, 1998, the Banks transferred (i) government securities with an aggregate FMV of $429,899,099 and a basis of $427,849,534 and (ii) leasehold interests in twenty-one commercial properties to Charter in exchange for (i) 4,000 shares of preferred stock in Charter and (ii) Charter's assumption of lease obligations (the rent payable under the transferred leases). The transferred leases were "underwater," with the present value of the future cash flows associated with such leases estimated to be negative $425,900,099. On December 17, 1998, the Banks sold their 4,000 shares of Charter preferred stock to WFC for $4,000,000. On February 26, 1999, WFC sold 4,000 preferred Charter shares to Lehman Brothers, Inc. for $3,750,022. On its consolidated federal income tax return for 1999, WFC included a deduction for a capital loss in the amount of $423,849,534. WFC did not utilize any portion of the 1999 capital loss on its 1999 return, and in 2003 filed a refund claim for taxes previously paid in 1996 based on an NOL carryback from its 1999 return. The IRS disallowed the refund claim filed by WFC.

WFC Holdings Corp. v. United States

- The district court held in favor of the government and found that the transaction should not be respected under the economic substance doctrine. *WFC Holdings Corp. v. United States*, No. 07-3320 (D.C. Minn. 2011).

Statutory Requirements

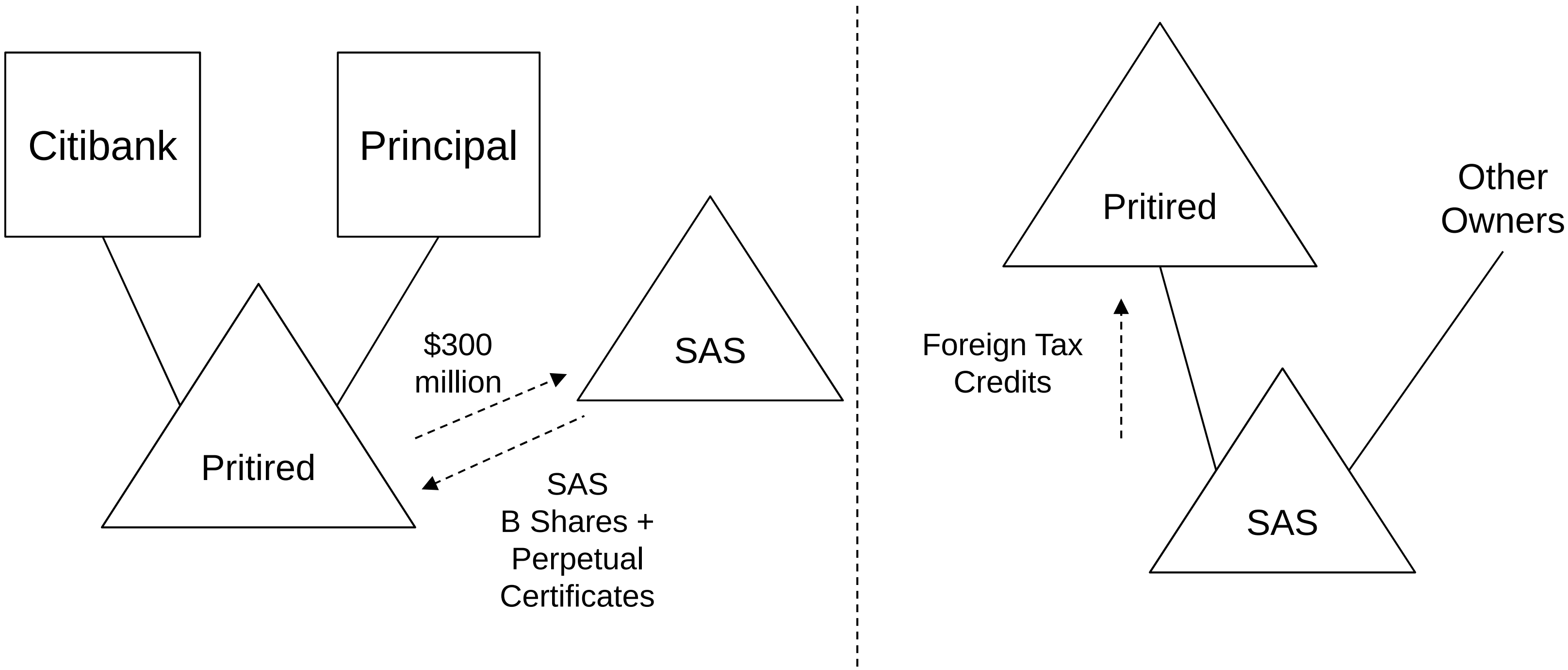
- The capital loss claimed by WFC resulted from its position that the transfer/assumption of liabilities in the Banks' section 351 exchange with Charter did not reduce the basis in the Charter stock received by the Banks under sections 358(d)(2) and 357(c)(3).
- The government, relying on section 357(b), contended that the amount of liabilities should be subtracted from the taxpayer's basis in the Charter stock.
- The court rejected the government's interpretation and concluded that section 357(b) did not operate to reduce WFC's basis in the Charter stock.
    - The court agreed with the decisions in *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006) and *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006) and the finding that section 357(b) applies only to determine whether gain is recognized in a section 351 exchange, not to calculate the basis of stock received in the exchange.
- The court also rejected the government's argument that the transaction should be separated into two parts: (i) the Banks' transfer of $426 million of securities in exchange for Charter's assumption of lease liabilities with a projected value of negative $426 million, and (ii) the Banks transfer of $4 million of securities in exchange for $4 million of Charter stock (with only the second transfer qualifying as a section 351 exchange).
    - The court noted that the government failed to provide any evidentiary support or case law that supported its position.

WFC Holdings Corp. v. United States

Economic Substance Doctrine

- Although the court found that the government did not show that WFC failed to comply with the technical requirements of the Code, it stated that WFC was not entitled to a refund unless the transaction passed muster under the common law “sham transaction” or “economic substance” doctrine.
- In conducting its analysis, the court applied the test set forth in *Rice’s Toyota World, Inc. v. Comm’r,* 752 F.2d 89 (4th Cir. 1985) – that a transaction will be characterized as a sham if (i) it is not motivated by any economic purpose outside of tax considerations (the business purpose test), and (ii) if it is without economic substance because no real potential for profit exists (the economic substance test).
    - The court noted that, because the transaction did not pass muster under either prong of the test in *Rice’s Toyota World*, it did not have to consider the consequence of failing to prove only one of the two prongs.
- The court found that the transaction lacked a legitimate business purpose aside from tax benefits, citing the following factors—
    - The evolution and development of the transaction strongly suggested that it was designed and understood as a tax shelter.
    - WFC failed to show that the asserted regulatory benefits of transferring the leases to Charter drove the transfer of the selected leases, and that such purpose motivated the transaction as a whole.
    - WFC failed to establish that it conducted the transaction to immunize its lease negotiators from pressure to cut unfavorable deals with bank customers leveraging their banking relationship with WFC.
    - The record did not support the finding that the transaction enabled any financial benefit from increased management efficiency through centralization and the avoidance of bureaucracy.
- The court also held that the transaction lacked objective economic substance—
    - The sale of the Charter stock to Lehman Brothers lacked economic substance, and did not enhance WFC’s ability to dispose of the underwater leases and otherwise had no non-tax economic value to WFC.
    - WFC could not show that the transaction had the potential to generate profits anywhere close to the loss it claimed as a result of the sale of the Charter stock.
    - Even excluding the purported $423 million capital loss, it was not clear that WFC had a reasonable expectation of profit absent tax considerations.
    - The purported $423 million loss on the stock sale was fictitious; the actual rent expense deductions to be taken by Charter were real losses to be deducted as incurred.

Pritired 1, LLC v. United States



Facts: Principal partnered with Citibank to create a partnership (Pritired), which invested in class B shares and perpetual certificates issued by two French entities (collectively, the "SAS") that had been created by two French banks. The SAS invested in an existing portfolio of debt securities from the French banks, as well as other securities for which the French banks were counterparties. The SAS paid French income taxes on the income from the investments. These French taxes were allocated among the owners of the SAS, primarily to Pritired. As a partner in Pritired, Principal claimed approximately $21 million in foreign tax credits. The IRS determined that Pritired was not entitled to claim an allocation of foreign taxes and disallowed its claimed share of foreign taxes. Correspondingly, the foreign tax credits claimed by Principal were disallowed.

Pritired 1, LLC v. United States

- The district court found for the government and upheld the disallowance of the foreign tax credits claimed by Principal. *Pritired 1, LLC v. United States*, No. 4:08-cv-00082-JAJ-TJS (S.D.C. Iowa 2011).
- The court upheld the following determinations made by the IRS: (i) the transaction was properly characterized as a loan and therefore no partnership existed, (ii) the transaction lacked economic substance, and (iii) the transaction violated the partnership anti-abuse rule.

Characterization as a Loan

- The court held that the transaction was in substance a loan. Therefore, Pritired was not a partner and its partners could not claim foreign tax credits for French taxes paid.
- In making this determination, the court evaluated the debt and equity characteristics of the perpetual certificates and class B shares in SAS, focusing on (i) characterization (i.e., form), (ii) market risk, (iii) credit risk, and (iv) voting rights.
    - The court determined that, although the class B shares were labeled as equity, those shares were tied to the perpetual certificates, which the parties labeled as debt in certain circumstances and equity in others. Thus, the court determined that the characterization factor was mixed.
    - With respect to market risk, the court observed that the transaction had a certain expected maturity date and was expected to provide “predicable, stable returns.” Thus, the court determined that the market risk factor was more consistent with debt treatment than equity treatment.
    - On the credit risk factor, the court determined that the perpetual certificates had ongoing payment attributes and liquidation priorities more akin to debt, while the class B shares had payment attributes and liquidation priorities more akin to equity.
    - With respect to voting rights, the court found that the perpetual certificates had no voting rights, which was consistent with debt treatment. Although the class B shares had certain voting rights, the court found that those voting rights “were more in the form of controls seen in debt covenants.”
    - After considering the characteristics of both the perpetual certificates and class B shares, the court concluded that they both “had attributes that more closely resembled debt rather than equity” and, thus, the taxpayers’ investment was in the nature of a loan.

Pritired 1, LLC v. United States

Economic Substance

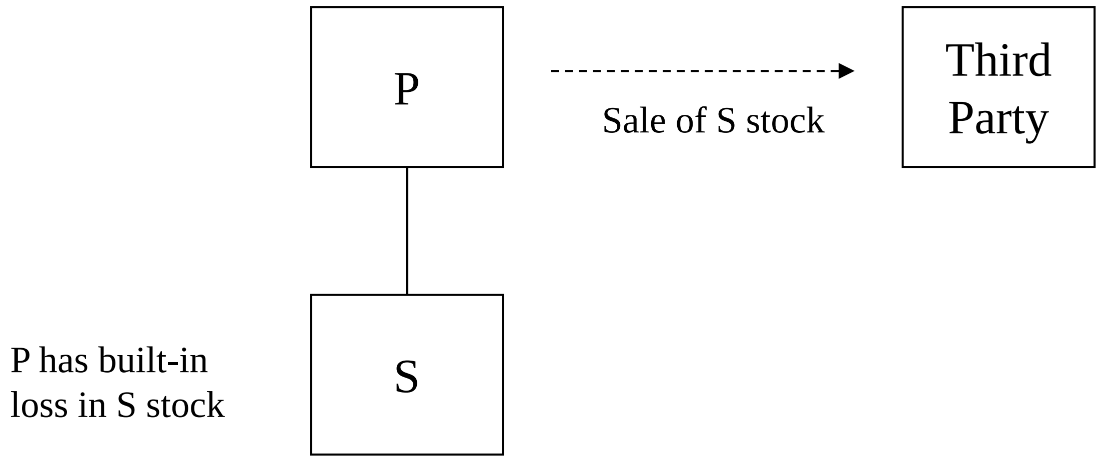
- Applying the Eight Circuit's two-prong test for economic substance, the court determined that the transaction lacked both a subjective business purpose and objective economic substance.
- The court stated that it could not find any credible business purpose for the transaction other than to generate and claim foreign tax credits.
    - According to the court, the business purpose of the transaction was to enhance low yield investments through foreign tax credits.
- The court also found no realistic opportunity to earn a meaningful profit independent of the foreign tax credits.
    - The court stated that the existence of some profit potential was insufficient to impute substance into an otherwise sham transaction where a common-sense examination of the evidence as a whole indicates the transaction lacked economic substance.
        - The court noted that the transaction would have a cash return and IRR lower than an otherwise comparable investment in a general obligation municipal bond.
    - The court also rejected the argument that the transaction had economic substance because it complied with Notice 98-5 in that the transaction was structured so that the ratio of foreign tax credits to expected profit (approximately 2 to 1) was in accord with the examples described in Notice 98-5.
        - The court stated that Notice 98-5 did not indicate that a transaction would have economic substance and be "saved" by staying within a certain ratio, and found that the transaction represented the type of behavior Notice 98-5 was intended to address.

Partnership Anti-Abuse Rule

- The court held that the transaction violated each of the requirements in Treas. Reg. § 1.701-2—
    - The transaction was not a bona fide partnership and did not have a "substantial business purpose" because it was "designed to transfer and shift the payment of French taxes to instruments that otherwise have a low and undesirable return."
    - The transaction was in substance a loan and therefore no partnership existed.
    - The economic agreement did not accurately reflect the partners' income and the transaction improperly shifted foreign tax credits to Pritired.

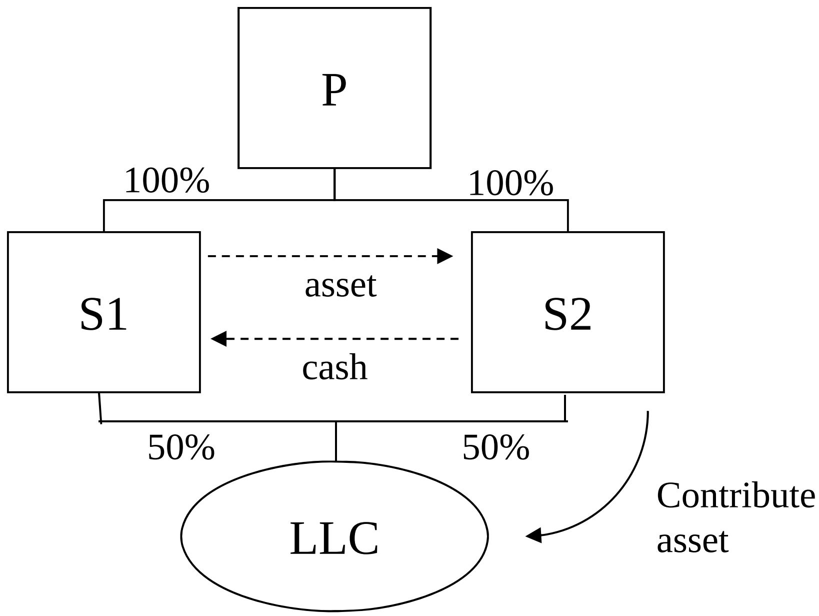
Economic Substance – Transaction Planning

Sale to Recognize Loss



- May a taxpayer sell stock solely to recognize a loss under the Federal Circuit's analysis in *Coltec*? No profit, no business purpose. Presumably not contrary to intent of Congress? How do you know that?
- The Supreme Court in *Cottage Savings* allowed a taxpayer to exchange mortgage securities for other mortgage securities and recognize a loss. The transaction was done solely for tax purposes and was disregarded for regulatory purposes.

Accelerating a Built-In Gain

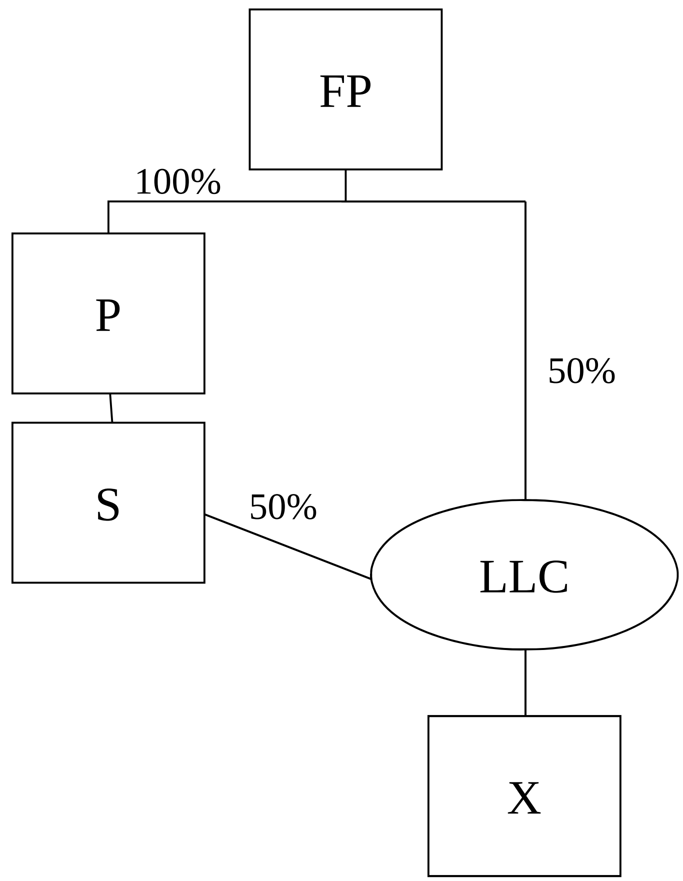


Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2, and they file a consolidated return. In Year 1, S1 sells an asset to S2 for cash, resulting in a deferred intercompany capital gain. In Year 3, the P group has a capital loss that it would like to use, so S2 contributes the asset to a newly formed LLC owned by S1 and S2.

Result: Because the asset is no longer owned by a member of the P consolidated group, the deferred capital gain should be triggered, which P wants in order to utilize other losses.

Analysis: No business purposes, no profit potential from contribution. Contrary to intent of Congress?

Busting Consolidation -- Example 1

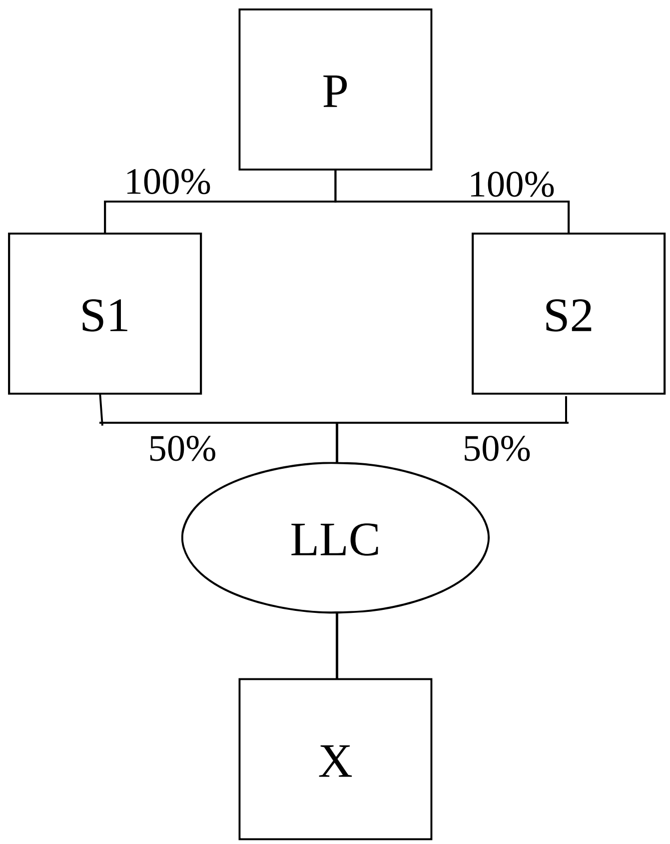


Facts: FP, a foreign corporation, owns 100% of the stock of P, which owns all of the stock of S, which owns all of the stock of X. P, S, and X file a consolidated return. In order to deconsolidate X, S contributes the stock of X to an LLC formed by S and FP.

Result: Because X is no longer an includible corporation, it should not be a member of P's consolidated group.

Analysis: No business purpose and no profit potential.

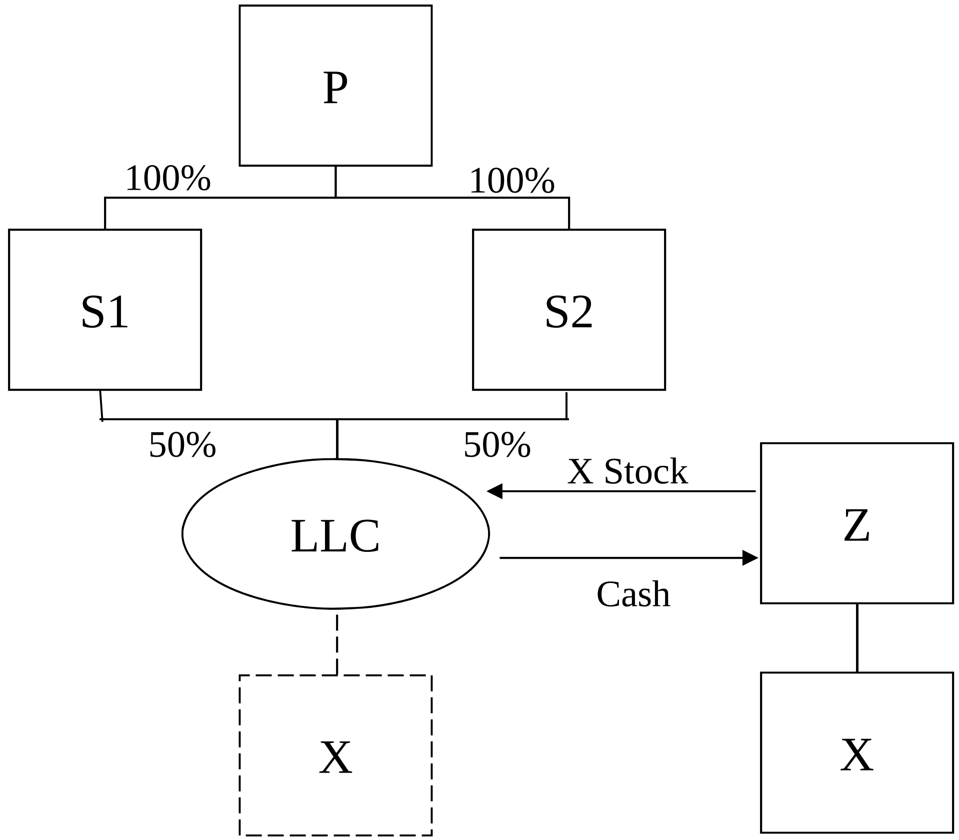
Busting Consolidation -- Example 2



Facts: P, a domestic corporation, owns 100% of the stock of S1, S2, and X, and they file a consolidated return. In order to deconsolidate X, P contributes 50% of the X stock to each of S1 and S2, and S1 and S2 contribute the X stock to a newly formed LLC.

Result: Because X is no longer an includible corporation, it should not be a member of P's consolidated group. No business purpose and no profit potential.

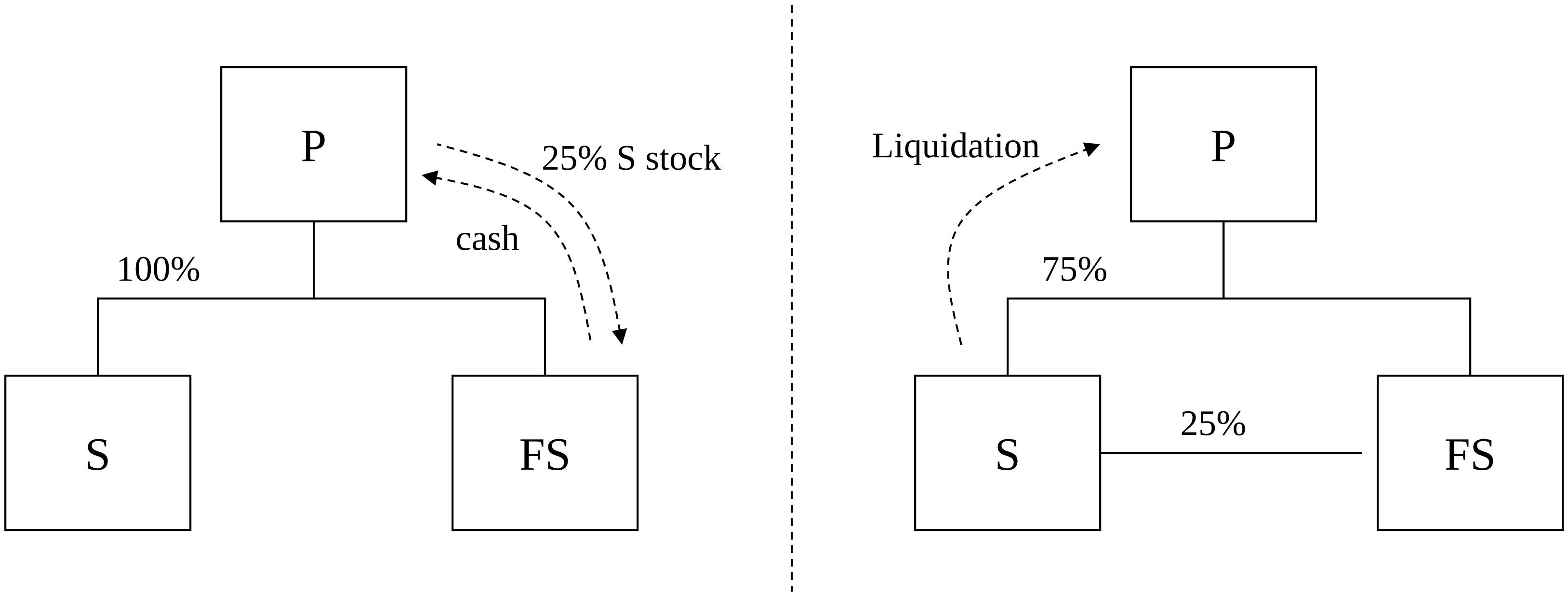
Avoiding Loss Disallowance Rules



Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2. The P group wants to purchase the stock of X from Z, but X has built-in gain assets that could trigger the application of the loss disallowance rules if the P group later disposes of the stock of X. To avoid the potential application of the loss disallowance rules, S1 and S2 form LLC, and LLC acquires the stock of X.

Result: Because X is not an includible corporation, it should not be a member of P's consolidated group. The use of the LLC had no business purpose and no profit potential.

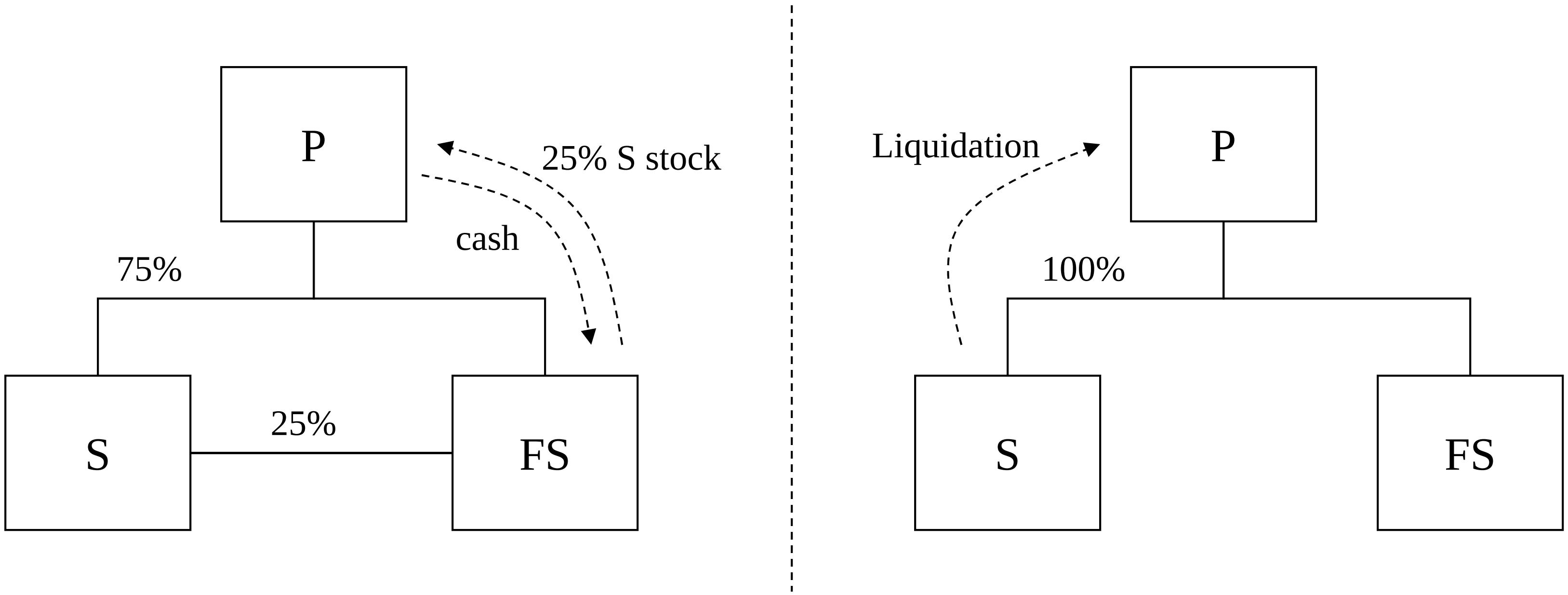
Section 331 Liquidation



Facts: P, a domestic corporation, owns all of the stock of S, which is a domestic subsidiary, and FS, which is a foreign subsidiary. P has a $100 basis in its S stock. The value of its S stock is $10. If P liquidates S, the loss in the S stock will not be realized. P therefore sells 25% of the S stock to FS and, after a period of time, S liquidates into P.

Result: P should recognize the loss on the remaining 75% of stock in S. There was no business purpose or non-tax profit potential for the division of ownership.

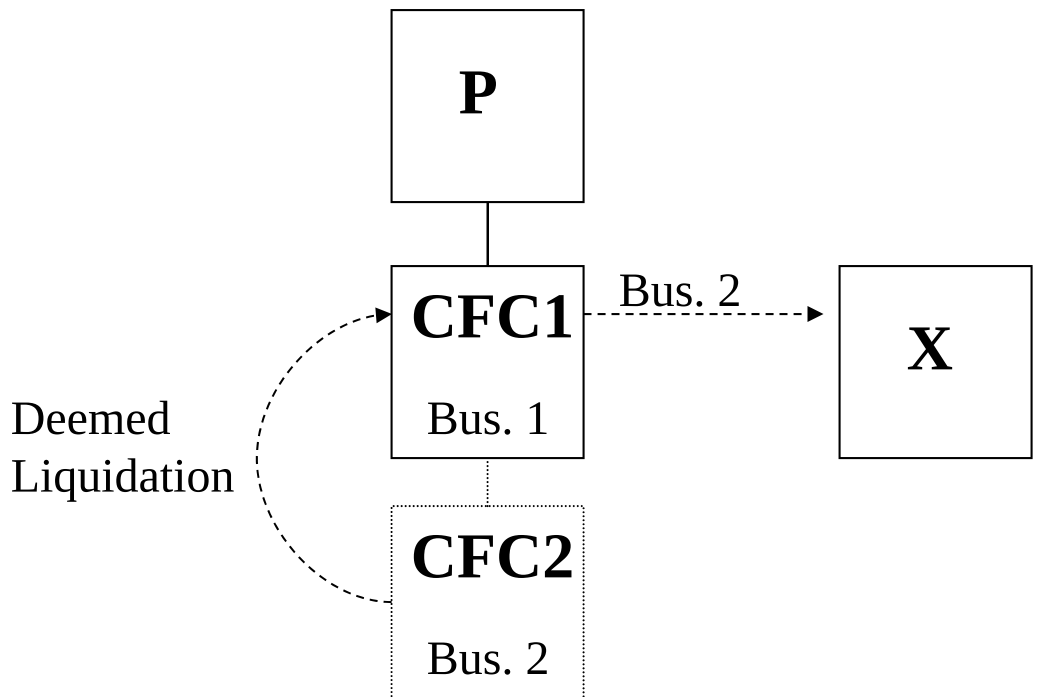
Section 332 Liquidation



Facts: P, a domestic corporation, owns 75% of the stock of S, which is a domestic subsidiary, and 100% of FS, which is a foreign subsidiary. P has a $10 basis in its S stock. The value of its S stock is $100. If P liquidates S, the gain in the S stock will be realized. P therefore purchases 25% of the S stock from FS *before a decision to liquidate is made*, and, after a period of time, S liquidates into P.

Result: P should not recognize the gain on the liquidation under section 332. Business purpose and non-tax profit potential?

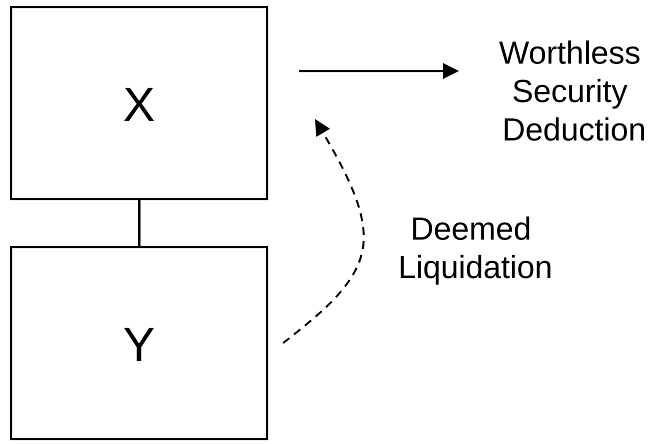
Check-and-Sell Transaction



Facts: P owns 100 percent of CFC1, which engages in business 1. CFC1 owns 100 percent of CFC2, which engages in business 2. CFC1 and CFC2 are controlled foreign corporations incorporated in the United Kingdom. On Date 1, P causes CFC1 to check-the-box for CFC2, which results in a deemed section 332 liquidation of CFC2. Immediately thereafter, P causes CFC1 sells all of the assets of business 2 (i.e., CFC2 assets) to X for cash.

Issue: Under the rationale of *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004), the income generated from the sale does not constitute Subpart F income. Was there a business purpose or profit potential from checking the box?

Check-the-box Election to Claim Worthless Security Deduction

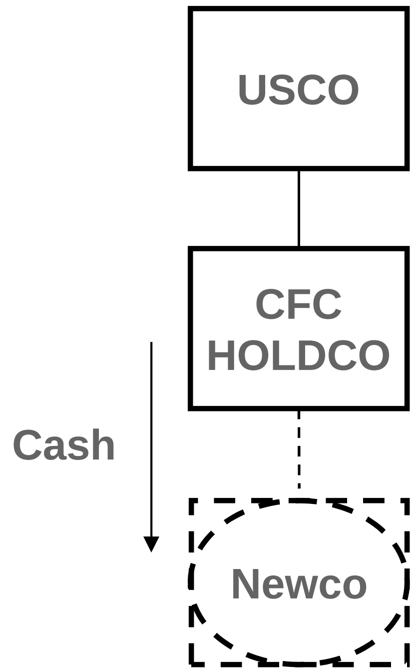


Facts: X makes an election to change the classification of Y, a foreign corporation, to a disregarded entity for federal tax purposes. Immediately before the effective date of the election, the fair market value of Y's assets does not exceed the sum of its liabilities.

Analysis: Under Rev. Rul. 2003-125, 2003-2 C.B. 1243, X is allowed to claim a worthless security deduction under section 165(g)(3) because the fair market value of Y's assets do not exceed the entity's liabilities (i.e., on the deemed liquidation of Y, X receives no payment on its stock).

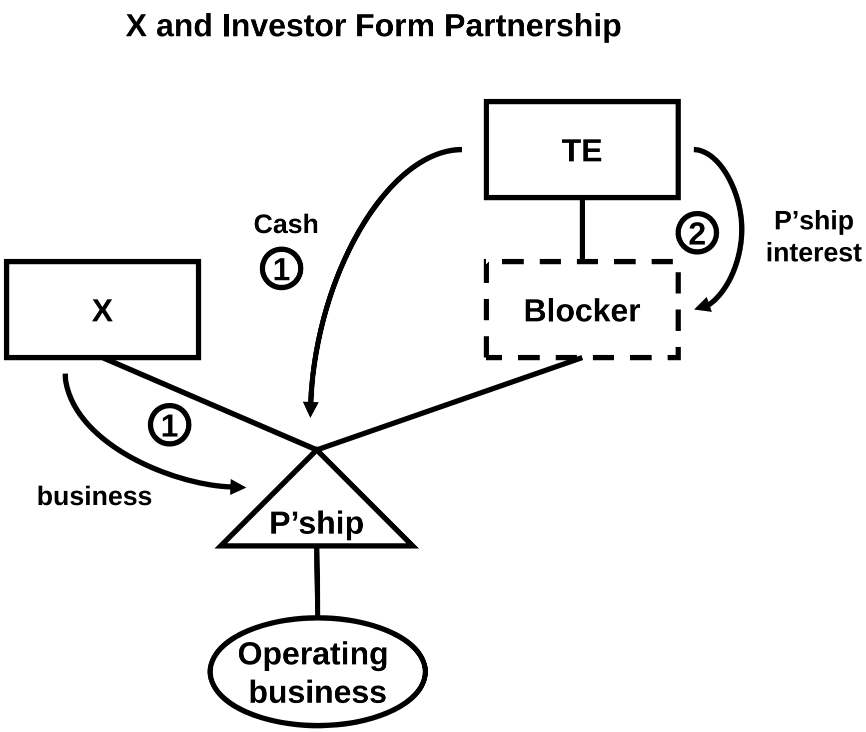
Question: Is this result affected by the ES doctrine if there was no business purpose for the check-the-box election?

Checking and Unchecking



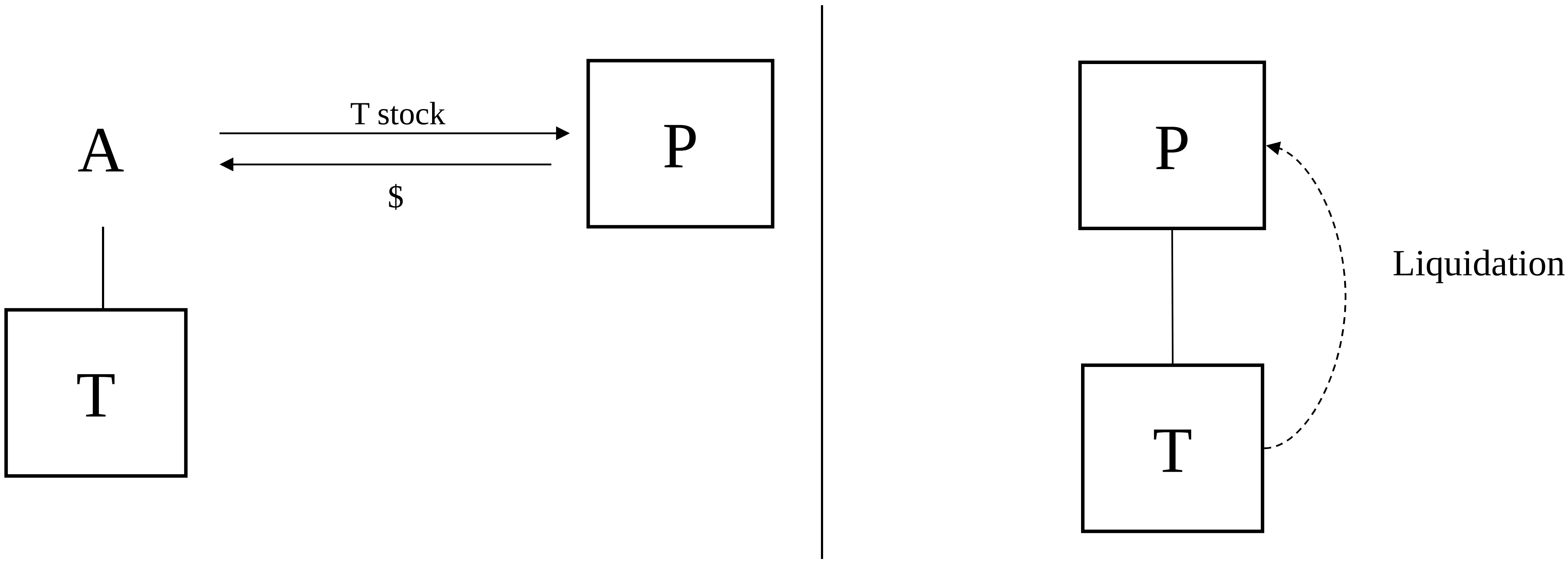
- USCO decides to start doing business in Country A
- USCO already owns CFC Holdco
- CFC Holdco contributes cash into Newco, organized in Country A and makes a check the box election to treat Newco as a disregarded entity

Use of a blocker to avoid UBTI



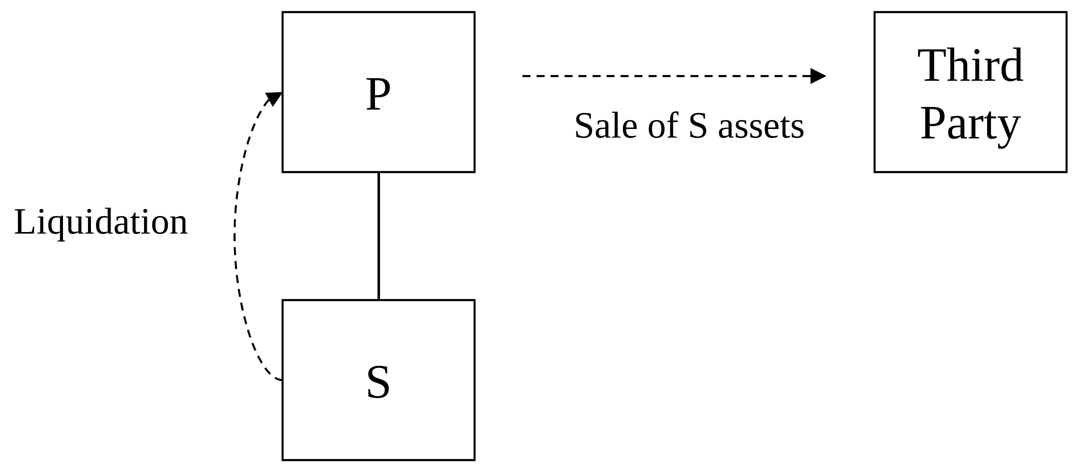
- X owns an operating business that requires additional funds to expand
- Tax-Exempt Investor ("TE") is interested in making an investment in the X business
  - Income produced by the X business would be UBTI to TE
- X and TE form a partnership, with X contributing its business and TE contributing cash
- TE forms a corporation ("Blocker") to acquire and hold its investment in the partnership in order to avoid exposure to UBTI

Purchase and Liquidation



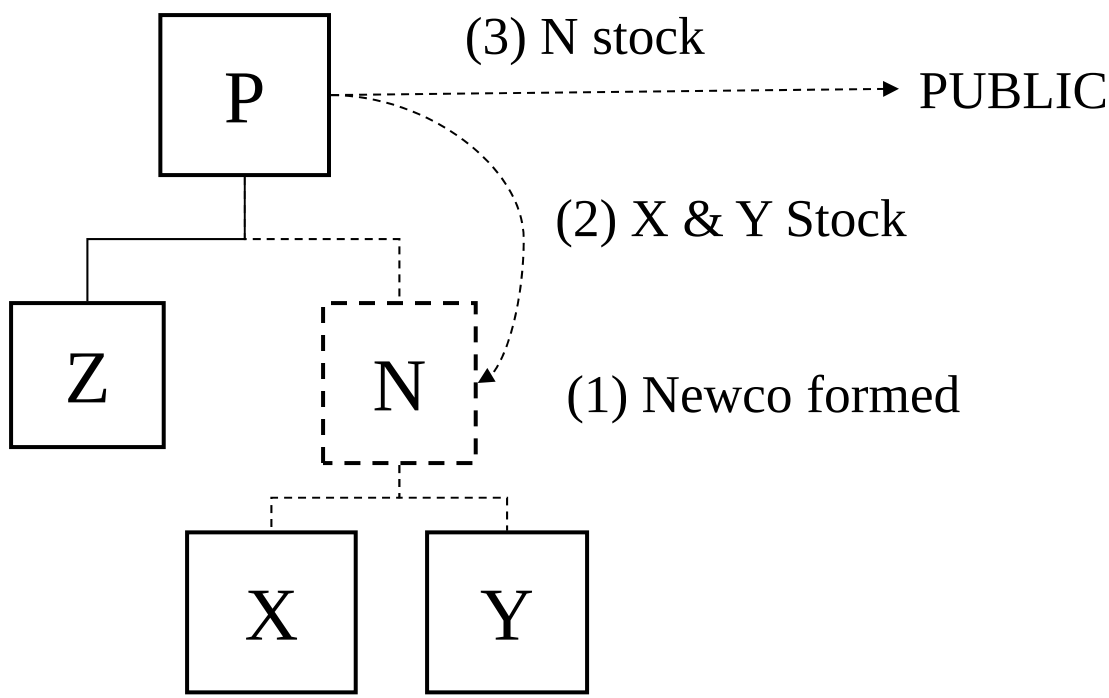
- Section 269(b) states deductions, credits, or other allowances may be disallowed, but only if the liquidation occurs within 2 years after a QSP.
- Does *Coltec* and other recent caselaw replace section 269(b), or mean that a liquidation 2 years and a day after a QSP can result in such a disallowance?

Liquidation and Sale



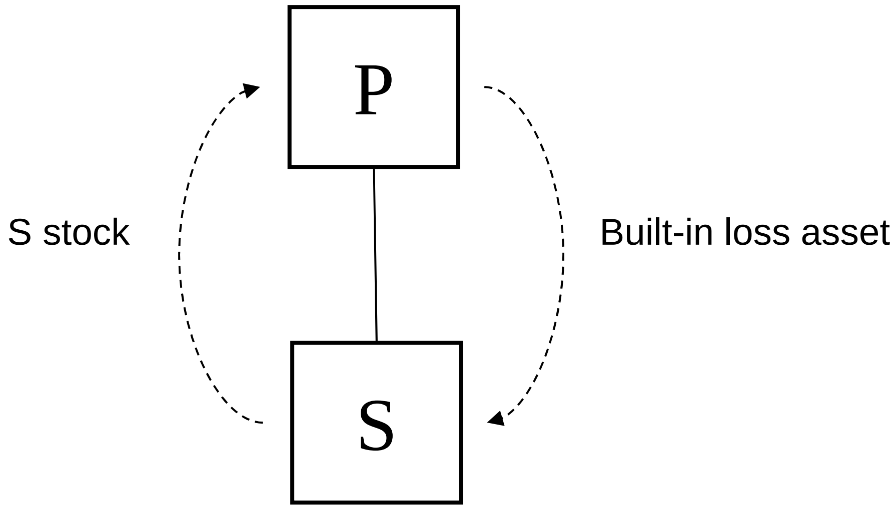
- In *Commissioner v. Court Holding*, the Supreme Court held that a liquidation of a corporation followed by a sale of the corporation's assets resulted in tax to the corporation because "a sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title." However, five years later, in *United States v. Cumberland Public Service Co.*, the Court held that a liquidation followed by a sale did not result in tax to the corporation. The Court stated, "The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes."
- In both *Court Holding* and *Cumberland* the sole purpose of the liquidation was to reduce tax; why did Cumberland win? Did the S. Ct. not understand the ES doctrine?

Busted Section 351 Transaction to Make Section 338(h)(10) Election



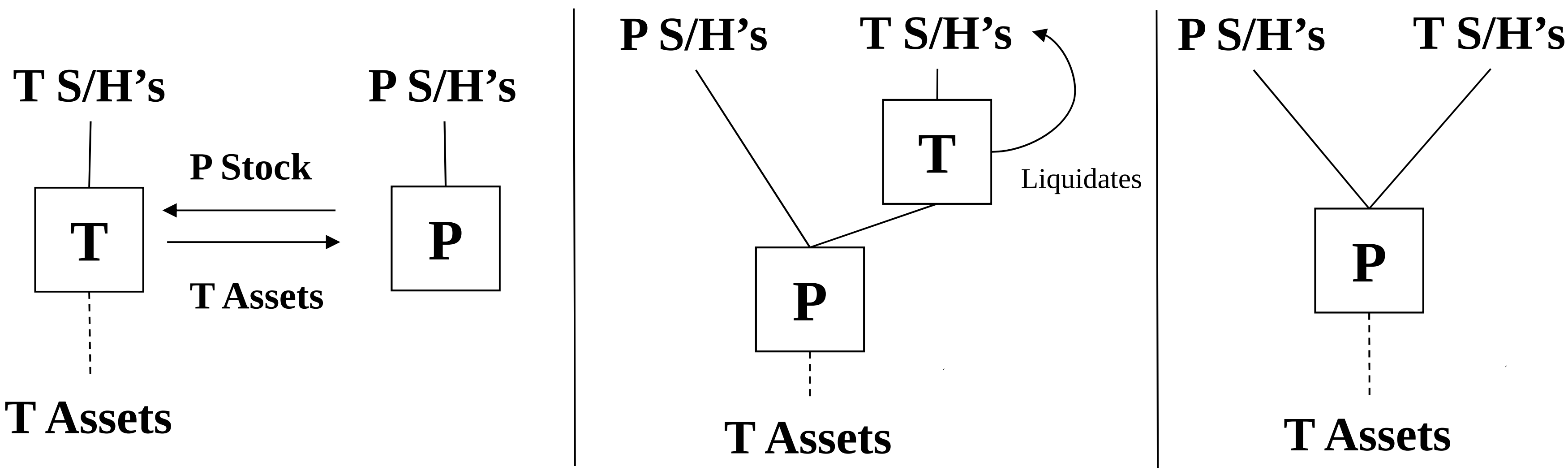
- A corporation transfers stock of a subsidiary to a newly formed subsidiary ("Newco") for its stock and sells that stock to the public to "bust" the section 351 transaction and to be eligible to make the section 338(h)(10) election for Newco.
- Was there a business purpose or profit potential for the step of busting the 351?

Section 351 Transaction with Built-in Loss Asset



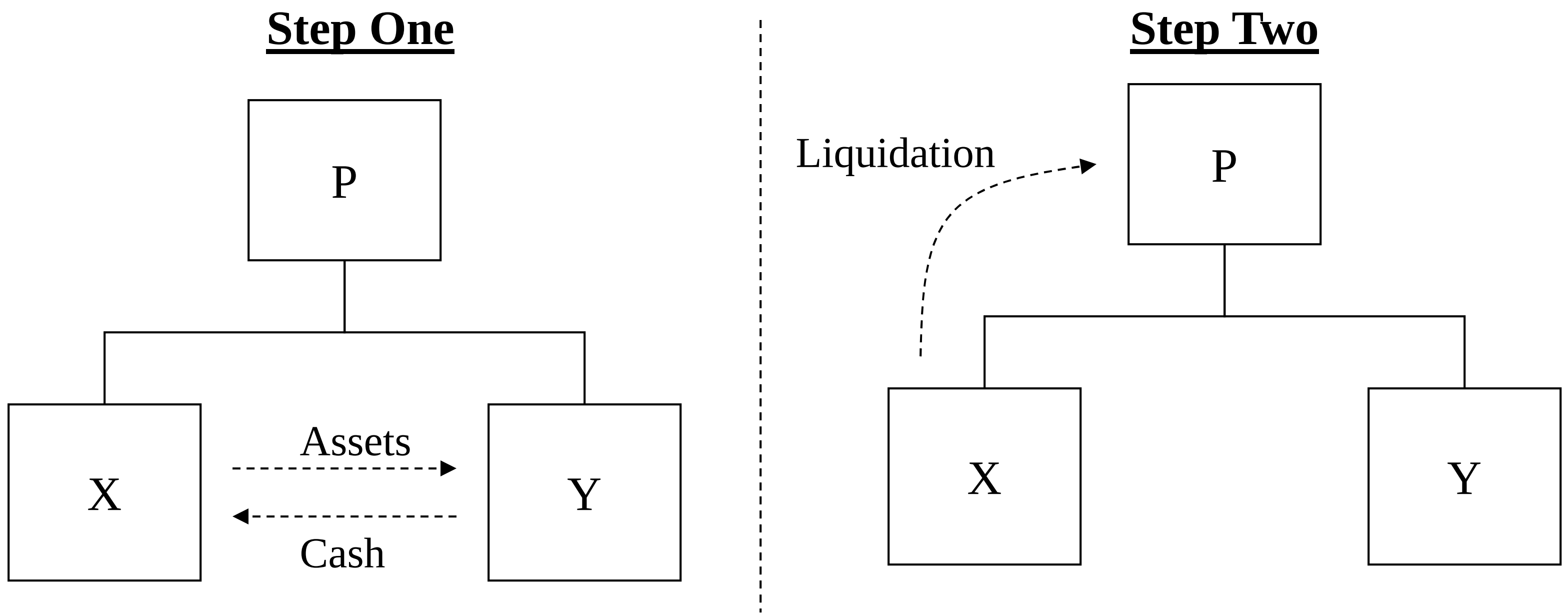
- A corporation transfers an asset with a built-in loss to its subsidiary in exchange for subsidiary stock. Does S hold the transferred asset with a carryover basis and/or does P obtain the S stock with an exchanged basis?
- Is duplicating a loss through a corporation inherently subject to ES doctrine, despite enactment of section 362(e)(2)?
- What if section 362(e)(2) does not apply? See *Shell Petroleum Inc. v. United States*, 2008-2 USTC ¶ 50,422 (S.D. Tex. 2008); *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009).

"C" Reorganization



- What if, as is likely the case, certain steps are undertaken solely to come within the reorganization provisions in section 368? For example, assume that substantially all of a target corporation's assets are acquired by another corporation solely in exchange for voting stock. If that corporation liquidates following the asset transaction to come within the terms of a "C" reorganization, is the liquidation step subject to risk because it occurred solely for tax reasons?

‘D’ Reorganizations – Cash – Rev. Rul. 70-240

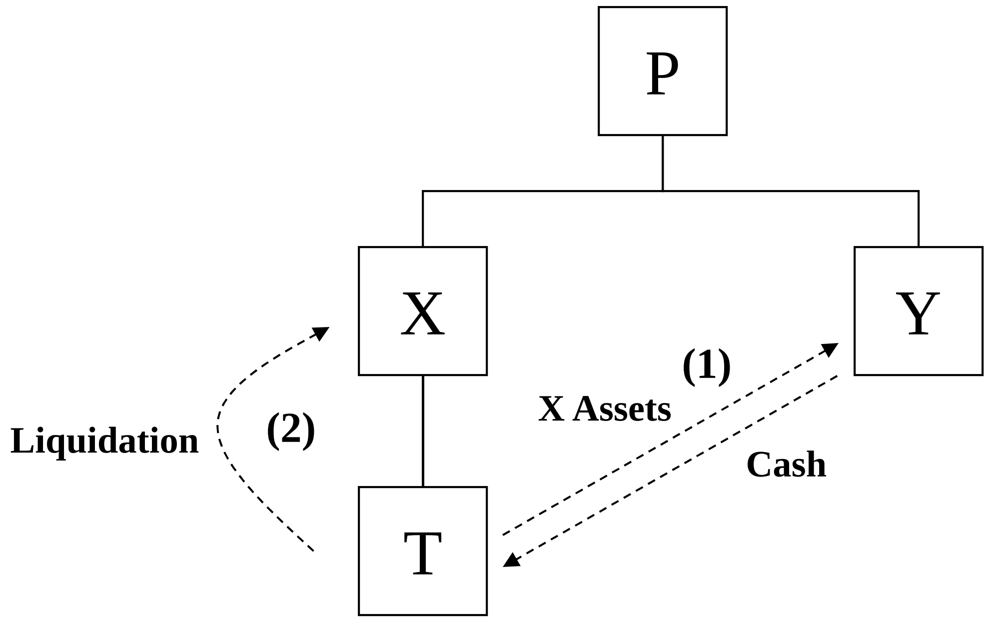


Facts: P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

Result: This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D), according to Rev. Rul. 70-240.

Analysis: Assume the business purpose was to extract cash from Y tax free (under section 356, the boot was limited to the gain in the X stock, which here was zero). There was no other business purpose or economic change of ownership.

All-Cash 'D' Reorganizations – Consolidation



Facts: P owns all of the stock of X and Y. X owns the stock of T. P, X, Y, and T are members of a consolidated group. T transfers its assets to Y in exchange for cash and immediately thereafter liquidates into X.

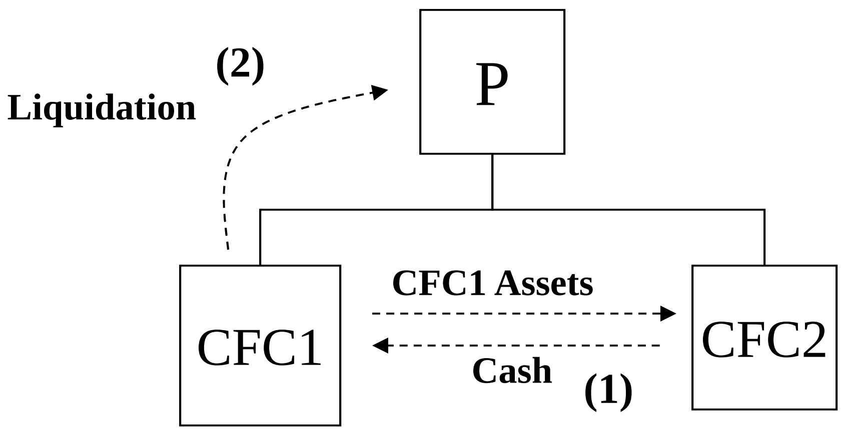
Result: In the consolidated return context, the following events are deemed to occur: (i) Y is treated as issuing its stock to T in exchange for T's assets; (ii) T is treated as distributing the Y stock to X in a liquidation; and (iii) Y is treated as redeeming its stock from X for cash. See Treas. Reg. § 1.1502-13(f) and (f)(7), ex. 3.

The final D regulations confirm that the remaining basis or ELA in the Y stock treated as redeemed will shift to a "nominal share" issued by Y. See Treas. Reg. § 1.368-2(l). An ELA will give rise to a deferred gain when the nominal share is treated as distributed from X to P in order to reflect actual stock ownership.

P may be able to avoid this result by having Y actually issue a single share of stock to T or by contributing a share of Y stock to X.

Question: Does the issuance of the one share have business purpose or economic substance?

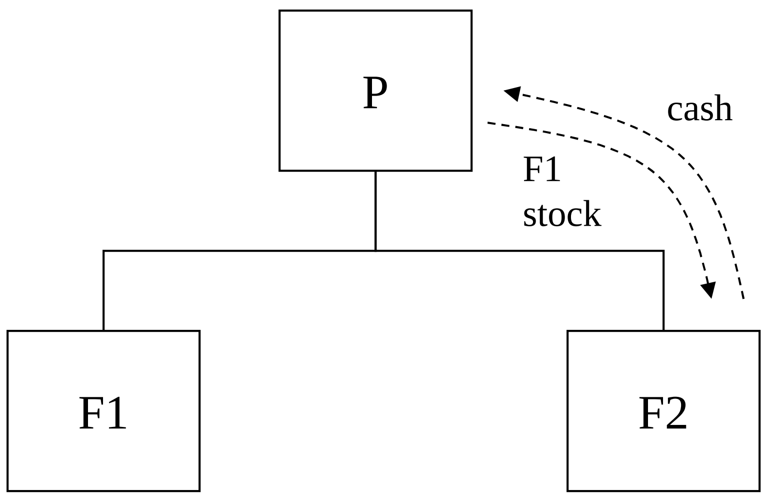
All-Cash ‘D’ Reorganizations – Foreign-to-Foreign



Facts: P owns all of the stock of CFC1 and CFC 2. CFC 1 and CFC 2 are foreign corporations. CFC 1 transfers its assets to CFC 2 in exchange for cash and immediately thereafter liquidates into P.

Result: This transaction should be treated as a valid “D” reorganization. See Treas. Reg. § 1.368-2(l); but see *Schering-Plough v. Corp. v. United States*, F. Supp. 2d 219 (D.C. N.J. 2009), aff’d, *Merck & Co., Inc. v. United States*, Docket No. 10-2775 (3d Cir. 2011) (implying that efforts to repatriate foreign income without income inclusion will be rejected under the ES doctrine).

Section 304 Cross-Border Transaction

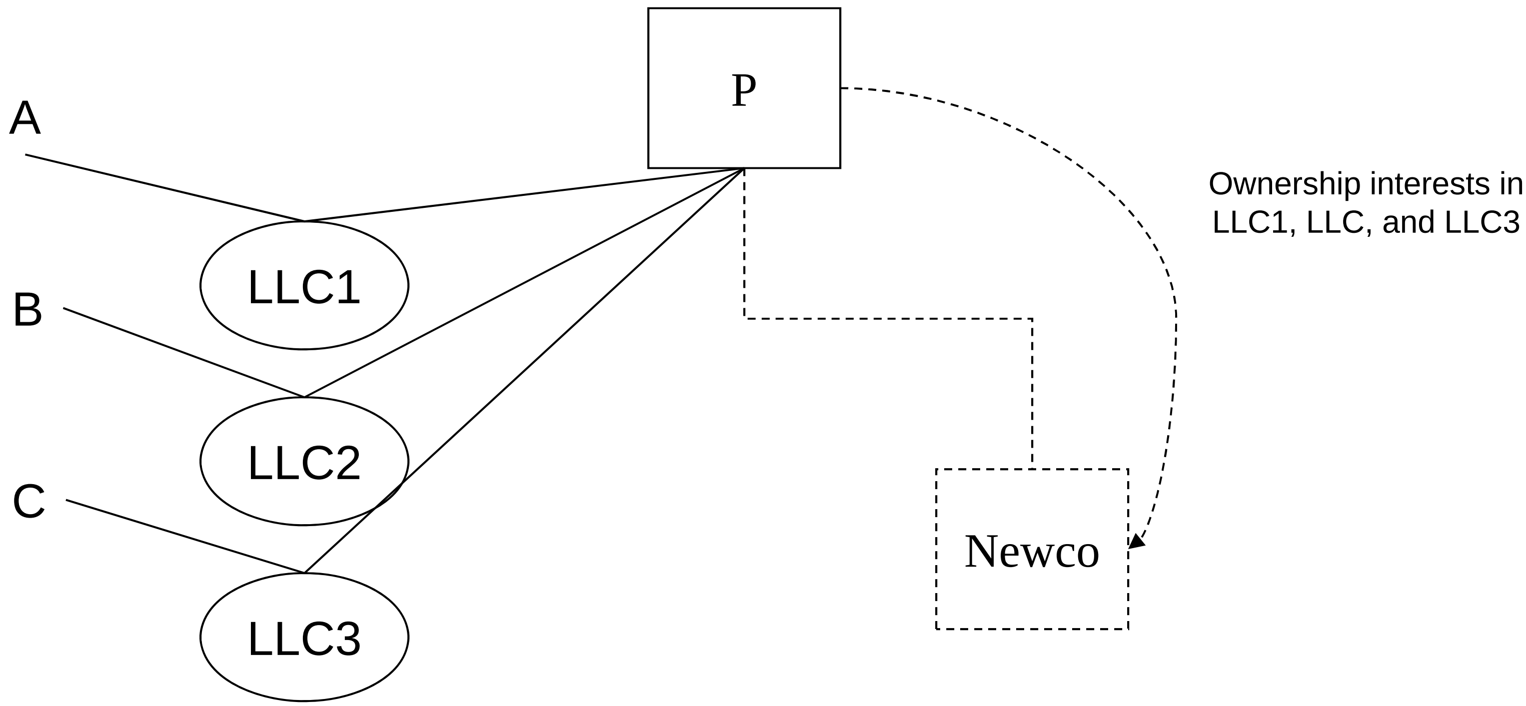


Facts: P, a domestic corporation, owns all of the stock of F1 and F2, both of which are foreign corporations. F2 has excess foreign tax credits. P sells F1 stock to F2 in exchange for cash in a transaction the sole purpose of which is to pull foreign tax credits out of F2.

Result: Section 304 applies to the transaction so that earnings are repatriated and foreign tax credits are pulled out of F2.

Question: Is this result questionable under the ES doctrine because there was no business purpose or profit potential?

Roll-up Transaction



- Assume that a parent corporation converts several LLCs or partnerships into a corporation in a roll-up transaction. Is this transaction subject to review if the roll-up was done in part to combine income and loss?
- Proposals indicate may be within “safe harbor”?