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The Economic Substance Doctrine

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The Economic Substance Doctrine

PORTFOLIO DESCRIPTION

Tax Management Portfolio No. 508-2nd, *The Economic Substance Doctrine*, analyzes the "economic substance doctrine" as codified in §7701(o) of the Internal Revenue Code. Section 7701(o) defines the "economic substance doctrine" as the "common law" developed by the courts to disallow tax benefits for tax-motivated transactions that had no "business purpose" or no "economic substance." The "business purpose" test looks to the taxpayer's motives for entering into the transaction, while the "economic substance" test looks to the reality of the transaction. Prior to codification, the presence of either "business purpose" or "economic substance" was sufficient in some circuits to sustain a transaction's tax benefits (the "disjunctive" test); in other circuits both needed to be present (the "conjunctive test").

Section 7701(o) codified the "conjunctive" test by disallowing the federal tax benefits of any transaction for which the courts have found *either* "business purpose" or "economic substance" to be "relevant" unless, apart from federal tax benefits, there is *both* a "substantial purpose" for entering into the transaction *and* a "meaningful change" in the taxpayer's "economic position." Section 7701(o) also clarifies how the "profit potential" of a transaction may be used to demonstrate economic substance.

Of even greater importance to post-codification tax planning is the 20% penalty on §7701(o) adjustments that is imposed by §6662(a) of the Internal Revenue Code (increased to 40% if the transaction is not "adequately disclosed" on the return). The penalty applies without regard to whether the taxpayer had a professional advisor's tax opinion or any other "reasonable basis" for believing the transaction at issue had economic substance.

Chapter I of the Portfolio summarizes the codified doctrine, including the strict-liability penalties that attach to economic substance adjustments and important guidance in the legislative history concerning when the doctrine is "relevant" to allowance of tax benefits from a tax-motivated transaction. Chapter II analyzes a series of court decisions that are regarded as landmarks in the development of the business purpose and economic substance doctrines. Chapter III analyzes other judicial doctrines, such as the step-transaction doctrine, that overlap or may supply insight into how the codified economic substance will be applied. Chapter IV distinguishes the conjunctive and disjunctive tests and analyzes the pre-codification circuit split concerning with test to apply. Chapter V discusses the pre-codification "profit potential" authorities. Chapters VI through VIII provide a comprehensive case-by-case survey of pre-codification case law, sorted by topic.

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DETAILED ANALYSIS

I. Introduction and Scope of Portfolio

A. The "Economic Substance" Doctrine Prior to Codification

Federal income tax consequences often influence a taxpayer's decision about whether to enter into a transaction, how to structure a transaction, or how to report a transaction for tax purposes. The line between creative and abusive tax planning has never been clear and likely never will be. Over the past 80 years, U.S. courts have been called upon to consider, under many different sets of facts, whether a taxpayer should be allowed the tax benefits of a transaction that is artfully designed to qualify for those tax benefits in a manner that may not have been anticipated by the authors of the Internal Revenue Code. The resulting corpus of case law embodies two virtually irreconcilable principles, both of which were articulated in the seminal case of *Gregory v. Helvering*.[1]

The issue in *Gregory* was whether a tax-motivated distribution of securities by a corporation to its owner, in which the securities were contributed to a corporation that was promptly liquidated after it was distributed to the owner, qualified as a tax-free "reorganization."[2] In a decision authored by Judge Learned Hand and affirmed by the Supreme Court, the Second Circuit Court of Appeals found that, on the one hand (no pun intended), "[a]nyone may so arrange his affairs that his taxes shall be as low as possible" but that, on the other hand, "[t]o dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'"[3]

Subsequent to the decision in *Gregory*, the Tax Court, the Claims Court, and all of the Courts of Appeal have endeavored to define the line where an "arrangement" to make the taxpayer's tax "as low as possible" crosses over into a tax "dodge" for which formally available tax benefits may be disallowed by the Commissioner. Over time, as a given court's rationale for allowing or disallowing tax benefits for a tax-motivated transaction came to be relied upon by that court or other courts in subsequent cases, the rationale matured into a judicial "anti-abuse doctrine."

Among the judicial anti-abuse doctrines claiming roots in *Gregory* are those that disallow the tax results of transactions that lack "business purpose" and/or "economic substance" and transactions that are mere "shams" or have a substance that differs from their form (the "substance-over-form" doctrine). Overlaying these doctrines is the "step-transaction" doctrine, pursuant to which a judicial anti-abuse doctrine may be applied to a single tax-motivated step in a multi-step transaction that, viewed as a whole, may have business purpose and economic substance. In many cases, a transaction's "profit potential" was the decisive factor in establishing the presence or absence of "business purpose" or "economic substance." The development of each of these doctrines is tracked in Chapter III.

In *Gregory*, the Supreme Court affirmed that the IRS could disallow the tax benefits of a transaction that had "no business or corporate purpose" and was "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else."[4] Subsequent appellate court decisions have cited *Gregory* as the original authority for disallowing tax benefits for a transaction "entered upon for no other motive but to escape taxation"[5] and also as the original authority for disallowing tax benefits of a transaction "lacking in economic substance."[6] In other words, in the eyes of many courts, the transaction in *Gregory* lacked both a "business purpose" and "economic substance."

In a subsequent landmark decision, *Frank Lyon Co. v. United States*,[7] the Supreme Court found that the IRS should "honor" the allocation of tax attributes pursuant to a multi-party leasing transaction that had "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features … ."[8] Thus, while *Gregory* has been taken as standing for the proposition that the *absence* of both "business purpose" and "economic substance" is sufficient to disallow the tax benefits of a transaction, *Frank Lyon* has been taken to stand for the proposition that the *presence* of both is sufficient to avoid disallowance.

Taken together, *Gregory* and *Frank Lyon* beg the question whether a tax benefit may be disallowed if a transaction has only "business purpose" or only "economic substance." Before the codification of the "economic substance doctrine in 2010, the presence of either "business purpose" (the "subjective" test) or "economic substance" (the "objective test") was sufficient to sustain a transaction's tax benefits (the "disjunctive" test) in some circuits; in other circuits, both needed to be present (the "conjunctive test"); in still others, the tests were amalgamated (the "unitary test"). The conjunctive/disjunctive/unitary split among the circuits is discussed in detail in Chapter IV.

B. Codification of the "Economic Substance" Doctrine

The tax-writing committees of Congress had been aware for some time of the conjunctive/disjunctive split among the U.S. Circuit Courts of Appeals, which, in the eyes of some members, symbolized a revenue-bleeding leniency shown by the courts toward the heavily crafted tax planning strategies that had been marketed to large corporations and high-net-worth individuals since the late 1980s by banks, accounting

[1] 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).
[2] See II.A. for a more complete description of the case.
[3] 69 F.2d 809 at 811.
[4] 293 U.S. 465 at 470.
[5] *E.g.*, *Commissioner v. Transport Trading & Terminal Corp.*,176 F.2d 570, 572 (2d Cir. 1949).
[6] *E.g.*, *Killingsworth v. Commissioner*, 864 F.2d 1214, 1216 (5th Cir. 1989).
[7] 435 U.S. 561 (1978). *See* II.I., below, for a more complete description of the *Frank Lyon* case.
[8] 435 U.S. at 583–84.

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firms, and others.[9] Over the course of a decade, numerous legislative proposals to "codify" or "clarify" the economic substance doctrine were introduced in the United States Congress.[10] In general, the proposals stated that the economic substance doctrine should be a conjunctive test that cannot be satisfied by reason of a transaction's potential for profit unless the present value of the reasonably expected pre-tax profits from the transaction is substantial in relation to the present value of the expected tax benefits.[11]

The economic substance doctrine was ultimately codified in §7701(o) of the Internal Revenue Code as part of the Health Care and Education Reconciliation Act of 2010.[12] Its terms are sufficiently brief to warrant their full inclusion here:

> (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.
>
> (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.

Section 7701(o) applies only to transactions entered into after March 30, 2010[13] and, for individuals, only to transactions undertaken in connection with a trade or business or an activity engaged in for the production of income.[14]

Section 7701(o)(1) codified the "conjunctive" test by disallowing the federal tax benefits of any transaction to which the economic substance doctrine is "relevant" unless, apart from federal tax benefits, there is *both* a "substantial purpose" for entering into the transaction *and* a "meaningful change" in the taxpayer's "economic position." The importance of codifying the "conjunctive" test remains to be seen, as the number of cases where a "disjunctive" analysis clearly led to different result than a "conjunctive" analysis is limited. For example, once a court has determined that a transaction lacks "economic substance," the taxpayer will face an uphill battle proving a non-tax "business purpose" even in "disjunctive" circuits.[15]

Moreover, although codification of the "business purpose" and "economic substance" anti-abuse doctrines ended the un-

[9] *See* Charlene Luke, *The Relevance Games: Congress's Choices for Economic Substance Gamemakers*, The Tax Law. 551 (Spring 2013).

[10] *See generally* Bassin & Lehrer, *Developments in Economic Substance: How Codification and New Case Law Will Change the Rules*, 26 Tax Mgmt. Real Est. J. 79 (Apr. 7, 2010); Jackel, *For Better or for Worse: Codification of Economic Substance*, Tax Notes, May 24, 2004, at 1069, discussing the various legislative proposals.

[11] Pub. L. No. 111-152, §1409. *See* PMTA 2010-055 (application of effective date to fiscal year taxpayer). *See, e.g.,* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005); Conference Committee Joint Explanation of H.R. 4297, Tax Increase Prevention and Reconciliation Act of 2005, at n. 373 and accompanying text.

[12] Pub. L. No. 111-152, §1409(a).

[13] Pub. L. No. 111-152, §1409(a).

[14] §7701(o)(5)(B).

[15] *See* McMahon, *Living with the Codified Economic Substance Doctrine*, 128 Tax Notes 731, 735 (Aug. 16, 2010) ("[N]one of the courts applying the disjunctive test ever upheld the tax benefits of a transaction on the grounds that one of the two prongs but not the other had been satisfied; where one has been found absent, the other has also been found lacking, and when one has been found present, the other has also been found to be present.").

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certainty concerning whether both must be present to sustain a tax benefit, codification did not put an end to many other uncertainties surrounding these and other judicial anti-abuse doctrines. Courts are reluctant to disregard transactions as they were actually structured; consequently, they often rely on two or more rationales in arriving at a conclusion, leaving unclear the weight given to each of the rationales in a given case.[16] Because judicial anti-abuse doctrines often overlap, it may not even be clear which doctrine has been applied.[17]

Section 7701(o) explicitly leaves in place prior case law concerning what will qualify as a "substantial" non-tax "purpose," what will qualify as a "meaningful change" in the taxpayer's "economic position," and whether the doctrines are "relevant" to a transaction, and it does not reconcile inconsistencies among the circuits concerning those matters. Putting aside the variance between "conjunctive" and "disjunctive" analysis, the courts have not consistently applied the various anti-judicial doctrines even when purporting to do so.[18] Consequently, a tax director or tax advisor that is designing a tax-motivated transaction or providing tax input into a business-motivated transaction must continue to account for the pre-codification cases that dealt with similar transactions, especially those decided in the circuit where a case for the taxpayer is likely to be decided. It should also be noted that the IRS has informally advised that the codification of the economic substance doctrine did not replace the common law doctrine.[19] To that end, the decisions in the leading cases are summarized, by category, in Chapter VIII.

C. *Penalties Under the "Economic Substance" Doctrine*

1. *Overview*

Much of the reporting and commentary on codification of the economic substance doctrine has focused on its termination of the conjunctive/disjunctive split among the circuits. As noted above, it is not yet clear how much impact this will actually have on the outcome in post-codification cases. Of far greater importance than the mandate of §7701(o), applying conjunctive analysis to economic substance cases, is the 20% accuracy-related penalty imposed by §6662(b)(6) on any "disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of §7701(o)) or failing to meet the requirements of any similar rule of law."[20] In addition, the penalty for erroneous claim for credit or refund also applies to any "excessive amount" (i.e., any excess of the amount of a claim for refund or credit over the allowable amount of the claim).[21] For further discussion of these penalties, see 648 T.M., *Reportable Transactions*, and 634 T.M., *Civil Tax Penalties*.

The penalties are "strict liability" penalties that apply without regard to whether the taxpayer had a professional advisor's tax opinion or any other "reasonable cause" for believing the transaction at issue had economic substance.[22] As if that were not enough, the accuracy-related penalty is increased to 40% if an economic substance transaction is not "adequately" disclosed on the tax return.[23]

The 20/40% penalty dramatically alters the playing field for taxpayers, the IRS, and the courts. For the taxpayer, the downside potential of aggressive tax planning is increased considerably, although the appetite for highly structured tax strategies that have been marketed to multiple clients has been waning since a string of court victories by the IRS in the early 2000s.[24] For the IRS, its armory has been furnished with a powerful new weapon, not only to challenge abusive tax planning, but also to achieve settlements in borderline cases. Paradoxically, while the penalty may empower the IRS in borderline cases, its severity may dissuade some courts from disallowing tax benefits in borderline cases where the taxpayer did in fact rely in good faith on a well-reasoned independent opinion.

2. *IRS Practice*

There is no "reasonable cause" defense to the economic substance penalty, so it is a strict liability penalty. For a discussion of the penalties and associated procedures, see 634 T.M., *Civil Tax Penalties*.

3. *40% "Nondisclosure" Penalty*

Section 6662(i) automatically increases the 20% economic substance penalty to 40% if "the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return."[25] Notice 2010-62 provides that, unless the transaction is a reportable transaction, as defined in Reg. §1.6011-4(b), the adequate disclosure requirements of §6662(i) will be satisfied if a taxpayer adequately dis-

[16] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (district court applied the economic substance doctrine to disallow the tax benefits, and, alternatively, the step transaction doctrine to collapse several steps of the transaction into a single transaction, which would have tax consequences different from the consequences of each step separately), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97 (Tax Court applied four alternative tests to disallow the tax benefits from the transaction: (i) validity of the entity; (ii) step transaction (end result and interdependence) doctrine; (iii) two-prong economic substance of the transaction; and (iv) existence of a true sale); *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003) (the district court decided to validate the transaction utilizing both the economic substance and sham transaction doctrines).

[17] *See* JCT Report (2005), I.C. ("The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS.").

[18] JCT Report (2005) ("Under current law, the application of the economic substance doctrine among the courts varies considerably, with one recent court even questioning the viability of the doctrine altogether. The lack of clarity undermines the prophylactic effect of the doctrine and produces unfairness. The potential unfairness is compounded by the recent increase in penalties in the event the IRS finds and challenges a tax shelter transaction and the taxpayer loses in court.").

[19] CCA 202240019 (common law doctrine can be applied to transactions entered after codification of economic substance doctrine).

[20] §6662(b)(6).

[21] §6676(b).

[22] §6664(c)(2), §6664(d)(2), §6676(c).

[23] §6662(i).

[24] *See, e.g.*, *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (CINS tax shelter); *Winn Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001)(COLI tax shelter); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, aff'd, 331 F.3d 972 (D.C. Cir. 2003) (lease stripping); *Long Term Capital Holdings v. Commissioner*, 330 F. Supp.2d 122 (D. Conn. 2004), aff'd, 150 Fed. Appx. 40 (2d Cir. 2005) (contribution of stock with a built-in loss to a partnership). Also note that penalties other than those under §6662(b)(6) and §6662(i) may apply in economic substance cases. *See, e.g., Daichman v. Commissioner*, T.C. Memo 2020-126 (holding taxpayers liable for §6662(a) and §6662(b)(2) accuracy-related penalty for tax years pre-dating enactment of §6662(b)(6) and §6662(i)).

[25] §6662(i)(2).

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closes on a timely filed original return (determined with regard to extensions) or a qualified amended return (under Reg. §1.6664-2(c)(3)) the relevant facts affecting the tax treatment of the transaction. If a disclosure would be considered adequate for purposes of §6662(d)(2)(B) (without regard to §6662(d)(2)(C)) before March 31, 2010, then it will be deemed to be adequate for purposes of §6662(i). The disclosure will be considered adequate only if it is made on a Form 8275 or Form 8725-R, or as otherwise prescribed in future guidance. Disclosures made consistent with the terms of Rev. Proc. 2022-39 on Form 15307, *Post-Filing Disclosure for Specified Large Business Taxpayers*, will also be taken into account for purposes of §6662(i).[26]

Note: In CCA 202244010, the IRS Chief Counsel addressed whether a taxpayer has adequately disclosed a noneconomic substance transaction for purposes of §6662(i) where the material facts are disclosed as reportable transactions on Form 8886 but are not separately disclosed on Form 8275 as required by Notice 2010-62. The IRS Chief Counsel concluded that disclosure on Form 8886 only is sufficient to avoid the 40% penalty. The IRS Chief Counsel explained that while Notice 2010-62 imposes an obligation to file Form 8275, such directive did not have the force and effect of law in the absence of regulations requiring Form 8275 to disclose a noneconomic substance transaction, and, under relevant case law addressing adequate disclosure,[27] a taxpayer would have a strong argument that filing Form 8886 with a timely filed return or qualified amended return would adequately inform the IRS of the transaction consistent with the requirements of §6662(i).

If a transaction lacking economic substance is a reportable transaction, as defined in Reg. §1.6011-4(b), the adequate disclosure requirement under §6662(i)(2) will be satisfied only if the taxpayer meets the disclosure requirements under the §6011 regulations in addition to the disclosure requirements described in the preceding paragraph. A taxpayer will not meet the disclosure requirements for a reportable transaction under the §6011 regulations by only attaching Form 8275, *Disclosure Statement*, or Form 8725-R, *Regulation Disclosure Statement*, to an original or qualified amended return.[28]

D. The Measurement of "Profit Potential" Under the Codified Doctrine

As noted above, the presence or absence of "profit potential" often has been the decisive factor in determining whether a transaction had "economic substance" or a non-tax "business purpose."[29] Many courts have questioned whether the taxpayer was subject to risk of loss and/or opportunity for gain from the disputed transaction,[30] and several variations of the "profit potential" requirement have emerged.[31] The most important controversies pertaining to the profit test include whether the profit test is part of the objective or subjective prong of the economic substance analysis and how much profit is enough to satisfy the applicable standard. As a legitimate transaction could conceivably lack economic profit, courts consider the transaction's overall economic effect when applying the economic substance doctrine, weighing quantitative factors such as the reasonableness of the sales price and adherence to contractual terms.[32]

An example of transactions failing the profit test and thus running afoul of the economic substance doctrine may be found in *Chemoil Corp. v. United States*,[33] where Chemoil, a marine fuel distribution company, had over $6.5 million in alcohol fuel mixture credit claims under §6426(b) disallowed. At issue were seven transactions in which the Chemoil both (i) sold ethanol at a pre-tax loss, and (ii) only added a small amount of gasolene to the ethanol, an amount so insignificant that it did not have any effect on the specifications of the fuel. Additionally, executives from Chemoil backdated an invoice to portray one transaction as occurring before the alcohol fuel mixture credit window expired. In upholding the credit disallowance and associated excessive claims penalty, the court noted that no evidence was presented that Chemoil was motivated by "anything other than tax benefits" when it agreed to the seven transactions; rather, the record contained multiple emails showing Chemoil employees' sole focus on claiming the alcohol fuel mixture credit.[34]

The pre-codification "profit potential" cases are analyzed in Chapter V.

Under the "special rule" in §7701(o)(2), a transaction's "profit potential" will be taken into account in determining whether the transaction has economic substance 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.[35] Fees and other transaction expenses, as

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[26] *See* Rev. Proc. 2022-39, *obsoleting* Rev. Proc. 94-69. Rev. Proc. 2022-39 is effective for examinations of eligible taxpayers (as defined in Rev. Proc. 2022-39, §3.01) that begin after November 16, 2022. The transitional relief set forth in §2.15 of Rev. Proc. 2022-39 continues to apply to taxpayers eligible for such relief with respect to examinations of tax year 2020 and earlier years. *See* Rev. Proc. 2022-39, §6.02.

[27] *See, e.g., Elliott v. Commissioner*, T.C. Memo 1997-294; *Estate of Reinke v. Commissioner*, T.C. Memo 1993-197, *aff'd*, 46 F.3d 760 (8th Cir. 1995).

[28] Given the procedures outlined in Notice 2010-62 on adequate disclosure, the IRS's annual guidance on adequate disclosure for reducing accuracy related penalties does not apply to the penalty under §6662(i). *See* Rev. Proc. 2011-13, §1, updated by Rev. Proc. 2012-15.

[29] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985) ("The economic substance inquiry … requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits."); *Sheldon v. Commissioner*, 94 T.C. 738, 759 (1990) (noting that where transactions are analyzed regarding their economic substance, "the focus is upon profit objective or the potential for profit."); *see IES Indus., Inc. v. United States*, 253 F.3d 350, 354 (8th Cir. 2001) (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit … apart from tax benefits.").

[30] *E.g., Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988).

[31] *See generally* Keinan, *The Profit Requirement under the Economic Substance Doctrine*, 21 J. Tax'n Inv. 81 (2003) (hereinafter "Keinan (2003)").

[32] *Frank Lyon Co. v. United States*, 435 U.S. 561, 582–83 (1978) (listing a number of factors that the court considered to be meaningful in determining the "substance and economic realities of the transaction"); *Bank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104, 119 (2d Cir. 2015) ("Determining whether a given transaction has economic substance under the objective prong therefore requires both a calculation of pre-tax profit and a consideration of the transaction's overall economic effect.").

[33] No. 19-CV-6314-LTS-JW, 2023 BL 337736 (S.D.N.Y. Sept. 26, 2023).

[34] *Chemoil Corp. v. United States*, No. 19-CV-6314-LTS-JW, 2023 BL 337736 (S.D.N.Y. Sept. 26, 2023); *see also Alternative Carbon Res., LLC v. United States*, 939 F.3d 1320 (Fed. Cir. 2019) (confirming economic substance doctrine applies to alcohol fuel mixture credit claims and characterizing as meritless argument that doctrine does not apply to profitless transactions where investment or activity is type which credit was intended to encourage).

[35] §7701(o)(2)(A); *see also* Notice 2010-62.

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well as foreign taxes in appropriate cases, will be treated as expenses in determining pre-tax profit.[36]

E. The "Relevance" of the Codified Doctrine to Post-Codification Transactions

By its own terms, §7701(o) applies only to transactions to which the pre-codification "business purpose" and "economic substance" doctrines were "relevant." The implication is that there are some transactions for which tax benefits have been allowed even in the absence of a "substantial [non-tax] purpose" and/or a "meaningful" change in the taxpayer's "economic position." In what is undoubtedly the most important item in the legislative history of §7701(o), the Technical Explanation of the Staff of the Congressional Joint Committee on Taxation defined as follows the transactions to which the codified economic substance doctrine is not "relevant":

> 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.[37]

According to the Technical Explanation,[38] the four examples are "illustrative and not exclusive." Notwithstanding the implication that there may be other, and perhaps many other, "irrelevant" transactions, the IRS has stated in Notice 2010-62, which contains its interim guidance on §7701(o), that neither the Treasury Department nor the IRS intends to issue general administrative guidance regarding the types of transactions to which the codified doctrine is "relevant," nor will the IRS issue a letter ruling or determination letter on whether the codified doctrine is "relevant" to, or disallows tax benefits for, a specific transaction.[39]

The examples in the Technical Explanation are very useful, but respect under "longstanding judicial and administrative practice" is a nebulous standard by which to identify other "examples." On the whole, "judicial practice" is unlikely to be a practical standard because few if any cases have distinguished the "relevance" of the economic substance doctrine to the transaction under review from whether "business purpose" and/or "economic substance" were present in the transaction.

In reality, the tax-motivated transactions to which the "business purpose" and "economic substance" doctrines have no "relevance" are essentially those that the IRS Commissioner, pursuant to "longstanding … administrative practice," has decided not to challenge in court. However, those transactions are nowhere catalogued, and Notice 2010-62 indicates that the IRS has no intention of publishing a catalogue anytime soon, if ever. The burden of proving that the IRS had been unconcerned about the absence of business purpose or economic substance in a class of pre-codification transactions may prove difficult for the taxpayer to bear, unless the transaction has been described in a ruling, technical advice memorandum, or provision of the Internal Revenue Manual that allowed the tax benefits for which the transaction was formally eligible.

Because "relevance" will be a key defense against most economic substance challenges, the courts eventually will have to consider a number of difficult questions, such as whether the codified economic substance doctrine is "relevant" to a post-codification transaction if (i) the transaction did not occur in the pre-codification era, (ii) the transaction occurred in the pre-codification era but did not come to the Commissioner's attention, or (iii) the Commissioner knew about the pre-codification transaction but chose not to pursue it (perhaps because it would have been litigated in a circuit that applied the disjunctive analysis)? Concerning this sort of question, Notice 2010-62 sends a mixed message.[40]

On the one hand, Notice 2010-62 states that the IRS will continue to analyze when the economic substance doctrine applies in the same fashion as it did prior to the enactment of §7701(o),[41] implying that the IRS will not challenge post-codification transactions that it had decided not to challenge in the pre-codification era. On the other hand, the Notice states that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop, implying that the IRS may change its views on what is "relevant" based on post-codification court decisions.

Gregory itself provides one touchstone for "relevance" that is not tied to "judicial and administrative practice." In deciding to disallow the tax benefits of a series of transactions that formally qualified as a "reorganization," Judge Hand gave foremost consideration to what he considered to be the "plain" intention of Congress to confer tax-exempt treatment on corporate readjustments "for reasons germane to the conduct of the venture in hand" and not on those that were an "ephemeral incident" to a tax scheme.[42] In other words, a taxpayer's reach for a tax result that was outside the scope "plainly" foreseen by Congress made it "relevant" to consider the purpose and substance of the transaction. Although not underscored in the *Gregory* decision, the fact that the Code's reorganization regime departed from the general rule that all income and gain is taxable evidently made it more important for the court to inquire into the purpose and substance of the transaction.

A similar focus on the intent of Congress in the awarding of tax benefits is found in the judicial definition of the economic substance doctrine that was utilized in the Joint Committee's Technical Explanation:

[36] §7701(o)(2)(B).

[37] Staff of the Joint Comm. on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010." as amended, at p. 152.

[38] *Id.* at n. 345.

[39] Notice 2010-62, 2010-40 I.R.B. 411, applicable to transactions entered into on or after March 31, 2010.

[40] *Id.*

[41] *Id.*

[42] *Helvering v. Gregory*, 69 F.2d 809, 811 (2d Cir. 1934).

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> The doctrine of economic substance becomes *applicable* [i.e. "relevant"] where a taxpayer seeks to claim tax benefits, *unintended by Congress*, by means of transactions that serve no economic purpose other than tax savings.[43]

Remarkably, the Technical Explanation buries in a footnote what appears to be the only general guideline for determining "relevance":

> If the realization of the tax benefits of a transaction is *consistent 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.[44]

In many economic substance cases, the taxpayer's first resort will be to legislative history showing that, without regard to his "purpose" or the "substance" of the transaction, the tax benefits from the transaction were foreseeable, if not foreseen, by Congress.

F. "Relevance" in Light of the UPS Decision

Over time, a "relevance" touchstone more important than Congressional intent may be the Eleventh Circuit's 2001 decision in *UPS of Am. v. Commissioner*.[45] The case, much beloved by international tax planners, focused on the transfer by UPS of its business of collecting premiums on "excess value" packages to a Bermuda subsidiary that it had distributed to its shareholders. Although the court described the restructuring as "more sophisticated and complex than the usual tax-influenced form-of-business," it concluded that the transaction had both "economic substance" and a valid "business purpose."[46]

The "economic substance" finding is unsurprising given the very real changes in the ownership of the transferred business. The "business purpose" finding was more remarkable, as there was little doubt that the economic benefit of the transaction was an overall reduction in federal income tax liability. The court effectively held that, without regard to tax motivation, a transaction has a "business purpose "as long as it figures in a bona fide, profit-seeking business" in a going concern.[47]

The court analogized UPS's decision to transfer its insurance business to a Bermuda company owned by its shareholders to a company's decision to fund itself by debt instead of by equity,[48] one of the examples given in the Technical Explanation of a transaction to which the "economic substance" doctrine was not "relevant." Given the court's analogy of UPS's "tax-influenced form-of-business" to the decision to fund a company with debt or equity, its decision that the transaction had sufficient "business purpose" might be more accurately characterized in the post-codification era as a decision that the presence of "business purpose" is not "relevant" to the allowance of tax benefits in any commercially reasonable business restructuring.

The Eleventh Circuit's conclusion that a transaction that "figures in a bona fide, profit-seeking business" of a "going concern" has a "business purpose" *per se* is echoed in the defense mounted today by the opponents of anti-inversion legislation. These opponents argue that their foreign-owned competitors are not forced to pay local income tax on profits earned abroad, making it difficult for a U.S. company to compete for business with companies incorporated in territorial tax jurisdictions such as Germany with respect to business that is most efficiently conducted in a low-tax jurisdiction such as Ireland. United States competitors entering into the taxpayer's business may freely opt to use a foreign holding company that will directly own all non-U.S. subsidiaries and will finance its U.S. subsidiary with tax-efficient loans. In other words, rules that prohibit rearranging an existing business in a manner that would be acceptable were the business to be organized anew burden older businesses with a critical competitive disadvantage.

In that light, the "relevance" test that might be extrapolated from *UPS* would be that the codified economic substance doctrine is not "relevant" to any restructuring of a corporation's business that leaves the corporation with a business structure that would be commercially reasonable had it been so structured from the commencement of business.

G. Coverage and Scope of the Portfolio

Chapter I of the Portfolio summarizes the codified doctrine, including important guidance in the legislative history concerning when the doctrine is "relevant" to allowance of tax benefits from a tax-motivated transaction. Chapter II analyzes a series of court decisions that are regarded as landmarks in the development of the business purpose and economic substance doctrines. Chapter III analyzes other judicial doctrines, such as the step-transaction doctrine, that overlap or may provide insight into how the codified economic substance will be applied. Chapter IV summarizes and analyzes the pre-codification circuit split over whether the economic substance analysis is conjunctive or disjunctive. Chapter V analyzes the pre-codification "profit potential" requirement. Chapters VI and VII discuss the application of the economic substance doctrine, respectively, to entity recognition and the integration or bifurcation of a series of transactions. Chapter VIII provides a comprehensive case-by-case survey of pre-codification case law, sorted by topic.

Several statutory and regulatory provisions, such as §269, apply principles equivalent or similar to the common law doctrines discussed herein. These provisions are not thoroughly discussed in the Portfolio.

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[43] Staff of the Joint Comm. on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, at 143 (citing *ACM P'ship v. Commissioner*, T.C. Memo 1997-115 (1997), aff'd 157 F.3d 231 (3d Cir. 1998)).

[44] Staff of the Joint Comm. on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, at p. 152, n. 344.

[45] *UPS of Am. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), rev'g and rem'g T.C. Memo 1999-268.

[46] *Id.* at 1020.

[47] *See also ACM P'ship v. Commissioner*, 157 F. 3d at 251.

[48] *UPS of Am.*, 254 F.3d at 1020 ("The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive.").

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II. Landmark Pre-Codification Decisions

This chapter sets forth the milestones in the evolution of the judicial anti-abuse doctrines that have emerged from the Supreme Court's decision in *Gregory v. Helvering*.[49] Until its decision in *Frank Lyon Co. v. United States*[50] in 1978, the U.S. Supreme Court had played a key role in shaping the scope and application of the common law doctrines.[51] Since *Frank Lyon Co. v. United States* was decided, other courts have taken the lead in interpreting and applying the various doctrines, and different views have emerged. Chapter II details the history of these court decisions.

The remainder of the Portfolio dissects these doctrines in general (Chapter III) and the economic substance doctrine including its variations in particular (Chapters IV through VIII). Accordingly, the landmark cases discussed in this chapter II also are discussed throughout this Portfolio.

A. Gregory v. Helvering

In *Gregory v. Helvering*, the taxpayer, Evelyn Gregory, was the sole owner of United Mortgage Corporation. The corporation owned securities of Monitor Securities Corporation with a built-in gain. Mrs. Gregory sought to transfer to herself 1,000 shares of Monitor Securities Corporation. To convert ordinary income on the securities into capital gains, Mrs. Gregory first removed the Monitor stock from United Mortgage through a tax-free "reorganization" pursuant to which she incorporated Averill Corporation, caused United Mortgage to transfer the Monitor Security stock to Averill, and caused United Mortgage to distribute its Monitor stock to her. A few days later, Averill was liquidated by distributing the Monitor Security stock to Mrs. Gregory. Mrs. Gregory immediately sold the stock for $133,333, declaring a capital gain of $76,000 on which she paid tax at the preferred capital gains rate.

The Commissioner disregarded the reorganization and imposed a tax as if United Mortgage had simply distributed the Monitor shares to Mrs. Gregory as a dividend, taxable at ordinary income rates. The Board of Tax Appeals upheld the Commissioner's adjustment. The Second Circuit, in a decision affirmed by the Supreme Court, overturned the Board's decision, holding that the formation, distribution, and liquidation of Averill were "real" transactions that the Commissioner could not simply disregard, but that that Mrs. Gregory should nevertheless be taxed as if the Averill stock had been distributed to her as a dividend. In the Supreme Court's own words:

> Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually, occurred, what do we find? Simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death. In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking though conducted according to the terms of (the statutory provision), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[52]

B. Higgins v. Smith

In *Higgins v. Smith*,[53] the issue considered was whether the taxpayer was entitled to deduct a loss arising from the sale of securities to a corporation wholly owned by the taxpayer under §23(e) of the Revenue Act of 1932.[54] The officers and directors of the corporation were subordinates of the taxpayer. The corporation's transactions were carried on under his direction and were restricted largely to operations in buying securities from or selling them to the taxpayer. While the corporation's accounts were kept completely separate from those of the taxpayer, there was no doubt that corporation was, in essence, the taxpayer's corporate self. The taxpayer sold securities to his corporation for less than what he paid for them and took the loss as a deduction.

The United States Supreme Court followed *Gregory v. Helvering* and further elaborated:

> The Government urges that the principle underlying *Gregory v. Helvering* finds expression in the rule calling for a realistic approach to tax situations. As so broad and unchallenged a principle furnishes only a general direction, it is of little value in the solution of tax problems. If, on the other hand, the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration… The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham

[49] 293 U.S. 465 (1935).

[50] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (sale-leaseback was held to be a part of genuine financing transaction).

[51] *Knetsch v. United States*, 364 U.S. 361 (1960); *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *Moline Props. v. United States*, 319 U.S. 436 (1943).

[52] *Gregory*, 293 U.S. at 469–470.

[53] *Higgins v. Smith*, 308 U.S. 473, 476–77 (1940).

[54] 47 Stat. 169.

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may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.

C. *Moline Props., Inc. v. United States*

Moline Props., Inc. v. United States introduced a different but strongly related doctrine, namely, the recognition of the separate existence of a corporation for tax purposes.[55] In this case, the sole shareholder of a corporation attempted to characterize gain from the sale of real property, title to which was held by the corporation, as gain to the shareholder on the ground that the existence of the corporation was "merely fictitious" for federal income tax purposes.[56] The United States Supreme Court held that the taxpayer could not disregard the corporate form of his business organization unless such form was a "sham or unreal."[57] The Supreme Court explained that "[i]n such situations the form is a bald and mischievous fiction."

The Supreme Court further observed that:

> Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[58]

Comment: Moline Props. was interpreted to establish a two-prong disjunctive test in determining whether a separate corporate entity should be recognized: (i) a subjective standard requiring the taxpayer to demonstrate a legitimate, non-tax business purpose that is served by the selection of the corporate form, and (ii) an objective standard requiring that the entity has engaged in sufficient business activity.[59] This two-prong test resembles the more general two-prong test of the economic substance doctrine discussed herein. The *Moline Props.* doctrine has been applied not only with respect to validity of corporations but also with respect to other entities including partnerships and trusts.[60] In addition, although in *Moline Props.* the *taxpayer* rather than the Government tried to convince the court to disregard the corporation, the doctrine has been applied in the other direction.[61]

D. *United States v. Cumberland Pub. Servs. Co.*

United States v. Cumberland Pub. Servs. Co. involved an in-kind partial liquidation distribution from a closely held corporation to its shareholders followed by a sale of the distributed assets by the shareholders to a third party.[62] A similar situation was involved five years before in *Commissioner v. Court Holding Co.*[63] In both cases, the Commissioner argued that tax at the corporate level resulting from the asset sale could not be avoided by using the shareholders as a conduit through which to pass title. In *Commissioner v. Court Holding Co.*, the Commissioner prevailed because it was found that the corporation had in fact negotiated the sale but "called off" the sale at the last moment. As the United States Supreme Court indicated:

> A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.[64]

In *United States v. Cumberland Pub. Servs. Co.*, the taxpayer prevailed because the court found that the corporation never negotiated the sale, but rather the sale was negotiated by the shareholders.[65] As Justice Black stated:

> 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 [here, a contribution and sale of land by partners following a genuine withdrawal of land from a partnership] cannot be attributed to the corporation for tax purposes.[66]

E. *Knetsch v. United States*

In *Knetsch v. United States*,[67] the taxpayer purchased from an insurance company $14 million in deferred annuity 30-year savings bonds for $4,000 cash, bearing interest of 2.5% and $4 million in nonrecourse annuity loan note, bearing interest at 3.5%. Because the transaction was, in effect, an insurance contract, the bonds had a cash loan value of $100,000 over face each year. The note was secured by the annuity policies. The terms of the annuities allowed Knetsch to borrow amounts secured by the value in excess of his indebtedness. On the same day he bought the annuities, Knetsch paid the first year's interest on the notes in the amount of $140,000. A few days later, Knetsch borrowed $99,000 against the loan value to make the interest payments so that the cash loan value of the contract increased only by $1,000 per year. Knetsch claimed a deduction of $143,465 as interest for that year. Knetsch repeated the same practice in the subsequent years and claimed similar interest deductions. The cash value of the annuities at maturity (when Knetsch would have been 90 years old) would have been $8,388,000 paying $90,171 monthly.

Stating the general objective economic substance standard, the Supreme Court stated that Knetsch's expenditures "did not appreciably affect his beneficial interest except to reduce his tax." The court observed that: "it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[68] The court held against the taxpayer

[55] 319 U.S. 436 (1943).
[56] *Id.* at 439.
[57] *Id.* at 438–39.
[58] *Id.*
[59] *Rogers v. Commissioner*, 34 T.C.M. 1254, 1256 (1975) ("*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity … . Business purpose or business activity are alternative requirements.").
[60] *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984).
[61] *Id. See also Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971), acq., 1972-2 C.B. 1 (IRS challenged the formation of a corporation).
[62] 338 U.S. 451 (1950).
[63] 324 U.S. 331 (1945).
[64] 324 U.S. 331 (1945).
[65] 338 U.S. 451 (1950).
[66] *Id.*
[67] 364 U.S. 361 (1960), aff'g 272 F.2d 200 (9th Cir. 1959).
[68] 364 U.S. at 366.

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on the grounds that the transaction had "no substance or purpose aside from the taxpayer's desire to obtain a tax benefit." The Supreme Court concluded that the transaction:

> was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000 … . It is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so-called 'interest' payments. The $91,570 difference retained by the company was its fee for providing the facade of 'loans' whereby the petitioners sought to reduce their 1953 and 1954 taxes … ."[69]

F. Goodstein v. Commissioner

The facts in *Knetsch v. United States* were equivalent to the facts in a series of cases referred to as the "Livingstone" cases.[70] The first "Livingstone" case was *Goodstein v. Commissioner*[71] in which the taxpayer purchased $10,000,000 Treasury notes with funds borrowed at an interest rate in excess of the bonds' yield. The interest on the borrowed funds was prepaid, and the taxpayer pledged the notes as collateral for the borrowed funds. After the notes were held for at least six months, the taxpayer instructed the lender to sell the notes, and to use the proceeds to pay off the debt. The taxpayer's tax motivation was to obtain interest deductions for the prepaid interest, and to receive a long-term capital gains treatment with respect to the sale of the notes. The taxpayer also made a profit of $75,984 from the transaction, due to an appreciation in the notes' value.[72]

The Tax Court and the Court of Appeals, however, disregarded the potential profit from the transaction and held that the purchase of the notes and the incurrence of debt were not genuine. The Court of Appeals concluded that the taxpayer and the lender did not have genuine borrower-lender relationships and, therefore, disallowed the interest deductions.

Comment: Goodstein v. Commissioner was decided one year before the Supreme Court's decision in *Knetsch v. United States*. In *Rubin v. United States*,[73] another "Livingstone" case, the facts were almost similar to those in *Goodstein*, but it was decided after the Supreme Court's decision in *Knetsch v. United States* The taxpayer purchased Treasury notes with a total face amount of $5,000,000 bearing a 1⅜% yield and financed it with a loan bearing a 2⁹⁄₁₆% rate of interest. In contrast to the court in *Goodstein*, the court in *Rubin* specifically addressed the issue of adequate profit motive and decided that a $5,574 profit made by the taxpayer was "incidental" and should be disregarded for purposes of the "sham" transaction analysis.[74]

G. Goldstein v. Commissioner

Goldstein v. Commissioner[75] involved a 70-year-old woman who won the Irish Sweepstakes. Her son, an accountant, formulated a plan to use §163 to obtain interest deductions to reduce his mother's tax burden on her sweepstakes winnings. The taxpayer borrowed $945,000 at 4% interest and invested the proceeds in U.S. Treasury securities maturing in three or four years, with a face amount of $1,000,000, which paid interest of 1.5%. Similar to the taxpayer in *Knetsch v. United States*, the taxpayer in *Goldstein* had locked in an economic loss from the inception of the transaction. The loans were secured by the Treasury notes, and it was contemplated that the overall transactions would result in economic losses, but that the net result would be tax benefits. Mrs. Goldstein argued that she realistically anticipated a gain due to anticipated appreciation in the value of the Treasury obligations, and that this gain would more than offset the loss that was bound to result due to the unfavorable interest rate differential.

The Tax Court held that "the transactions [with the banks here involved] were shams."[76] The Court of Appeals, however, rejected the Tax Court's characterization of the transactions as "sham" transactions on the ground that the transactions were made with two different and independent banks, on a nonrecourse basis. The Court of Appeals concluded, therefore, that the transactions did, in fact, take place and therefore could not be ignored as "shams." However, it affirmed the Commissioner's decision to disallow the deductions on the grounds that the taxpayer's *purpose* in entering into the transaction was solely to obtain tax benefits. The Court of Appeals disallowed the interest deduction claimed under §163, citing a lack of economic substance as well as a lack of a non-tax business purpose as the reason for disallowance.[77]

Comment: Goldstein v. Commissioner established the distinction between the concepts of "sham in substance" and "sham in fact" (see discussion below in Chapter III). The Court of Appeals recognized that a transaction can be treated as real and not *fictitious*, but have no economic substance beyond the creation of tax benefits.[78]

H. Estate of Franklin v. Commissioner

The court in *Estate of Franklin v. Commissioner*[79] was faced with a transaction involving a nonrecourse debt with a value that significantly exceeded the value of the collateral. In this case, a couple purported to sell a motel to a partnership (in which Franklin was an investor) for $1,224,000, payable entire-

[69] *Id.*

[70] *See generally* Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes 985 (1981) (hereinafter "Warren 1981"). Eli Livingstone was a Boston broker who invented and sold these transactions.

[71] 267 F. 2d 127 (1st Cir. 1959), aff'g 30 T.C. 1178 (1958).

[72] Professor Alvin Warren indicated that this profit should be discounted based on the difference between the yield on the bonds, which was 1⅜% and the interest rate of the loan, which was 2⅜%. *See* Warren 1981.

[73] *Rubin v. United States*, 304 F.2d 766 (7th Cir. 1962).

[74] *See also Lewis v. Commissioner*, 328 F.2d 634, 640 (7th Cir. 1964), where the court held that even when the taxpayer may expect a profit or loss due to the market's fluctuations, this expectation is " incidental to the chimerical character of the transaction."

[75] 364 F.2d 734 (2d Cir. 1966).

[76] 44 T.C. at 298.

[77] *Id.* at 740 ("section 163 does not permit a deduction for interest paid or accrued in loan arrangements … that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.").

[78] *See ACM P'ship v. Commissioner*, T.C. Memo 1997-115 at 111 ("The *Goldstein* case marks an important step in the development of the economic substance doctrine. (footnote omitted) Unlike many purported tax shelters, the tax-motivated transactions in that case were not fictitious.").

[79] 544 F.2d 1045 (9th Cir. 1976).

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ly in the form of a nonrecourse note bearing interest at a rate of 7.5%. The note called for "prepaid interest" in the amount of $75,000, payable immediately, monthly principal and interest installments of $9,045.36, and a balloon payment of $975,000 at the end of 10 years. The motel was leased back to the sellers for a monthly rental of essentially the same as the payments on the note. The seller/lessee also was responsible for all taxes, utilities, and so forth on the property. Thus, the only cash that ever changed hands was the initial $75,000. If the partnership wished to own the property at the end of the 10-year period, it would have to make the $975,000 payment to avoid a default on the loan.

The Tax Court held that the transaction was in substance an option sold to the partnership for $75,000 to acquire the motel at the end of the 10-year period for $975,000.[80] The Ninth Circuit took a different approach and held that, because the taxpayer had failed to show that the amount of the note was at least approximately equivalent to the fair market value of the property acquired, the partnership had no "investment in the property" and, therefore, the indebtedness was not a bona fide debt obligation.

Comment: Estate of Franklin v. Commissioner has been followed in most other circuits, the Court of Federal Claims, and the Tax Court.[81] A notable exception is *Pleasant Summit Land Corp. v. Commissioner*.[82] In *Pleasant Summit*, the Third Circuit allowed the taxpayer depreciable basis and interest deductions for nonrecourse debt, in part assumed and in part newly incurred, in connection with the acquisition of property, *to the extent* of the fair market value of the property acquired. This gave the taxpayer a basis in the property equal to the *sum* of its cash investment (which was not trivial) and the fair market value of the property. The court reasoned that the debt was valid to the extent of the fair market value of the property because, although a taxpayer holding property subject to nonrecourse debt in excess of the value of the property would have no incentive to repay the debt in full, it would have an incentive to offer the creditor cash equal to the fair market value of the property, and a rational creditor would have a corresponding incentive to accept the offer.[83]

I. Frank Lyon Co. v. United States

Frank Lyon Co. v. United States[84] involved a sale-leaseback transaction. In this case, the taxpayer borrowed $7.1 million, bought a building from a bank for $7.6 million (the $7.1 million plus $0.5 million of the taxpayer's own funds), and leased the building back to a bank for rent equal to the taxpayer's payments of principal and interest on the $7.1 million loan. The term of the lease was 25 years, with options to extend it up to 40 more years. The lease agreement also provided the taxpayer with a fixed rate of return on its $0.5 million investment. At the end of the lease term, the bank could either acquire the building or extend the lease. The taxpayer claimed depreciation deductions from the building and interest deductions on the loan, and reported the payments from the bank as income from rent.

The IRS argued that the taxpayer acted as a conduit for mortgage payments and disallowed depreciation and interest deductions. The taxpayer argued that it was a separate entity and that the business purpose of the transaction was to overcome legal and regulatory constraints to which the bank was subject.

The Supreme Court held for the taxpayer and held that the transaction was not a sham. The Supreme Court set forth the following standard to determine when a transaction should be respected for tax purposes:

> Where … there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation.[85]

Comment: Frank Lyon Co. v. United States established the two-prong economic substance test, consisting of the objective economic substance test and subjective business purpose test. Since the *Frank Lyon* decision, however, the Supreme Court has not issued significant economic substance cases.

J. Rice's Toyota World Inc. v. Commissioner

In *Rice's Toyota World Inc. v. Commissioner*,[86] another case involving a sale-leaseback transaction, the taxpayer purchased a 70% interest in a six-year old IBM computer for $1,455,227. The taxpayer paid the purchase price to a financing company with a $250,000 recourse note, payable over three years, and two nonrecourse notes, totaling $1,205,227, payable over eight years. The taxpayer leased the computer back to the financing company for eight years, with rents calculated so that the pre-tax cash flows to the taxpayer were $10,000 per year. In fact, the only amounts ever to change hands were the $10,000 annual payments, representing the excess of the taxpayer's income over its debt obligation. The transaction was entered into by the taxpayer to generate accelerated depreciation and inter-

[80] 64 T.C. 752 (1975).

[81] *See also Odend'hal v. Commissioner*, 80 T.C. 588 (1983) (where amount of nonrecourse note given as part of purchase price of certain interests in real estate unreasonably exceeds value of interests acquired, taxpayers cannot include nonrecourse amount in depreciable basis and cannot deduct interest paid on nonrecourse note).

[82] 863 F.2d 263 (3d Cir. 1988).

[83] *Cf. Regents Park Partners v. Commissioner*, 63 T.C.M. 3131 (1992). The Tax Court allowed a partial basis for nonrecourse debt on special facts that the court felt justified a diversion from *Estate of Franklin*. A partnership purchased two troubled apartment buildings from the Department of Housing and Urban Development (HUD) for $250,000 cash, a repair escrow of over $1M, and the assumption of nonrecourse notes burdening the properties in total for over $37,000,000, all subject to a Provisional Workout Arrangement (PWA) involving HUD and the creditors. The PWA contemplated that payments of principal and interest on the outstanding debt would be partially deferred, and that eventually a portion of the principal balance of the debt would be forgiven. The court found that the combined fair market value of the property was $28,000,000 and allowed the taxpayer a fair market value basis in the buildings on the ground that the PWA and the other circumstances surrounding the acquisition indicated that, at the time of the acquisition, the parties genuinely expected that the acquiring partnership would end up paying at least the equivalent of the property's fair market value. Unlike *Pleasant Summit*, the partnership's basis was limited to the fair market value of the property, not the sum of the fair market value and the amount of consideration provided other than the assumption of the note.

[84] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[85] *Id.*

[86] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

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est expense deductions in the early years of the lease. The Tax Court disallowed the deductions, reasoning that the taxpayer had no business purpose for entering the transaction other than to achieve tax benefits and that the transaction had no economic substance because there was no reasonable possibility of a pre-tax profit.[87]

The Fourth Circuit affirmed in part, disallowing the deductions on all aspects of the program except for interest payments on recourse debt financing. In so doing, the Fourth Circuit interpreted the two-prong test established by the Supreme Court in *Frank Lyon Co. v. United States* as a disjunctive test. Specifically, the Fourth Circuit held that a transaction will be treated as having no economic substance if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and the transaction has no economic substance because no reasonable possibility of profit exists."[88]

Comment: Rice's Toyota World Inc. v. Commissioner has been cited by numerous courts for: (i) the proposition that the two-prong test is a disjunctive test; (ii) the proposition that a court can bifurcate a transaction and allow tax benefits from a debt incurred in connection with a transaction that lacks economic substance as a whole; and (iii) the importance of the pre-tax profit potential requirement.

K. Glass v. Commissioner (Option-Straddle Cases)

In *Glass v. Commissioner*,[89] the Tax Court consolidated more than 1,000 cases with similar facts, totaling more than $61 million for the years 1975–1980. In this case, the taxpayers bought and sold options for future delivery of metal in one year and subsequently entered into offsetting positions, to create approximately equal amounts of losses and gains in the first year. The straddles were designed to transform short-term capital gain into long-term capital gain in the second year. The overall impact of the transactions was that the losses were ordinary and gains were long-term capital gains (under the then-prevailing law). There were two issues before the Tax Court: (1) whether the transactions were shams; and (2) if not, whether the transactions were entered into for profit under the statutory standard set forth in §108.

The Tax Court found that the transactions had neither non-tax motivation nor economic substance. Accordingly, the Tax Court held that the deductions taken pursuant to the transactions had to be disregarded for federal income tax purposes. The Tax Court elaborated that the transactions were "intentional[ly] skewed … to realize year one losses … ."[90] Although some potential for a profit existed, the Tax Court observed that the taxpayers *avoided* making a profit by realizing losses in the first year that "were not necessary or helpful in profiting from difference gains in petitioners' commodity straddle transactions."[91] The Tax Court further held that §108 was "not available to permit loss deductions in the first year of commodity straddle transactions when, as here, the sham involves a series of transactions having no business or profit-making function apart from obtaining tax deductions."[92]

Comment: Glass v. Commissioner was affirmed on appeal in the First,[93] Fourth,[94] Fifth,[95] Sixth,[96] Seventh,[97] Eighth,[98] Ninth,[99] Tenth[100] and Eleventh[101] Circuits. In virtually all appeals, the courts have held that the transactions lacked economic substance and disallowed the benefits. In one notable case, *Yosha v. Commissioner*,[102] the taxpayer entered into option straddle transactions involving the same commodity, the same strike price, and the same expiration date. The Seventh Circuit observed that the taxpayer literally could not have expected any profit.[103] As Judge Posner indicated, the matching strike prices and expiration dates created no chance for profit. Judge Posner explained the distinction between the objective element of the economic substance test, on which *Goldstein v. Commissioner*[104] and later *ACM P'ship*[105] are based, and the "entered into for profit" test, which applies to individuals and S corporations pursuant to §165(c)(2). In contrast to §165(c)(2), which applies to individuals who incur expenses in an activity that is not their trade or business, the economic substance standard applies to disallow the taxpayer's position if the taxpayer has no non-tax motivations. Accordingly, Judge Posner indicated that taxpayers must meet a much lower standard to avoid being subject to re-characterization under the economic substance doctrine than they must meet to avoid being subject to the "entered into for profit" standard. Judge Posner concluded that under both standards, the taxpayer's losses should be disallowed.

Subsequent straddle cases involved commodities brokers and dealers who purchased straddles for their own account and filed suits in Tax Court. In these cases, the taxpayers contended that under the straddle rules then in effect, commodities dealers were entitled to deduct losses incurred as a result of straddle transactions, even where the transactions lacked economic substance.[106]

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[87] 81 T.C. 184 (1983).

[88] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 90.

[89] 87 T.C. 1087 (1986).

[90] *Id.* at 1174.

[91] *Id.* at 1175–76.

[92] *Id.* at 1176.

[93] *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989).

[94] *Friedman v. Commissioner*, 869 F.2d 785 (4th Cir. 1989).

[95] *Killingsworth v. Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Herrington v. Commissioner*, 854 F.2d 755 (5th Cir. 1988).

[96] *Ratliff v. Commissioner*, 865 F.2d 97 (6th Cir. 1989).

[97] *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Kielmar v. Commissioner*, 884 F.2d 959 (7th Cir. 1989).

[98] *Lee v. Commissioner*, 897 F.2d 915 (8th Cir. 1989).

[99] *Keane v. Commissioner*, 865 F.2d 1088 (9th Cir. 1989).

[100] *Bohrer v. Commissioner*, 945 F.2d 344 (10th Cir. 1991).

[101] *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989).

[102] *Yosha v. Commissioner*, 861 F.2d at 501.

[103] Surdell, *A New Test for Corporate Tax Shelters*, 97 TNT 110-102 n. 57; Hariton, *Sorting out the Tangle of the Economic Substance*, 52 Tax Law. 235 n. 47 (1999).

[104] 364 F.2d 734 (2d Cir. 1966).

[105] *ACM P'ship v. Commissioner*, 157 F.3d 231, 248 (3d Cir. 1998).

[106] *See Gardner v. Commissioner*, 954 F.2d 836 (2d Cir. 1992) (The Tax Court and the Second and Third Circuits upheld the IRS's denial of these deductions, holding that the relevant broker/dealer exception did not apply to sham transactions; however, the D.C. Circuit allowed the losses under the exception); *Fox v. Commissioner*, T.C. Memo 1988-570; *Lerman v. Commissioner*, 939 F.2d 44 (3d Cir. 1991).

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L. Cottage Sav. Ass'n v. Commissioner

Cottage Sav. Ass'n v. Commissioner[107] is one of the few cases since *Frank Lyon Co. v. United States* in which the United States Supreme Court has dealt, only implicitly, with the economic substance doctrine.[108] In this case, the taxpayer exchanged bundles of mortgages between two savings and loan institutions, which the IRS contended did not give rise to realized losses because the economic characteristics of the two bundles were the same. Specifically, the IRS disallowed the claimed deductions for the difference between the face value of mortgage given by the taxpayer and the fair market value of those that it received. The taxpayer argued that the exchange should be respected because it was motivated not only by tax considerations, but also by regulatory obligations, namely, to avoid risk of closure by the Federal Home Loan Bank Board.

The Sixth Circuit held that the exchange lacked economic substance.[109] The United States Supreme Court, however, reversed the decision and held that, while the taxpayer exchanged the mortgages to generate tax losses, the evidence presented was sufficient to support the taxpayer's valid business purpose. The Supreme Court rejected the IRS argument, holding that for an exchange of properties to be taxable, the properties need only represent different property rights, and that properties are "different" to a "material" extent under Reg. §1.1001-1(a) "so long as their respective possessors enjoy legal entitlements that are different in kind or extent."[110]

M. Contingent Installment Sale Cases (CINS)

These cases are discussed in greater detail throughout this Portfolio. Generally, in a typical CINS transaction, a partnership between a U.S. and foreign partner was formed to acquire non-readily-marketable property and sell it in exchange for a large fixed payment plus small contingent payments. The resulting gain for the year of the sale was allocated to the foreign partner, while the later years' corresponding losses would be allocated to the U.S. partner. The transaction was specifically designed to accelerate gain for the foreign partner and provide, through the partnership agreement, a distributive share of most of the losses to the domestic partners in later tax years.

ACM P'ship v. Commissioner[111] was the first CINS transaction reviewed by the Tax Court. The Tax Court held that the transaction lacked economic substance and described the economic substance doctrine as follows:

> The tax law … requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[112]

The Third Circuit redefined the objective test as examining "whether the transaction has any practical economic effects other than the creation of income tax losses." Applying this standard, the Third Circuit affirmed the Tax Court's decision.[113]

Subsequently, the D.C. Circuit followed *ACM P'ship v. Commissioner* in three decisions involving similar facts and held for the government.[114] The taxpayer's only temporary victory was in *Boca Investerings v. United States* at the district court, but on appeal, the D.C. Circuit reversed and held for the Government.[115]

N. Corporate Owned Life Insurance (COLI)

Another series of important cases (also discussed in greater detail herein) involving economic substance/sham transaction analysis were the COLI cases. The COLI cases involved taxpayers who received substantial tax savings by participating in transactions involving corporate owned life insurance (COLI) policies. The government won the first three cases. In *Winn Dixie Stores Inc. v. Commissioner*,[116] the first government victory, the Tax Court and the Eleventh Circuit held that the taxpayer had neither economic substance nor business purpose for entering into the transaction, and denied the associated tax benefits. Later, in *IRS v. CM Holdings, Inc.*,[117] the United States District Court (Delaware) held that the leveraged COLI program of CM Holdings' subsidiary, Camelot Music, was a sham. The third victory for the government was in *Am. Elec. Power, Inc. v. United States*,[118] where the Tax Court held not only that the taxpayer's COLI transaction was a sham, but also that certain aspects of the transaction were shams in fact, while the plan as a whole was a sham in substance.

Dow Chem. Co. v. United States[119] was the first COLI case in which the taxpayer prevailed. The district court in *Dow Chem. Co. v. United States* held that, in contrast to the facts in

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[107] 499 U.S. 554 (1991), rev'g 890 F.2d 848 (6th Cir. 1989), rev'g 90 T.C. 372 (1988).

[108] In another Supreme Court case, the court applied the substance over form analysis to construe a sale and repurchase of federal securities as a loan. The Court found that the economic realities of the transaction did not support the form chosen by the taxpayer. *See Neb. Dep't of Revenue v. Loewenstein*, 513 U.S. 123 (1994).

[109] 890 F.2d 848 (6th Cir. 1989).

[110] Taxpayers expressed concern that the Supreme Court may have put in place a new, "hair-trigger" threshold for when a modification of a debt instrument by an issuer and a holder gives rise to a deemed exchange. On December 1, 1992, in response to *Cottage Savings* and in an effort to provide greater certainty, the IRS issued proposed regulations under §1001 to clarify when a modification of a debt instrument will be deemed to be an exchange. On June 25, 1996, the IRS issued final Reg. §1.1001-3 relating to the modification of debt instruments. In most cases, the regulations provide clear guidance as to when a modification of the terms of a debt instrument is of such significance that it rises to the level of a deemed exchange. *See BNA Daily Tax Rpt.*, G-3 (Oct. 7, 2010), where IRS Associate Chief Counsel William D. Alexander stated that *Cottage Savings* remains good law even after Congress codified the economic substance doctrine in §7701(o), and noted, "It is interesting that the Supreme Court is applying a substance-based, not the economic substance doctrine, but a substance-based analysis to realization in deciding whether you have something materially different."

[111] T.C. Memo 1997-115, aff'd, 157 F.3d 231 (3d Cir. 1998).

[112] 73 T.C.M. at 2215.

[113] *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

[114] *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000); *Saba P'ship v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001); *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003).

[115] *Boca Investerings P'ship v. United States*, 167 F. Supp.2d 298 (D.D.C. 2001).

[116] 254 F.3d 1313 (11th Cir. 2001), aff'g 113 T.C. 254 (1999).

[117] 301 F.3d 96 (3d Cir. 2002), aff'g 254 B.R. 578 (D. Del. 2000).

[118] 136 F. Supp.2d 762 (S.D. Ohio 2001), aff'd, 326 F.3d 737 (6th Cir. 2003).

[119] 250 F. Supp.2d 748 (E.D. Mich. 2003).

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the other three cases, the transaction in that case did not lack economic substance.[120] After the decision in *Dow Chem. Co. v. United States*, the Sixth Circuit affirmed the District Court's decision in *Am. Elec. Power Co. v. United States* and held that the COLI transaction involved was a "sham in substance" but not a "sham in fact."[121] The district court denied the government's motion for amendment of its decision in *Dow Chem. Co. v. United States* and further held not only that the transaction as a whole had economic substance, but also that none of the parts of the transaction was a factual sham.[122] However, the Sixth Circuit reversed and remanded the district court decision and held that the COLI plans were economic shams and that the IRS properly disallowed Dow's deductions.[123]

Comment: In *Xcel Energy Inc. v. United States*,[124] another case involving similar facts, the United States District Court for the District of Minnesota held that the taxpayer had an insurable interest in the lives of its employees, but decided that genuine factual issues remained and declined to rule on whether the interest the company paid on loans against the policies' cash value is deductible.

O. Lease Stripping

Andantech, LLC v. Commissioner[125] involved a lease stripping transaction. Andantech was formed by two Belgian individuals with little equity and a $14.9 million loan from a Swiss Bank. Andantech purchased computers from Comdisco for $14.9 million in cash and $107 million in notes and leased them back to Comdisco. Andantech sold the rents due from Comdisco for $87.8 million and redeemed the $87.8 million of the notes due to Comdisco. Shortly thereafter, the Belgian members assigned their interests in Andantech to U.S. entities (98% interest to RDL Leasing) in return for preferred shares in RDL. The new members contributed capital to repay the loan from the Swiss Bank.

The Tax Court found that: (i) Andantech was not a valid partnership for federal income tax purposes because the partners never intended to join together for the purpose of carrying on a business and sharing in the profits and losses from an equipment leasing activity; (ii) the period when Andantech was owned by the Belgian members, through the sale of the rent income, should be disregarded under the step-transaction doctrine because the involvement of the Belgian members was merely to act as a shell or conduit to strip the rental income from the overall transaction;[126] (iii) the sale and leaseback should be disregarded because it lacked economic substance and business purpose;[127] and (iv) the Tax Court examined whether the sale from Comdisco to the taxpayer was a "sale" for federal income tax purposes and concluded that the taxpayer did not obtain the burdens and benefits of ownership of the computers.[128] The D.C. Circuit affirmed the Tax Court's decision solely on the theory that the *entity* lacked business purpose and economic substance.[129] Courts frequently have observed that the application of the economic substance and similar doctrines should be limited, and the economic substance doctrine Code provision that was enacted on March 30, 2010 expressly provides that "[t]he 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."[130]

P. Taxpayers' Victories

Courts frequently have observed that the application of the economic substance and similar doctrines should be limited. In *N. Ind. Pub. Serv. Co. v. Commissioner*,[131] the taxpayer (NIPSCO)'s goal was to obtain exemption for interest payments under the treaty between the United States and the Netherlands Antilles. The taxpayer created a Netherlands Antilles subsidiary for the purpose of obtaining funds. The subsidiary issued notes in the Eurobond market with a call option guaranteed by NIPSCO, and NIPSCO received the proceeds in exchange for a $70 million note. The subsidiary earned income on the spread between the interest it received from NIPSCO and the interest it paid to the holders of the notes. When NIPSCO paid off the note, the subsidiary redeemed the notes for a premium in addition to principal and interest paid to the holders of the notes. Subsequently, the subsidiary was liquidated.

The IRS argued that the subsidiary was merely a conduit and should be disregarded. The Tax Court rejected the IRS's argument on the ground that the subsidiary had legitimate business purpose, that is, to borrow money in Europe at a favorable rate and to lend it to NIPSCO.[132]

The Seventh Circuit affirmed the Tax Court's decision. The Seventh Circuit began with the general principle that a "tax avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what would otherwise be his taxes."[133]

The Seventh Circuit concluded that:

> *Knetsch* and the captive insurance company cases do not dictate the outcome the Commissioner desires. Those cases allow the Commissioner to disregard transactions that are designed to manipulate the Tax Code so as to create artificial tax deductions. They do not allow the Commissioner to disregard eco-

[120] In *Dow Chem. Co.*, the district court decided to validate the transaction utilizing both the economic substance and sham transaction doctrines.

[121] *Am. Elec. Power Co. v. United States*, 326 F.3d 737 (6th Cir. 2003).

[122] *Dow Chem. Co. v. United States*, 278 F. Supp.2d 844 (E.D. Mich. 2003).

[123] *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007).

[124] No. 0:04-cv-01449, 2005 BL 42037, 36 EBC 2294 (D. Minn. Oct. 12, 2005).

[125] T.C. Memo 2002-97.

[126] *Id.* at 96.

[127] The Tax Court separated between the substance of the partnership and the substance of the partnership's transactions (although it reached the conclusion that neither had substance). *Id.* at 114. *See also ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) (Tax Court and D.C. Circuit applied a separate analysis for transaction's substance and entity's substance).

[128] *Id.*

[129] 331 F.3d 972 (D.C. Cir. 2003). In *CMA Consol. Inc. v. Commissioner*, T.C. Memo 2005-16, the Tax Court held that lease stripping transactions similar to the ones in *Andantech, LLC v. Commissioner*, that were structured using tax-indifferent parties, had neither economic substance nor profit potential aside from the tax benefits.

[130] §7701(o)(5)(C).

[131] 115 F.3d 506 (7th Cir. 1997).

[132] 105 T.C. 341 (1995).

[133] 115 F.3d at 511.

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> nomic transactions, such as the transactions in this case, which result in actual, non-tax-related changes in economic position.[134]

In *UPS of Am. v. Commissioner*,[135] the Eleventh Circuit discussed the essence of the business purpose doctrine. UPS collects a premium (excess value charges) for packages with a value of more than $100. In 1983, UPS formed an offshore a Bermuda subsidiary (OPL) and distributed the subsidiary's stock to its employee-shareholders. UPS also entered into an agreement with a domestic insurer (NUF) pursuant to which UPS would collect and remit the premiums to NUF. NUF and OPL entered into a reinsurance contract pursuant to which NUF would remit to OPL the premiums received from UPS, less certain commissions and expenses. Before the disputed restructuring, UPS reported the premiums as income and deducted expenses actually paid for damaged packages. Because the premium income earned by OPL was not subject to U.S. tax until the income was repatriated back into the United States (i.e., as a dividend to its shareholders), the transaction would have resulted in deferral of tax on the income attributable to the premiums.

The Tax Court held that UPS shifted $70 million of income offshore to OPL and explained that UPS (and not OPL) earned the income and improperly assigned it to OPL. The Tax Court found that the formation of OPL lacked economic substance and business purpose; therefore, OPL's participation in the arrangement should be ignored and its income should be taxed to UPS.[136]

The Eleventh Circuit reversed and remanded the Tax Court's decision. The Eleventh Circuit applied the two-prong test and, although it observed that the transaction was "more sophisticated and complex than the usual tax-influenced form-of-business," it concluded that the transaction had economic substance. The Eleventh Circuit continued to the subjective prong and observed that a transaction has "a 'business purpose' when we are talking about a going concern like UPS, as long as it figures in a bona-fide, profit seeking business."[137] The Eleventh Circuit also acknowledged that choosing one form over another solely for tax purposes may still satisfy the business purpose test. As the Eleventh Circuit illustrated, when a business chooses between debt and equity financing, there may be no tax-independent reason to choose between these different ways of financing, but it does not mean that the taxpayer lacks a business purpose.[138] The court also distinguished between individuals and business entities and determined that, with respect to business entities, it is much easier to articulate a "business purpose" for the transaction. Accordingly, the Eleventh Circuit found that UPS was conducting a bona fide business.

During the same period, two cases, factually identical to each other, were decided for the taxpayer on appeal. Both *IES Indus., Inc. v. United States*[139] and *Compaq Computer Corp. v. Commissioner*[140] involved the purchase of American Depository Receipts ("ADRs") "cum dividend" and their virtually immediate sale "ex dividend."[141]

The Tax Court in *Compaq Computer Corp. v. Commissioner* and the U.S. District Court for the Northern District of Iowa in *IES Indus., Inc. v. United States* disallowed the losses and tax credits claimed on the grounds that the disputed ADR transactions lacked both economic substance and business purpose. The Eighth Circuit reversed *IES Indus.* in July 2001, and the Fifth Circuit reversed *Compaq Computers* in December 2001. Both appellate courts reversed on the ground that the ADR transactions had both economic substance and business purpose.[142] Both appellate courts focused on the profit potential from the transactions, and both acknowledged that in calculating the profit potential, the foreign (Dutch) tax *should not* be treated as a cost.

Q. IRS Pronouncements

The IRS has also applied the economic substance doctrine in numerous rulings and other guidance.[143] Some notable examples are discussed below.[144]

In Rev. Rul. 2000-12,[145] the IRS described the fundamentals of the economic substance doctrine:

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[134] 115 F.3d at 513. The court observed that the method used to obtain the financing was "not, at the time, an uncommon practice to accomplish this end," and that the entity "was managed as a viable concern," which "conducted recognizable business activity — concededly minimal activity, but business activity nonetheless." *Id.*

[135] *UPS of Am. v. Commissioner*, T.C. Memo 1999-268, rev'd & rem'd, 254 F.3d 1014 (11th Cir. 2001).

[136] T.C. Memo 1999-268.

[137] *See also ACM P'ship v. Commissioner*, 157 F. 3d at 251.

[138] 254 F.3d at 1020 ("The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive.").

[139] 253 F.3d 350 (8th Cir. 2001), aff'g in part & rem'g in part 2001-2 USTC ¶ 50,470.

[140] 113 T.C. 214 (1999), rev'd, 277 F.3d 778 (5th Cir.2001) (stating that a "taxpayer's subjective intent to avoid taxes … will not by itself determine whether there was a business purpose to a transaction" and that steps to avoid risk may show "good business judgment consistent with a subjective intent to treat … trade as a money-making transaction.").

[141] *See generally* Shaviro & Weisbach, *The Fifth Circuit Gets it Wrong in Compaq v. Commissioner*, 94 Tax Notes 511 (2002).

[142] Today, §901(k) denies tax credit for dividends if a taxpayer holds the shares for 15 or fewer days, but this provision did not apply to the *Compaq* case.

[143] FSA 200218022 (citing *Nicole Rose Corp. v. Commissioner*, the Chief Counsel's Office applied §482 to reallocate rental income, rental deductions, and loss deductions claimed in several stripping transactions and transfers of stripped leasehold interests). *See also* FSA 200152002, FSA 200046019, FSA 200242004; I.L.M. 200246014 (Aug. 8, 2002), I.L.M. 200250013 (Aug. 30, 2002); FSA 200219008.

[144] The IRS has issued several Coordinated Issue Papers discussing various transactions that according to the IRS, have no economic substance. *See Coordinated Issue Paper Addresses Passthrough Entity Straddle Tax Shelters*, 2005 TNT 90-34 (May 9, 2005). Effective Jan. 21, 2014, all current Coordinated Issue Papers are decoordinated, and any guidance or tools relevant to addressing an issue or transaction that were provided in a Coordinated Issue Paper will be made available through LB&I directives or other guidance. The decoordination of any coordinated issue has no effect on whether the issue will continue to be pursued by LB&I in a taxpayer examination or on the IRS's views regarding any transaction, including listed transactions. LB&I-04-0114-002 (Jan. 21, 2014).

[145] 2000-1 C.B. 744 (discussing the situation where a taxpayer that acquires two debt instruments where the value of first is expected to increase significantly while the value of the other is expected to decreases significantly. The question was can the taxpayer recognize a current loss on the sale of the debt instrument whose value decreases while not recognizing the gain on the other debt instrument?").

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> The courts have held that a loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable.[146]

Similarly, in Rev. Rul. 99-14,[147] the IRS ruled that a taxpayer may not deduct, under §162 and §163, rent and interest paid or incurred in connection with a lease-in/lease-out (LILO) transaction that lacks economic substance. Citing *Frank Lyon Co. v. United States*, the IRS explained that "a transaction will be respected for tax purposes if it has 'economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached.'"[148]

Rev. Rul. 2002-69[149] also involved a LILO transaction. The IRS ruled that, under the substance-over-form and economic substance principles:

> A taxpayer may not deduct currently, under §162 and §163, rent or interest paid or incurred in connection with a LILO transaction that properly is characterized as conferring only a future interest in property … Where appropriate, the IRS will continue to disallow the tax benefits claimed in connection with LILO transactions upon other grounds, including that the substance over form doctrine requires their recharacterization as financing arrangements and that they are to be disregarded for lack of economic substance.

Notice 2005-13[150] involved transactions in which a taxpayer enters into a sale-leaseback arrangement with a tax-indifferent person. The IRS used the economic substance doctrine to alert taxpayers that such transactions may not be respected. The IRS distinguished the transactions discussed in the Notice from the transaction in *Frank Lyon Co. v. United States* on several grounds, and observed that a "sale-leaseback will not be respected unless the owner/lessor acquires and retains "significant and genuine attributes" of a traditional owner, including "the benefits and burdens of ownership."[151] The IRS Chief Counsel's Office, in CCA 200821032, stated that market risk is critical in determining ownership. It reasoned that the taxpayer's less than 10% of at-risk equity was insufficient to establish ownership; therefore, the taxpayer was not entitled to depreciation deductions.[152]

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[146] Citing *ACM P'ship v. Commissioner*, 157 F.3d at 252 ("Tax losses such as these … which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); *Scully v. United States*, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); *Shoenberg v. Commissioner*, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"), *cert. denied*, 296 U.S. 586 (1935).

[147] 1999-13 I.R.B. 3, *modified and* superseded by Rev. Rul. 2002-69, 2002-44 I.R.B. 760.

[148] *See also Coordinated Issue Paper Addresses Partnership Straddle Tax Shelters*, 2005 TNT 91-27 (May 9, 2005). Note that, effective Jan. 21, 2014, all current Coordinated Issue Papers are decoordinated, and any guidance or tools relevant to addressing an issue or transaction that were provided in a Coordinated Issue Paper will be made available through LB&I directives or other guidance. LB&I-04-0114-002 (Jan. 21, 2014).

[149] 2002-2 C.B. 760.

[150] 2005-9 I.R.B. 630. *See* CCA 200712044 (transaction substantially similar to sale-in/lease-out transactions described in Notice 2005-13 because: (1) deductions for depreciation, interest, and amortization of transaction costs exceed rent income during transaction's early years; (2) "sale" proceeds set aside to satisfy tax-indifferent party's obligations under transaction documents; and (3) tax-indifferent party retains market risk for property's residual value).

[151] *Id.*

[152] CCA 200821032.

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III. Other Judicial Anti-Abuse Doctrines

This chapter surveys the judicial anti-abuse doctrines in general. While this Portfolio focuses on the economic substance doctrine, it is almost impossible, and in fact ill-advised, to consider this doctrine in isolation. As discussed in greater detail below, the economic substance doctrine not only has developed from the more general doctrine of substance-over-form but also is closely related to the sham transaction and business purpose concepts. This chapter, therefore, discusses the four other common law doctrines and the relationship between these doctrines and the economic substance doctrine. The chapter begins by discussing in depth the "umbrella" substance-over-form principle, including a comprehensive discussion on a taxpayer's right to disavow the form of a transaction (the *Danielson*/Strong Proof standard). Other doctrines discussed below include the sham transaction doctrine (emphasizing the distinction between "sham-in-substance" and "sham-in-fact"), step transaction (a variation on the substance-over-form doctrine) and business purpose. Finally, the last part of this chapter discusses the relationship between the above four doctrines and the economic substance doctrine.

A. Substance Over Form

The substance-over-form doctrine originated in *Gregory v. Helvering*,[153] where the Supreme Court of the United States articulated that: "As a general rule, the incident of taxation depends on the substance rather than form of the transaction."[154] Thus, the Supreme Court established that the substance rather than the form of a transaction ought to govern in determining the tax consequences of the transaction.[155] In *Saviano v. Commissioner*,[156] the Seventh Circuit elaborated that:

> [t]he freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the IRS and the courts will play along. The Commissioner and the courts are empowered, are in fact duty-bound, to look behind the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.

Courts have applied the substance-over-form doctrine since *Gregory v. Helvering* to disallow tax benefits arising out of transactions the forms of which have differed from their substance.[157] The substance-over-form doctrine is triggered, therefore, only when the transaction's substance actually differs from its form.[158]

Nevertheless, as discussed below, where substance and form differ by the taxpayer's own choice, taxpayers may be required to suffer the tax consequences of their form.[159] Generally, the IRS can prevent taxpayers from disavowing the form of their transactions, absent a "strong proof" in some courts,[160] and an even stricter standard referred to as the "*Danielson* rule" in other courts.[161] In other words, the courts over the years have supported the government's efforts both to assert substance over form but also to require taxpayers to suffer the consequences of the form they have selected.[162] These standards are discussed in greater detail below.

The substance-over-form doctrine is viewed as the most general common law doctrine from which the other four doctrines discussed herein have emerged.[163] As the Tax Court indicated in *Andantech, LLC v. Commissioner*:

> Substance over form and related judicial doctrines all require a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened.[164]

Under the substance-over-form doctrine, a court has the power to recharacterize a transaction in accordance with its true substance if such substance is demonstrably contrary to its outward form.[165] The effect of such a determination is generally to

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[153] 293 U.S. 465 (1935).

[154] *See also True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999) (substance over form is a "fundamental tax principle," and applies to "look beyond the taxpayers' characterization" of the challenged business transactions); *Kornfeld v. Commissioner*, 137 F.3d 1231, 1234 (10th Cir. 1998) ("the taxation scheme set out in the Internal Revenue Code is complicated and the tax consequences of many transactions depend on form, how the transaction is structured," but at the same time, the "incidence of taxation depends on the substance of a transaction."); *United States v. Scott*, 37 F.3d 1564, 1572 (10th Cir. 1994) ("the income tax consequences under the Internal Revenue Code depend upon the substance of the situation, not the form."); *Newman v. Commissioner*, 894 F.2d 560, 562 (2d Cir. 1990) ("[i]n reviewing a transaction for tax consequences, the substance of the agreement takes precedence over its form."); *Kuper v. Commissioner*, 533 F.2d 152, 155 (5th Cir. 1976); *Derr v. Commissioner*, 77 T.C. 708, 722 (1981) ("It is now well established that the incidence of taxation depends upon the substance of the transaction and not the mere form, where the form is not imbued with economic reality."); *Leahy v. Commissioner*, 87 T.C. 56 (1986) ("[I]t is well established that the economic substance of a transaction rather than its form controls for Federal income tax purposes … [W]e must be concerned with the economic realities and not the form employed by the parties."); Rev. Rul. 2002-69, 2002-2 C.B. 760 ("The substance of a transaction, not its form, governs its tax treatment.").

[155] *See generally* Isenbergh, *Musing on Form and Substance and Form in Taxation*, 49 Chi. L. Rev. 859 (1982).

[156] 765 F.2d 643 (7th Cir. 1985), aff'g 80 T.C. 955 (1983).

[157] *IRS v. CM Holdings*, 301 F.3d at 102 ("The rationale behind the *Gregory* and *Knetsch* line of cases is that courts should not elevate form over substance by rewarding taxpayers who have engaged in transactions that lack any purpose save that of tax savings. The taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible.").

[158] *Tracinda Corp. v. Commissioner*, 111 T.C. 315, 326 (1998) ("in order to apply either the substance-over-form doctrine or the step-transaction doctrine, we must determine that the substance of the transaction differs from its form.").

[159] *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974); *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

[160] *Schultz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961), aff'g 34 T.C. 235 (1960); *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959), aff'g 29 T.C. 129 (1957); *Krieder v. Commissioner*, 762 F.2d 580, 586–87 (7th Cir. 1985); *Major v. Commissioner*, 76 T.C. 239, 249 (1981).

[161] *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

[162] *Id.*

[163] *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) ("The step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form."); *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987) ("The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction.").

[164] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 89 (citing *Harris v. Commissioner*, 61 T.C. 770, 783 (1974)).

[165] *United States v. Ingalls*, 399 F.2d 143 (5th Cir. 1968).

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produce a different tax result than the result that the form of the transaction would require.[166]

As the Fifth Circuit stated in *Crenshaw v. United States*:

> [Taxpayers] cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status. The most obvious answer to Taxpayer's argument that the parties' characterization is conclusive is that such a result would completely thwart the Congressional policy to tax transactional realities rather than verbal labels … Otherwise, form, rather than substance, would invariably prevail.[167]

Substance over form is generally raised *by the Commissioner* when the taxpayer chooses a form that not only differs from the substance of the transaction, but also a form that provides the taxpayer with a tax benefit, to which the taxpayer would normally not be eligible if the form is consistent with the substance.[168] In its report on tax shelters in 1999, the United States Department of the Treasury indicated:

> Generally, the tax results arising from a transaction (or series of transactions) are obvious, uncontroverted, and based on the 'form' of the transactions the taxpayer has chosen. In some rare (but important) cases, however, the 'substance' of a particular transaction produces tax results that are inconsistent with its 'form' as embodied in its underlying documentation … . Under the substance-over-form doctrine, the IRS and the courts may recharacterize a transaction in accordance with its substance, if the substance of the transaction is demonstrably contrary to the form.[169]

Comment: The transaction's form, however, may not be easily ignored.[170] Applying the standard of *Frank Lyon Co. v. United States*, the Second Circuit indicated in *Newman v. Commissioner* that relevant criteria in determining whether a transaction's form ought to be respected include: (i) the existence of a business purpose; (ii) whether the transaction has changed the parties' economic interests; (iii) whether the transaction's terms were arm's-length terms; and (iv) did the parties respect their own form.[171] Thus, the Second Circuit indicated that the form will not be disregarded simply because the substance may differ from the transaction's form.

The substance-over-form doctrine is frequently applied in the context of leasing.[172] The Supreme Court indicated in 1939 in *Helvering v. F. & R. Lazarus & Co.* that "[i]n the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding."[173] Similarly, in *Frank Lyon Co. v. United States*, the Supreme Court held that with respect to lease transactions "so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes."[174]

In *Bussing v. Commissioner*,[175] a Swiss subsidiary of a computer leasing company (AG) purchased computer equipment in a five-year sale/leaseback transaction. Subsequently, AG sold the equipment to a domestic corporation, which in turn sold interests in the equipment to Bussing (the taxpayer) and four other investors. The taxpayer acquired his interest in the computer equipment subject to the underlying lease with a cash payment, short-term promissory notes, and a long-term promissory note to the domestic corporation. The taxpayer then leased his interest in the equipment back to AG for nine years. The rents due to the taxpayer from AG equaled the taxpayer's annual payments on the long-term promissory note for the first three years and potentially, could generate nominal annual cash flow from that point. Applying the substance-over-form doctrine, the court first disregarded the domestic corporation's participation in the transactions. The court also disregarded the taxpayer's long-term indebtedness because it was offset by AG's rent payments in a "purported sale-leaseback pursuant to which the respective lease and debt obligations flow between only two parties."[176] The court basically held that the obligations between AG and the taxpayer cancelled each other out and that the taxpayer would not be required to make any payments on his obligation. The court collapsed the offsetting loan and lease, and concluded that, to the extent of his cash payment the taxpayer had acquired an interest in a joint venture.

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[166] Notable examples are the debt v. equity cases, where a court may recharacterize debt as equity for tax purposes, and, accordingly, deny the deductions for "interest" payable on the debt. *See Laidlaw Transp., Inc. v. Commissioner*, T.C. Memo 1998-232.

[167] 450 F.2d 472, 477–78 (5th Cir. 1971).

[168] *Keeler v. Commissioner*, 243 F.3d 1212, 1217 (10th Cir. 2001) ("In inquiring whether taxpayer's deductions were properly disallowed, we look past the form of the transactions at issue and examine their substance.").

[169] Treasury Report (1999), at 46–47.

[170] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) ("In applying the doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed.").

[171] *Newman v. Commissioner*, 902 F.2d at 163–164 ("While we exalt substance over form, we do not ignore the form."). *See also* FAA 20123401F (finding substance of installment sale followed by loan monetizing installment sale notes was consistent with form where each step had specific business purpose, economic interest of parties changed, transaction was arm's length, and all parties treated steps as separate). *Cf.* CCA 202118016 (distinguishing FAA 20123401F where monetized installment sale involves intermediary who does not appear to be true buyer of asset sold by taxpayer and §453A(d) pledging rule applies).

[172] *See generally* 545 T.M., Equipment Leasing: Tax Principles and Structuring.

[173] 308 U.S. 252, 255 (1939), aff'g 101 F.2d 728 (6th Cir. 1939).

[174] 435 U.S. at 584. *See also Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939) ("Calling a transaction a lease does not make it one, if in fact it is something else."). For other lease cases that followed *Frank Lyon* in applying a substance over form analysis, see also *Swift Dodge v. Commissioner*, 692 F.2d 651, 652 (9th Cir. 1982) ("The characterization of a transaction for federal tax purposes is controlled by the substantive provisions of the agreement and the parties' conduct, rather than by the particular terminology used in the agreement," citing *Frank Lyon Co. v. United States*, 435 U.S. at 573); *Leslie Leasing Co. v. Commissioner*, 80 T.C. 411, 423 (1983) (discussing *Swift Dodge v. Commissioner* and stating that "In making our determination, we are concerned with the economic substance of the transactions in the case at bar."); *Kan. City S. Ry. v. Commissioner*, 76 T.C. 1067, 1093 (1981) ("It is clear that the labels employed by the parties to a transaction are not controlling and that the substance of the transaction, rather than its form, is determinative."). *See also* Rev. Rul. 72-543, 1972-2 C.B. 87 and Rev. Rul. 68-590, 1968-2 C.B. 66 ("The substance of a transaction, rather than its legal form, is controlling for federal income tax purposes.").

[175] 88 T.C. 449 (1987).

[176] *Id.* at 458.

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In *Exelon Corp. v. Commissioner*,[177] the Tax Court applied the substance-over-form doctrine to recharacterize a purported sale and leaseback of power plants as financing transactions (low-risk loans). The taxpayer (T), an electric utility company, sold its fossil fuel power plants. In an attempt to avoid tax on the substantial gain from the sale, T purported to structure a series of like-kind exchanges under §1031 using sale-leasebacks of interests in other power plants with two unrelated tax-exempt public utility companies (C and M). T funded the transactions entirely with the proceeds from the sale of its power plants. C and M leased power plants to T for a term exceeding the plants' useful lives, each receiving in return a lump-sum payment of cash, and T subleased the power plants back to C and M. C and M returned part of the lump sums to T as a prepayment of the subleases, set aside part for investment and to secure options allowing C and M to repurchase their power plants at the end of the sublease periods, and retained the remainder. T characterized the transactions as like-kind exchanges of T's "active" ownership interests in its two power plants for "passive" leasehold interests in other power plants owned by C and M. Six months after closing the transactions, T received prepayment from C and M of all rent due under the sublease agreements. The IRS disallowed T's treatment of the transactions as §1031 like-kind exchanges on the ground that T did not acquire and retain significant and genuine attributes of a traditional owner, including the benefits and burdens of ownership, of the replacement property. Applying the substance-over-form doctrine to the transactions, the Tax Court agreed with the IRS that T's agreements with C and M were not true leases but rather loans, because the benefits and burdens of ownership were not transferred to T. For a more detailed discussion of *Exelon*, including key factors that led the court to conclude that the benefits and burdens of ownership were not transferred to T, see 567 T.M., *Tax-Free Exchanges Under Section 1031*.

The IRS has also raised the substance-over-form doctrine in cases involving related parties.[178] For example, the substance-over-form doctrine was applied with respect to intramarital transfers of income.[179] In *Helvering v. Clifford*, the United States Supreme Court held that a husband who had assigned securities to a trust, the net income of which was supposed to go to his wife, was to be taxed on the income of the trust because his control of the trust was such that he owned, for tax purposes, the securities in the trust.[180]

On the other hand, in *Goodman v. Commissioner*, the Tax Court indicated that "[related party] transactions will not be ignored or recharacterized for Federal tax purposes solely because relationships exist among the persons involved in them."[181]

Similarly, the substance-over-form doctrine may be used in cases involving transactions between a shareholder or employee and a company.[182] In *United States v. Ingalls*,[183] the taxpayer (a shareholder and employee) borrowed $258,664 from a family owned company. The amount owed was $228,360 on January 30, 1961, at which time the taxpayer sold his stock, and the employment contract was terminated. To terminate the contract, the corporation purchased it for the $228,360 that the taxpayer owed to the corporation. To avoid the realization of $228,360 of ordinary income in 1961, the taxpayer and the corporation agreed that the corporation would pay him $22,836 a year for 10 years and the taxpayer would pay $22,836 per year on his debt. The parties exchanged checks as of February 1 of each year. The Fifth Circuit found that the transaction had no substance and held that:

> The question for decision is whether the compromise of taxpayer's employment contract claim against the Ingalls Iron Works Company is legally effective to spread the proceeds of the compromise over a ten-year period for income tax purposes… The agreement here eliminates even the formality of having to plead the set-off since by contract the parties agree that if the taxpayer fails to pay the company, the company is authorized to effect a private set-off by making the bookkeeping entry mentioned above. The agreement speaks for itself and makes clear that the taxpayer had to perform no additional act for the debt to be discharged. A simple bookkeeping entry by the company each February 1 was all that was necessary. The exchange of checks by the company and the taxpayer was thus an empty ritual acted out for the benefit of the Commissioner and, in reality, the taxpayer was discharged from his indebtedness on January 30, 1961.

Substance-over-form is frequently raised by the IRS in the context of distinguishing between debt and equity for tax purposes.[184] Treasury issued final regulations under §385 in 1981, but these regulations proved to be controversial and were withdrawn. In the absence of regulatory guidance, the characterization of an instrument as debt or equity is determined pursuant to case law. Over the years, courts have developed guidance in this area by identifying factors that are relevant to the characterization of an obligation as debt or equity for United States

[177] 147 T.C. 230 (2016), aff'd, 906 F. 3d 513 (7th Cir. 2018), reh'g en banc denied, No. 17-2964, 2018 BL 448954 (7th Cir. Dec. 05, 2018).

[178] *Davis v. Commissioner*, 585 F.2d 807 (6th Cir. 1978); *Teong-Chan Gaw v. Commissioner*, T.C. Memo 1995-531 at 130–31 ("In deciding whether to apply substance over form and related principles to the transactions at issue, we examine the relationships among the persons involved in those transactions because those relationships are factors that we may consider in deciding whether those transactions should be ignored or recharacterized.") (citing *Wrenn v. Commissioner*, 67 T.C. 576, 584 (1976) and *Aiken Indus., Inc. v. Commissioner*, 56 T.C. at 934).

[179] *Helvering v. Clifford*, 309 U.S. 331 (1940).

[180] 309 U.S. 331 (1940).

[181] *Goodman v. Commissioner*, 74 T.C. 684, 707–09 (1980), aff'd *without pub. opin.*, 673 F.2d 1332 (7th Cir. 1981). *See also Bolger v. Commissioner*, 59 T.C. 760 (1973).

[182] *Higgins v. Smith*, 308 U.S. 473 (1940).

[183] 399 F.2d 143 (5th Cir. 1968).

[184] An equity interest has traditionally been defined as embarking on a corporate venture and taking the risks of loss attendant upon it, so that one might share in the profits of its success, whereas debt has been defined as an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof. *See* Garlock, *Federal Income Taxation of Debt Instruments* (4th ed. 2000) at 1.01[B] (citing *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960) and *United States v. Title Guar. & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943)).

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federal income tax purposes.[185] In *Estate of Mixon v. Commissioner*,[186] the court identified 13 factors which merit consideration in determining whether an instrument constitutes debt or equity. These factors include: (1) the names given to the instrument; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

Laidlaw Transp., Inc. v. Commissioner[187] involved advances made by a Dutch financing subsidiary of a Canadian parent company to the U.S. operating subsidiaries of the Canadian parent. The Tax Court held that such advances were equity, despite the fact that the payments were made between sister corporations and not between a parent corporation and its subsidiary. The case focused on a debt/equity analysis and applied the thirteen criteria established in *Estate of Mixon*.[188] In denying the interest deduction in its entirety (payments totaling $133 million were made to the Dutch financing entity in the years at issue), the Tax Court relied on a number of findings, including the common management of the entities, the circular flow of funds resulting from "interest reinvestment loans," representations made to the Canadian tax authorities that the advances were in the nature of capital contributions, the fact that principal on the loans was not reduced over a period of four years, and the postponement of loan maturity dates.[189]

In Notice 94-47,[190] the IRS also attempted to set forth its own debt equity guidelines, which generally are consistent with the above common law principles.

Substance-over-form has frequently been applied in the context of evaluating whether a transfer of ownership (i.e., a true sale) occurred.[191] In *Falsetti v. Commissioner*, the Tax Court held that:

> In the context of a sale transaction, as here, our task is to determine whether the parties have in fact done what the form of their arrangement purports to do. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981). In other words, we must determine whether [the taxpayer], in fact, sold the property to Monterey Pines Investors.[192]

In general, a sale of property occurs when the burdens and benefits of ownership are transferred from the seller to the buyer.[193] Specifically, the Tax Court in *Grodt & McKay* set forth the following factors for recognizing the existence of a sale for tax purposes:

> (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.[194]

The substance-over-form doctrine has also been applied to evaluate whether a person should be treated as a partner in a partnership where a partnership was formed, but it is asserted that the arrangement lacks economic substance.[195]

Several statutory and regulatory provisions explicitly apply the substance-over-form doctrine. For example, pursuant to Reg. §1.165-1(b):

> Nature of loss allowable. To be allowable as a deduction under §165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in §165(h) and §1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. *Substance and not mere form shall govern in determining a deductible loss.* (Emphasis added.)

Similarly, Reg. §1.701-2 (the regulatory partnership anti-abuse rules) provide that:

> (a) Intent of subchapter K
>
> Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements —

[185] *See generally* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971).

[186] *Estate of Mixon v. Commissioner*, 464 F.2d 394 (5th Cir. 1972).

[187] T.C. Memo 1998-232.

[188] *Estate of Mixon v. Commissioner*, 464 F.2d 394 (5th Cir. 1972). For another example where the court applied factors similar to those laid out in Mixon to determine whether a transaction should properly be characterized as debt or equity, see *Pepsico P.R., Inc. v. Commissioner*, T.C. Memo 2012-269 (in characterizing advance agreements between U.S. parent's U.S. subsidiaries and foreign holding company as equity, court found following factors dispositive: (1) potential 50-year term of agreements; (2) fact that repayment of advances was conditioned on financial well-being of receiving company, i.e., foreign holding company; (3) absence of any legitimate credit safeguards afforded to holders of advance agreements; (4) subordination provisions in advance agreements; (5) debt-equity ratio of foreign holding company; (6) inability of foreign holding company to obtain independent financing; and (7) relatively high risk to U.S. parent regarding potential non-repayment of advances).

[189] T.C. Memo 1998-232.

[190] 1994-1 C.B. 357.

[191] *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981).

[192] 85 T.C. 332, 348 (1985).

[193] *Frank Lyon Co. v. United States*, 435 U.S. at 571.

[194] 77 T.C. 1221, 1237–38 (1981).

[195] *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012) (finding that corporation is not a bona fide partner in a partnership; "looking past the form of the transaction to its substance, neither PB's 'vigorous[] negotiat[ion]' nor its 'comprehensive due diligence investigation' is, in this context, indicative of an intent to be a bona fide partner in HBH"); *Southgate Master Fund, LLC v. United States*, 659 F.3d 466 (5th Cir. 2011) (same; "an application of *Culbertson*'s totality-of-the-facts-and-circumstances test demonstrates that the Southgate partnership was a sham that need not be respected for tax purposes").

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> (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
>
> (2) The form of each partnership transaction must be respected under *substance over form* principles. (Emphasis added).[196]

Comment: Since *Gregory v. Helvering*, the general doctrine of substance-over-form has taken various directions with the creation of the other common law doctrines discussed herein. Generally, the doctrines that have emerged can be divided into two subtests under the substance-over-form doctrine: (i) the economic substance/sham transaction doctrines (with the business purpose doctrine included as the subjective prong), and (ii) the step transaction doctrine.

B. Taxpayers' Ability to Disavow Their Own Form: Strong Proof/Danielson

1. Overview

In general, taxpayers have found it very difficult to successfully invoke common law anti-abuse doctrines to challenge their own transaction form.[197] Only in a few cases, taxpayers have succeeded in challenging their own form.[198] As discussed herein, a court will not easily allow the taxpayer to disavow his or her own form, even if it is evident that the form differs from the transaction's substance.[199] In addition, different courts have not consistently articulated the standard that taxpayers must meet to disavow their chosen form.[200] In general, two approaches have emerged, the "strong proof" standard,[201] and the more rigid "Danielson" standard,[202] both of which are discussed below.

In *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*,[203] the taxpayer issued $50 face value debentures in exchange for its outstanding preferred shares, which at the time were quoted at approximately $33 per share on the over-the-counter market. The taxpayer argued that the debt discount, measured by the difference between a claimed $33 per share value for the preferred and the face amount of the debentures constituted deductible interest as original issue discount. The Tenth Circuit held for the taxpayer, holding that the taxpayer issued its $50 debenture for $33 in cash and then used that cash to purchase and retire outstanding preferred at $33 per share.[204]

Nevertheless, the Supreme Court observed that discount can be recognized as amortizable deductible interest only when it is issued for *cash* and not property. The United States Supreme Court reversed the decision and observed that:

> Even if we were to assume, *arguendo*, that the hypothetical transaction posed by the taxpayer and the Court of Appeals was indistinguishable, as a matter of economic reality, from what actually occurred, we would not be required, for that reason alone, to recognize a claimed deduction for debt discount.[205]

Explaining its decision, the Supreme Court set forth the fundamental principle pursuant to which:

> [w]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not.[206]

In *Complex Media. Inc. v. Commissioner*,[207] the Tax Court explained that you cannot read the *Alfalfa* quote, which suggests an absolute prohibition, in isolation. According to the court, when the quote is read in the context of the entire opinion, the "quotation should be interpreted to mean only that a taxpayer's ability to identify an alternative path to a given end result that provides more favorable tax consequences than the path actually taken is not enough to entitle the taxpayer to the desired tax treatment."

In general, courts have imposed on taxpayers a higher standard of proof when the taxpayers rather than the IRS raised the substance-over-form doctrine.[208] As the Tax Court stated in *Bolger v. Commissioner*,[209] "a taxpayer may have less freedom

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[196] *See also* Reg. §1.721-1(a) ("[Partnership's] Contributions, Distributions and Transfers") (the "substance of the transaction will govern, rather than its form.").

[197] *Estate of Rogers v. Commissioner*, 29 T.C.M. 869, 872 (1970), aff'd per curiam, 445 F.2d 1020 (2d Cir. 1971); *Halstead v. Commissioner*, 296 F.2d 61 (2d Cir. 1961); *Spector v. Commissioner*, 641 F.2d 376, 381 (5th Cir. 1981), cert. denied, 454 U.S. 868 (1981); *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984); *Maletis v. United States*, 200 F.2d 97 (9th Cir. 1952)); *MAS One LP v. United States*, 390 F.3d 427 (6th Cir. 2004). *Cf. Comdisco v. United States*, 756 F.2d 569, 578 (7th Cir. 1985).

[198] *Helvering v. Lazarus*, 308 U.S. 252 (1939); *Estate of Weinert v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961); *Ill. Power Co. v. Commissioner*, 87 T.C. 1417 (1986), *acq.*, 1990-1 C.B. 1; *Complex Media. Inc. v. Commissioner*, T.C. Memo 2021-14, *nonacq.* AOD 2023-2; *Pac. Gamble Robinson v. Commissioner*, T.C. Memo 1987-533.

[199] *Stokely-Van Camp v. United States*, 974 F.2d 1319, 1325 (Fed. Cir. 1992) ("generally, a taxpayer may not disregard the terms of a contract allocating the payment thereunder and adopt a different allocation having more favorable tax consequences.").

[200] *Schatten v. United States*, 746 F.2d 319, 322 (6th Cir. 1984).

[201] *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959); *Schultz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961); *Pac. Gamble Robinson v. Commissioner*, T.C. Memo 1987-533; *Sonnleitner v. Commissioner*, 598 F.2d 464, 467 (5th Cir. 1979); *Dixie Fin. Co. Inc. v. United States*, 474 F.2d 501 (5th Cir. 1973); *Balthrope v. Commissioner*, 356 F.2d 28 (5th Cir. 1966); *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009).

[202] *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).

[203] *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[204] 472 F.2d 796, 802 (10th Cir. 1973).

[205] 417 U.S. at 148.

[206] 417 U.S. at 149.

[207] T.C. Memo 2021-14 (citing *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974)). *See* AOD 2023-2 (recommending nonacqiescence in *Complex Media. Inc.;* court's reading of quotation in *Alfalfa* "could prevent taxpayers from disavowing the form of their transactions only if it could show purposefully conflicting tax benefits" even when taxpayer withholds vital information).

[208] *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959) ("[w]hen the parties to a transaction … have specifically set out the covenants in the contract and have given them an assigned value, strong proof must be adduced by them in order to overcome that declaration."); *Schultz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961); *Pac. Gamble Robinson v. Commissioner*, T.C. Memo 1987-533; *Sonnleitner v. Commissioner*, 598 F.2d at 467; *Dixie Fin. Co. Inc. v. United States*, 474 F.2d 501 (5th Cir. 1973); *Balthrope v. Commissioner*, 356 F.2d 28 (5th Cir. 1966).

[209] 59 T.C. 760, 767, n. 4 (1973), *acq.*, 1976-2 C.B. 1. *See also Estate of Rogers v. Commissioner*, 29 T.C.M. at 872 (the "so-called 'two-way street'

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than the Commissioner to ignore the transaction form that he has adopted."[210]

An important factor in courts' determination whether to allow taxpayers to disavow their own form is consistency between the transaction's parties.[211] In *Estate of Durkin v. Commissioner*, the Tax Court held that "[i]f a party disavows the form of a transaction, the Commissioner may be whipsawed between one party claiming taxation based on form, and the opposite party claiming taxation based on substance."[212] Similarly, in *Taiyo Hawaii Co. v. Commissioner*,[213] the disputed instrument was indebtedness in form but the taxpayer wanted to treat it as equity for tax purposes. The Tax Court held that only if "tax reporting and other actions have shown an honest and consistent respect for the substance of the transaction," the taxpayer could disavow its own form.

Nevertheless, it is not always a "one way street."[214] In *Cutts v. Commissioner*,[215] a case dealing with netting §7872 cross-loans, the IRS argued that the taxpayer, who chose the transaction's form, may not challenge its own form (i.e., separate "due to" and "due from" obligations), unless the IRS chooses to challenge that form.

The Tax Court disagreed, however, and held that:

> Resort to substance is not a right reserved for the Commissioner's exclusive benefit to use or not to use — depending on the amount of tax to be realized … . The taxpayer too has a right to assert the priority of substance — at least in a case where his tax reporting and actions show an honest and consistent respect for the substance of a transaction.[216]

In *AG Processing, Inc. v. Commissioner*,[217] the IRS argued that the taxpayer's attempt to amend their earlier year tax returns to alter the tax treatment of certain items was a form of disavowing the form of the transaction. The taxpayer had received a PLR ruling that certain transactions were per-unit retain allocation paid in money (PURPIMs) for purposes of computing domestic production activities deduction (DPAD) under §199. The IRS allowed the treatment in the year of the PLR, but objected to the taxpayer amending returns from earlier years to be consistent. The court concluded that the taxpayer did not disavow the form of the transaction, but instead relied on the definition of per-unit retain allocations (PURAs) and the rationale of the PLR to apply the correct tax treatment to the transactions from earlier tax years.

2. *Applicable Standard*

Courts are divided over the standard that the taxpayer must meet to be eligible to disavow its own form.[218] While several U.S. Circuits as well as the Tax Court allow a taxpayer to disavow its own form if the taxpayer shows "strong proof" to support its alternative form,[219] the Third Circuit set forth a stricter standard in *Commissioner v. Danielson*.[220] Under what has become known as the "*Danielson*" standard, a taxpayer is permitted to disavow its own form only by proving that the contract between the parties should be disregarded on the grounds of mistake, fraud, undue influence, or similar grounds.[221] The latter standard has been adopted by the Fifth, Sixth, Eleventh, and Federal Circuits.[222] The First Circuit has declined to apply the *Danielson* standard and appears to have adopted the "strong proof" standard.[223] Although the Tax Court generally follows

seems to run downhill for the Commissioner and uphill for the taxpayer."); *Halstead v. Commissioner*, 296 F.2d 61 (2d Cir. 1961) ("Since the taxpayer represented to the taxing authorities that the form of business he set up was an actual partnership, he may not now disclaim its validity."); *Spector v. Commissioner*, 641 F.2d at 381 ("Just as the Commissioner in determining income tax liabilities may look through the form of a transaction to its substance … . so, as a general rule, may he bind a taxpayer to the form in which the taxpayer has cast a transaction."); *Bradley v. United States*, 730 F.2d at 720 ("It is well settled law that the Commissioner of the Internal Revenue Service, in determining income tax liabilities, may look through the form of a transaction to its substance. The law further declares that as a general rule, the Commissioner may bind a taxpayer to the form in which the taxpayer has cast a transaction."); *Maletis v. United States*, 200 F.2d 97 (9th Cir. 1952) ("[the taxpayer] now seeks to disclaim the partnership's validity for those years. This he cannot do."). *Cf. Comdisco v. United States*, 756 F.2d at 578.

[210] *See also Stokely-Van Camp v. United States*, 974 F.2d at 1325 ("generally, a taxpayer may not disregard the terms of a contract allocating the payment thereunder and adopt a different allocation having more favorable tax consequences.").

[211] *Comdisco v. United States*, 756 F.2d at 578 ("We see no reason to extend the Government's power to hold a taxpayer to the technical form of its transactions to situations in which the Government will never face conflicting claims. Therefore, in this case, we abandon the approach that binds a taxpayer to the labels given to a transaction in favor of an analysis that looks at the economic substance of the transaction.").

[212] 99 T.C. 561 (1992) (citing *Comdisco v. United States*, 756 F.2d at 577).

[213] 108 T.C. 590 (1997).

[214] *Comdisco v. United States*, 756 F.2d at 578.

[215] T.C. Summ. Opin. 2004-8, Doc 2004-1867.

[216] Citing *Estate of Weinert v. Commissioner*, 294 F.2d at 755.

[217] *AG Processing, Inc. v. Commissioner*, 153 T.C. No. 3 (Oct. 19, 2019).

[218] *Schatten v. United States*, 746 F.2d at 322 ("Although recognizing that the Tax Court has rejected the *Danielson* rule, see, e.g., *Weiner v. Commissioner*, 61 T.C. 155, 159–60 (1973), we conclude that the *Danielson* approach is sounder.").

[219] *Schultz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961); *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959); *Krieder v. Commissioner*, 762 F.2d 580, 586–87 (7th Cir. 1985); *Major v. Commissioner*, 76 T.C. at 249; *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009).

[220] *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967). For an in-depth discussion of the *Danielson* doctrine, see Johnson, *The* Danielson *Rule: An Anodyne for The Pain of Reasoning*, 89 Colum. L. Rev. 1320 (1989).

[221] *See Tseytin v. Commissioner*, No. 16-01674, 2017 BL 289754 (3d Cir. Aug. 18, 2017), *aff'g* T.C. Memo 2015-247 (taxpayer must bear tax consequences of his business decisions where no *Danielson* exceptions apply); *Commissioner v. Danielson*, 378 F.2d 771, 775 ("For these reasons we adopt the following rule of law: a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.").

[222] *Bradley v. United States*, 730 F.2d at 720 ("Taxpayers have failed to submit any evidence to prove the existence of a mistake, undue influence, fraud, or duress so as to merit release from the transaction form that they employed."); *Schatten v. United States*, 746 F.2d at 322 ("For three reasons, we agree with the Third and Fifth Circuits that a party may not challenge the tax consequences of a settlement agreement absent proof which in an action between the parties to the agreement would be admissible to alter the construction or to show its unenforceability because of mistake, undue influence, fraud or duress."); *Spector v. Commissioner*, 641 F.2d 376 (5th Cir. 1981) ("At the outset, we note that several policy considerations argue for application of the Danielson rule [to this case].").

[223] *Leslie S. Ray Ins. Agency, Inc. v. United States*, 463 F.2d 210, 211–12 (1st Cir. 1972) (rejecting *Danielson* standard); *Harvey Radio Labs., Inc. v. Commissioner*, 470 F.2d 118, 120 (1st Cir. 1972) (rejecting IRS's invitation to apply strict *Danielson* standard and taxpayer's invitation to apply flexible "economic realities" standard; finding that taxpayer failed to present evidence meeting "strong proof" standard); *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009) (citing *Leslie S. Ray* and *Harvey Radio*, and finding "strong proof" standard applicable to facts of case).

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the "strong proof" standard,[224] a Tax Court might be obligated to follow the stricter *Danielson* standard if an appeal from this court would be made to a circuit that applies *Danielson*.[225]

3. The Strong Proof Standard

a. Articulation

Under this standard, in order for a taxpayer to be allowed to disavow its own form, the taxpayer must show a "strong proof" that the transaction's substance is inconsistent with its form.[226] Thus, if a taxpayer fails to provide such a strong proof, it will be bound by its own form, regardless of whether the substance differs from the form.[227] The "strong proof" standard has been adopted by the Second, Seventh, and Ninth Circuits.[228]

The Tax Court elaborated in *Coleman v. Commissioner*:

> [w]e emphasize that we are not holding that Atlantic was not the owner of the equipment, but only that petitioners have the burden of producing, at a minimum, "strong proof" that the other elements of the burdens and benefits of ownership were such that Atlantic should be considered the owner and, additionally, that Majestic assumed such burdens and was entitled to such benefits of ownership with the result that it (and therefore petitioners) should be entitled to depreciate its (and their) investment in the equipment irrespective of any ownership by Atlantic. Absent such "strong proof," petitioners must be held to have failed to carry their burden of proof as to the original deficiencies and respondent must, by virtue of the prima facie case stemming from the location of title, be held to have carried his burden of proof as to the increased deficiencies.[229]

b. What Constitutes a "Strong Proof"?

Generally, courts have established that the "strong proof" standard is not as strict as the *Danielson* standard discussed below, but it has been uncertain what is the minimum requirement to satisfy it.[230] As the Tax Court indicated in *Major v. Commissioner*:

> Where one alleges that an allocation is actually other than that contained in a contract, that party must prove it beyond a mere preponderance of the evidence — he must present "strong proof" that the allocation is correct based on the intent of the parties and the economic realities.[231]

A preponderance of evidence (i.e., more than 50%) is generally the minimum to satisfy the "strong proof" standard, and some courts may even require more.[232] As the Tax Court confirmed in *Ill. Power Co. v. Commissioner*:

> A precise definition of "strong proof" has not been articulated. Suffice it to say that the strong proof standard requires a showing of somewhat more than a preponderance of the evidence and somewhat less than the so-called "Danielson test" under which a party can challenge the form of an agreement "only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."[233]

The Tax Court in *Complex Media. Inc. v. Commissioner*,[234] further explained:

> Therefore, we now conclude that the additional burden the taxpayer has to meet in disavowing transactional form relates not to the quantum of evidence but instead to its content — not how much evidence

[224] *Elrod v. Commissioner*, 87 T.C. 1046, 1066 (1986) ("[The Tax] Court has not adopted the *Danielson* rule as set forth by the Court of Appeals for the Third Circuit… Inasmuch as this case would be appealable to the Court of Appeals for the Fourth Circuit, we are not bound to apply this rule in the instant case… The strong proof rule is a standard applied by this Court.").

[225] *See, e.g.*, *Dev. Corp. of Am. v. Commissioner*, T.C. Memo 1988-127 ("while we still adhere to our strong proof standard, we are bound to apply the *Danielson* rule in the instant case.").

[226] *Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837, 842 (1978) ("the transaction herein was structured in an arm's-length transaction between unrelated parties and had obvious tax consequences, beyond the issue involved herein, to [the taxpayer] and a third party … who are not before us in this proceeding… In such a situation, we should proceed with caution and seek strong proof [footnote omitted] from the party to the transaction who asks us to accede to blandishments that its form be ignored."); *GC Servs. Corp. v. Commissioner*, 73 T.C. 406, 412 n. 2 (1979) ("the petitioner must establish by "strong proof" that the terms of the written instrument did not reflect the actual intention of the parties thereto."); *Lucas v. Commissioner*, 58 T.C. 1022, 1032 n. 1 (1972) ("Where a taxpayer has entered into a written agreement, such as the contract of sale here, that provides for the specific terms of a transaction the tax consequences of which are in issue, we have applied the rule that 'strong proof' must be adduced by the taxpayer if he seeks to establish a position at variance with the language of the agreement to which he was a party."); *Mittleman v. Commissioner*, 56 T.C. at 175 ("we reiterated our prior position that strong proof is required to establish that the substance of an agreement is different from its form."); *Schultz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961); *Major v. Commissioner*, 76 T.C. at 247 ("Where one alleges that an allocation is actually other than that contained in a contract, that party must prove it beyond a mere preponderance of the evidence — he must present 'strong proof' that the allocation is correct based on the intent of the parties and the economic realities."); *Pac. Gamble Robinson v. Commissioner*, T.C. Memo 1987-533; *Boseker v. Commissioner*, 52 T.C.M. 70, 73 (1986); *O'Callaghan v. Commissioner*, T.C. Memo 1984-214.

[227] *Id.*

[228] *Schultz v. Commissioner*, 294 F.2d 52 (9th Cir. 1961); *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959); *Krieder v. Commissioner*, 762 F.2d at 586–87 ("We therefore hold that the Tax Court did not err in using the strong proof standard in this case under the assumption that it would be acceptable to this circuit."); *Major v. Commissioner*, 76 T.C. at 249 (applying strong proof standard in case appealable to the Seventh Circuit).

[229] 87 T.C. 178, 204 (1986).

[230] *Ill. Power Co. v. Commissioner*, 87 T.C. 1417, 1433 n. 15 (1986).

[231] *Major v. Commissioner*, 76 T.C. at 247. *See also Boseker v. Commissioner*, 52 T.C.M. 70, 73 (1986) ("The 'strong proof' rule requires a taxpayer to present strong proof, i.e., more than a preponderance of the evidence, that the intended allocation of the purchase price is other than the allocation described in the contract."). *Cf. O'Callaghan v. Commissioner*, T.C. Memo 1984-214 ("The determination of whether a party has 'adduced' the requisite 'strong proof' demands an examination of whether the covenant has 'some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement.'").

[232] *Elrod v. Commissioner*, 87 T.C. at 1066 ("The strong proof standard requires the taxpayer to present 'strong proof,' that is, more than a preponderance of the evidence, that the terms of the written instrument do not reflect the actual intentions of the contracting parties.").

[233] *Ill. Power Co. v. Commissioner*, 87 T.C. at 1433 n.15.

[234] T.C. Memo 2021-14. *See also* AOD 2023-2 (recommending nonacquiescence in *Complex Media. Inc.* as to whether a party's failure to report transaction fully or consistently is considered major factor in a decision to allow taxpayer to disavow form of transaction).

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> but what that evidence must show by the usual preponderance. The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself, as in *Estate of Durkin*,[235] or to a counterparty, as in *Coleman*)[236] that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in *Danielson*[237] will not be present.

4. Danielson

In *Danielson v. Commissioner*,[238] shareholders of a loan company sold the company to another loan company. The purchaser offered the seller's shareholders, including the taxpayer, a lump sum payment and allocated a large portion of the payment to a covenant not to compete. The taxpayer, however, ignored the allocation on his tax return, and did not allocate any amount to the covenant.

The taxpayer argued that the covenant had no "arguable relationship with business reality." Accordingly, the taxpayer argued that the allocation of the significant amount to the covenant had no substance. The IRS disagreed and argued that the taxpayer must be bound to the form of the transaction he chose, namely the allocation. The Tax Court held for the taxpayer on the grounds that there was no real substance in the covenant, and, therefore, the taxpayer was correct in not allocating any amount to it. The Tax Court relied, therefore, on the "strong proof" standard.[239]

The Third Circuit vacated the Tax Court opinion and created the stricter standard: "a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."[240]

In the absence of statutory or regulatory guidance, the Third Circuit relied on tax policy considerations in its decision. The Third Circuit stated the following reasons for creating the stricter standard:

> [T]o permit a party to an agreement fixing an explicit amount for the covenant not to compete to attack that provision for tax purposes, absent proof of the type which would negate it in an action between the parties, would be in effect to grant, at the instance of a party, a unilateral reformation of the contract with a resulting unjust enrichment. If allowed, such an attack would encourage parties unjustifiably to risk litigation after consummation of a transaction in order to avoid the tax consequences of their agreements.
>
> And to go behind the agreement at the behest of a party may also permit a party to an admittedly valid agreement to use the tax laws to obtain relief from an unfavorable agreement.
>
> Of vital importance, such attacks would nullify the reasonably predictable tax consequences of the agreement to the other party thereto. Here the buyer would be forced to defend the agreement in order to amortize the amount allocated to the covenant. If unsuccessful, the buyer would lose a tax advantage it had paid the selling-taxpayers to acquire. In the future, buyers would be unwilling to pay sellers for tax savings so unlikely to materialize.
>
> Finally, this type of attack would cause the Commissioner considerable problems in the collection of taxes. The Commissioner would not be able to accept taxpayers' agreements at face value. He would be confronted with the necessity for litigation against both buyer and seller in order to collect taxes properly due. This is so because when the Commissioner tries to collect taxes from one party he may, as here, dispute the economic reality of his agreement. When the Commissioner turns to the other party, there will likely be the arguments that the first party, as here, received consideration for bearing the tax burden resulting from the sale and that the covenants did indeed have economic reality.[241]

Comment: The *Danielson* test uses contract law principles (specifically the "parol evidence rule") for purposes of determining if a contract between parties ought to be disregarded for tax purposes.[242] As the Eighth Circuit explained in *Molasky v. Commissioner*:[243]

> The parol evidence rule prohibits parties from introducing extrinsic evidence to vary or contradict the terms of a complete, valid and unambiguous written instrument, absent a claim of fraud, duress, accident or mistake.

The first Court of Appeals to apply the *Danielson* strict standard was the Third Circuit in *Sullivan v. United States*,[244] where the court applied a similar policy analysis. The Third Circuit observed that "Perhaps the most persuasive of the reasons set forth in support of this new rule was that it would alleviate problems for the Commissioner in the collection of taxes and in the administration of the tax laws."[245]

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[235] 99 T.C. 561 (1992).
[236] 87 T.C. 178 (1986).
[237] 378 F.2d 771 (3d Cir. 1967).
[238] *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).
[239] 44 T.C. 549 (1965).
[240] 378 F.2d at 775.
[241] *Commissioner v. Danielson*, 378 F.2d at 775.
[242] *Id. See also Carl Goudas v. Commissioner*, T.C. Memo 1996-555, n. 13 ("The *Danielson* rule encompasses and mirrors the parol evidence rule.").
[243] 897 F.2d 334 (8th Cir. 1990).
[244] 618 F.2d 1001 (3d Cir. 1980).
[245] 618 F.2d at 1004. *Cf. Amerada Hess Corp. v. Commissioner*, 517 F.2d 75, 86 (3d Cir. 1975) (refusing to apply the *Danielson* test).

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Following the same above policy considerations, several other Circuits[246] and Courts of Claims have adopted this standard.[247] In *Dakan v. United States*,[248] the court stated *per curiam*, "The trial judge holds that in the absence of mistake, fraud, undue influence, etc., the taxpayer is bound by the allocations he made in the sales agreement."[249]

Not all circuits, however, have followed the *Danielson* strict standard. For example, in *Comdisco, Inc. v. United States*, the Seventh Circuit explained that the *Danielson* standard is justified only when the Government is faced with conflicting positions, and each party claims tax benefits.[250] As the Seventh Circuit observed:

> Often called the *Danielson* rule, the disparate treatment arose and has since been applied in cases where two parties to a deal have both sought to acquire beneficial tax treatment. The most common type of case in which the form-substance question arises is where there is a question whether a transaction is a liquidation or a sale of a business. *See, e.g.*, *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984) cert. denied, 469 U.S. 882, 105 S. Ct. 250 83 L. Ed. 2d 187 [(1984)]. Depending upon the nature of the deal, one party or the other, but not both, will receive the beneficial treatment. *See Sonnleitner v. Commissioner*, 598 F.2d 464, 466–67 (5th Cir. 1979) The form of the deal usually results in one party claiming the benefits. If the second party later disavows the form of the deal, the Government would be faced with the prospect of having to proceed against both taxpayers to resolve who should receive the advantageous treatment. Instead, the *Danielson* rule has evolved and received general acceptance. The only exception to the general rule allowing the Government to bind taxpayers to the form of their transactions when the Government faces potentially conflicting claims arises in cases where the challenge is necessary to avoid unjust results. *See, e.g.*, *Ullman v. Commissioner*, 264 F.2d 305, 308 (2d Cir. 1959). *Accord Sonnleitner v. Commissioner*, 598 F.2d 464.[251]

Thus, the Seventh Circuit indicated that the *Danielson* standard is appropriate only in situations where one party to a transaction claims tax benefits based on the form agreed upon by the parties, and subsequently (or concurrently) the counterparty wishes to disavow the transaction form and also enjoy tax benefits.[252] In this case, the court observed that the parties ought to be bound by the transaction's form.

The Fourth Circuit has specifically declined to adopt the *Danielson* or "strong proof" standards. It applies a two-pronged "economic realty" approach, assessing the intent of the parties and the economic substance of the transaction.[253] In *Bergbauer*, the taxpayer was a consulting partner, whose consulting business was acquired by another entity. Under the terms of the sale, each consulting partner would receive shares of stock in the other entity, which would vest immediately. The partners also attended a meeting where the tax consequences associated with the transaction were explained. At this meeting, there was a discussion regarding the immediate vesting upon the transaction's closing, which the partners approved of because of the expectation that the stock value would rise. After two years, the value of the stock dropped drastically and many partners sought alternative means to profit on the transaction. Heeding advice from other consulting partners, the taxpayer filed an amended income tax return relying on the proposition that the transaction was not a fully taxable event, which reduced the amount of reported income by a significant amount. Later, the government brought suit against the taxpayer to recover the refund pursuant to §7405.

Applying the Fourth Circuit's two-pronged economic reality test,[254] the court granted summary judgment for the government, holding that the stock received by the taxpayer was fully taxable in the year received. Under the first prong, the intent of the parties, the court looked within the four corners of the transaction documents for any expressed intent regarding the tax implications. The court found that the documents contained provisions that strongly suggested that the taxpayer knew that his shares were immediately and fully taxable. However, the court noted, the documents also contained provisions that restricted and limited the taxpayer's use of the shares of stock.

The court resolved the conflicting provisions of the documents by looking at the extrinsic evidence surrounding the transaction. It stated that: (1) during the meeting of consulting partners, the taxpayer was specifically told of the tax consequences; (2) the documents explicitly stated that the taxpayer would be taxed on all shares immediately; and (3) the taxpayer filed an initial return reporting the gross sale proceeds and it was not until the stock began to plummet that the taxpayer filed

[246] *Spector v. Commissioner*, 641 F.2d at 385 ("To allow one taxpayer to later challenge the form of the agreement necessarily would endanger and perhaps ultimately defeat the reasonable expectations of the other party, who has proceeded taxwise under the parties' contract and agreement, as to the tax consequences flowing therefrom."); *Schatten v. United States*, 746 F.2d at 322 ("we agree with the Third and Fifth Circuits that a party may not challenge the tax consequences of a settlement agreement absent 'proof which in an action between the parties to the agreement would be admissible to alter the construction or to show its unenforceability because of mistake, undue influence, fraud or duress.'"); *Molasky v. Commissioner*, 897 F.2d 334 (8th Cir. 1990) (accepting the "parol evidence rule"); *Bradley v. United States*, 730 F.2d at 720–21 ("Because appellant taxpayers failed to produce the type evidence required by *Spector*, we conclude that they are unable to alter the form in which they cast their sale agreement.").

[247] *Forward Commc'ns Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979) ("[the Court of Claims] has cited *Danielson* with approval on several occasions.").

[248] 203 Ct. Cl. 655, 492 F.2d 1192 (1974).

[249] *Forward Commc'ns Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979) ("[the Court of Claims] has cited *Danielson* with approval on several occasions."). *See also Davee v. United States*, 195 Ct. Cl. 184, 444 F.2d 557 (1971); *Eckstein v. United States*, 196 Ct. Cl. 644, 452 F.2d 1036 (1971); *Cf. Campbell v. United States*, 661 F.2d 209, 217 (Ct. Cl. 1981) ("neither the *Danielson* facts nor the *Danielson* rationale applies to this case.").

[250] 756 F.2d 569, 577 (7th Cir. 1985).

[251] *Id.*

[252] *See generally* Johnson, *The Danielson Rule: An Anodyne for the Pain of Reasoning*, 89 Colum. L. Rev. 1320 (1989).

[253] *United States v. Bergbauer*, No. RDB-05-2132 (D. Md. March 18, 2008). For additional discussion of the *Bergbauer* decision, see Willens, *Courts Ruling on E&Y Partner Stock Receipts Disallow Disavowal of Agreements*, BNA Daily Tax Rpt. J-1 (Sept. 23, 2008).

[254] *See Wrangler Apparel Corp. v. United States*, 931 F. Supp. 420, 424 (M.D. N.C. 1996) (citing *General Ins. Agency Inc. v. Commissioner*, 401 F.2d 324 (4th Cir. 1968)).

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an amended return attempting to alter the tax consequences of the transaction.

The second prong of the economic reality test requires that the agreement bargained for have some independent value grounded in economic reality, the court explained. The court determined that each party bargained for and received real economic benefit evidenced by the fact that the partners believed that their newly acquired shares would continue to increase in value and therefore sought immediate taxation on their total received shares to capitalize on anticipated future gains.

In addition, even in the Third Circuit, where the *Danielson* standard was created, some courts have refused to follow the strict standard. For example, in *Amerada Hess Corp. v. Commissioner*,[255] the Third Circuit refused to apply the *Danielson* standard. In that case, taxpayers had assigned an arbitrary price to common stock for purposes of negotiating an agreement. The court did not bind the parties to the valuation set forth in the contract (as would be required under *Danielson*) and held that the *Danielson* standard was inapplicable because applying it would be contrary to the statutory language. Specifically, the court observed that Congress required "the fair market value [to be] the factor controlling the parties' tax liability," in contrast to the arbitrary number selected by the parties in the contract for other purposes.

Similarly, in *Campbell v. United States*,[256] the taxpayers sold stock they owned in a family company to the corporation. Part of the sale price was made up of unregistered notes and shares in the corporation, which were non-negotiable and unsecured. The corporation did poorly and the taxpayers eventually foreclosed. The taxpayers amended their tax return for the year of sale, taking the position that the corporation's stock and notes received had no ascertainable fair market value at the date of sale and therefore their tax liability was reduced. The Court of Claims refused to apply the *Danielson* standard and held that it is "difficult to see … how a bare bones recital as to the amount and form of consideration to be paid can double as an agreement intending to establish the fair market value." The court observed that the fair market value was never determined by the parties to the contract and, therefore, there is no practical way of applying the standard.

Comment: As opposed to the strong proof standard pursuant to which a taxpayer can make substantive arguments to support the claim that the substance of the transaction differs from its form, the *Danielson* standard does not allow substantive arguments to be made by the taxpayer, and looks for arguments that the contract is unenforceable due to mistake or undue influence.[257]

C. Sham Transactions

In some cases, taxpayers not only have adopted transaction forms that differ from the true substance of the underlying transactions but also have presented false or incomplete facts about those transactions.[258] The IRS may invoke the sham-transaction doctrine in such cases, declare that a particular transaction or some part of it is merely a sham, and disallow the associated tax benefits.[259] In *Frank Lyon Co. v. United States*, the United States Supreme Court defined "sham transaction" as "an elaborate financing scheme designed to provide economic benefits to [the other party] and a guaranteed return to [the taxpayer]."[260] The Eleventh Circuit has stated that a transaction with the sole function of the production of tax deductions is a sham regardless of the taxpayer's motives.[261] A relevant factor in identifying a sham transaction has been the absence of arm's-length negotiations over price and the relationship between the stated price and the fair market value of the underlying transaction.[262]

In *Gilbert v. Commissioner*,[263] the Second Circuit observed that *Gregory v. Helvering* applies not only to transactions that never took place (i.e., factual shams) but also to real transactions with no economic substance (i.e., substantive shams). The Second Circuit held that:

> In many cases in which the Gregory principle is called into play the question is whether a tax-significant transaction has occurred. But this is not to say that Gregory has application only where the question is whether a transaction is to be completely ignored for tax purposes. The principle is fully as applicable where there is no doubt that a very real transaction has taken place and the question is whether the characterization urged by the taxpayer accords with substantial economic reality.[264]

Nine years later, the Second Circuit in *Goldstein v. Commissioner* specifically established the distinction between substantive and factual shams.[265] In general, courts have followed

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[255] 517 F.2d 75 (3d Cir. 1975), cert. denied, 423 U.S. 1037 (1975).

[256] 661 F.2d 209, 216–17 (Ct. Cl. 1981).

[257] *See generally* Johnson, *The* Danielson *Rule: An Anodyne for the Pain of Reasoning*, 89 Colum. L. Rev. 1320, 1322–23 (1989).

[258] *See generally Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Knetsch v. Commissioner*, 364 U.S. 361 (1960); *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir 1976); *Brown v. Commissioner*, 85 T.C. 968, 1000 (1985). For a more detailed discussion of the sham transaction doctrine, see Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998* (including Provisions Relating to Corporate Tax Shelters) (JCS-3-99) at 182 (hereinafter "JCT Report (1999)").

[259] *Id. See also Am. Elec. Power Co. v. United States*, 326 F.3d 737 (6th Cir. 2003); *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003).

[260] 435 U.S. at 573 (1978). *See also Karr v. Commissioner*, 924 F.2d at 1022–23 ("A sham transaction is one which, though it may be proper in form, lacks economic substance beyond the creation of tax benefits"); *Ferguson v. Commissioner*, 29 F.3d 98, 101 (2d Cir. 1994) ("The question whether a transaction is devoid of economic substance is often analyzed in terms of its being 'sham.' A sham transaction analysis requires a determination 'whether the transaction has any practicable economic effects other than the creation of income tax losses.'").

[261] *Kirchman v. Commissioner*, 862 F.2d at 1491.

[262] *UPS of Am., Inc. v. Commissioner*, T.C. Memo 1999-268.

[263] 248 F.2d 399, 406 (2d Cir. 1957).

[264] *See also IRS Chief Counsel Offers Historical Overview of Shelters*, 2005 TNT 29-61 (Feb. 11, 2005). In a paper prepared in December 2003 before he became IRS chief counsel, Donald Korb provides a historical overview of the tax shelter problem and observes that "Although the sham transaction doctrine generally applies when the purported activity giving rise to the tax benefits does not actually occur, in certain circumstances, a transaction may be found to constitute a sham even when the purported activity does occur. For example, if a transaction is entered into to generate loss for the taxpayer, and the taxpayer actually has risk with respect to the transaction, but that risk has been eliminated through a guarantee by a broker that the broker will bear the market risk and that the only consequences to the taxpayer will be the desired tax benefits, such transaction may be found to be a 'sham in substance.'"

[265] 364 F.2d 734 (2d Cir. 1966).

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this distinction and have identified two types of sham transaction standards:[266] (i) "sham in substance" (or "economic sham"), which has been generally viewed by courts as similar to the general two-prong economic substance standard;[267] and (ii) "sham in fact" (or "factual sham"), where the disputed transaction really never occurred.[268] The latter group of transactions includes "transactions that have been created on paper but which never took place."[269]

Lerman v. Commissioner[270] involved options straddle transactions similar to the option straddles in *Glass v. Commissioner*,[271] with a notable difference; while in the latter case, the taxpayers were not commodities dealers, in *Lerman v. Commissioner*, the taxpayer were dealers in commodities. The Third Circuit elaborated that:

> An economic sham is distinguished from a factual sham. A factual sham is one in which the alleged transactions never actually took place. In an economic sham, or a sham in substance, the alleged transactions actually took place, but are nonetheless without economic substance."[272]

[266] *Kirchman v. Commissioner*, 862 F.2d at 1492 ("Courts have recognized two basic types of sham transactions. Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents."); *James v. Commissioner*, 899 F.2d at 908, n. 4 ("While most courts refer to these principles under the general heading of the sham transaction doctrine, some courts reserve the term 'sham,' as did the Tax Court in this case; see 87 T.C. at 918 for transactions which occur only on paper or do not, in fact, occur. Other courts distinguish between the mere paper chase, calling it a factual sham, and transactions which do occur but lack economic substance, so-called substantive shams."); *Arrowhead Mt. Getaway v. Commissioner*, T.C. Memo 1995-54, n. 15 ("Courts often distinguish between 'factual shams,' transactions which in fact never occurred, and 'economic shams' (sometimes called 'shams in substance'), transactions which occurred but which lacked economic substance.").

[267] The Ninth Circuit has defined a transaction as a sham in substance if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions. *Sochin v. Commissioner*, 843 F.2d at 354. *See also Killingsworth v. Commissioner*, 864 F.2d at 1216 ("We agree with the Tax Court's conclusion that 'it requires no lengthy or elaborate analysis of the facts to demonstrate that [the taxpayers] did not enter into these transactions primarily for economic profit, and that the transactions under scrutiny were not the type of tax-motivated transaction which Congress intended to encourage.'"); *Horn v. Commissioner*, 968 F.2d at 1236 ("We pause to note that we are speaking only of 'economic shams' — that is, transactions which actually occurred but which exploit a feature of the tax code without any attendant economic risk."); *Krumhorn v. Commissioner*, 103 T.C. 29, 46 (1994) ("Economic shams or transactions lacking economic substance are transactions that have actually taken place, but which have no economic significance beyond expected tax benefits."); *Falsetti v. Commissioner*, 85 T.C. 332, 347 (1985).

[268] *Horn v. Commissioner*, 968 F.2d at 1236 ("Standing opposed to economic shams are 'factual shams' — transactions which either did not occur, did not occur as reported or were performed in violation of some of the background assumptions of commercial dealing, for example arms-length dealing at fair market values."); *Krumhorn v. Commissioner*, 103 T.C. at 46 (1994) ("A fictitious trade, or factual sham, is one in which the alleged transaction never took place.").

[269] *Kirchman v. Commissioner*, 862 F.2d at 1492.

[270] 939 F.2d 44 (3d Cir. 1991).

[271] 87 T.C. 1087 (1986).

[272] 939 F.2d at 49 note 6.

1. Sham-in-Substance

In *Falsetti v. Commissioner*,[273] the Tax Court explained what constitutes "sham-in-substance:"

> Before we give our reasons, we deem it advisable to set forth a working definition of what constitutes a sham in substance, basing our definition upon the rationale of such cases as *Knetsch v. Commissioner*, 364 U.S. 361 (1960) and its progeny, and dictum in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). For purposes of this case, we define 'sham in substance' as the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits.[274]

Other courts have stated that a transaction is a sham if it satisfies neither the objective economic substance prong nor the subjective prong.[275] As the court indicated in *Lerman v. Commissioner*, a transaction will be a sham in substance if: (1) it is not motivated by any economic purpose outside of tax considerations; and (2) it is without economic substance because no real potential for profit exists.[276] In *Friedman v. Commissioner*,[277] the Fourth Circuit stated that: "A 'sham' transaction is one that has no economic effect other than the creation of tax losses." Other courts have stated that a transaction is a sham "if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions."[278]

Comment: Under any of the above alternatives, a sham in substance is a standard equivalent to the economic substance standard, and, in fact, many courts have collapsed these two tests into a single test. The Senate Report for the JOBS Act of 2004 even declared that "the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably."[279] Thus, this Portfolio treats the sham in substance test and economic substance test as similar if not the same.

2. Sham-in-Fact

The sham-in-fact principle has been viewed as a threshold question. In other words:

[273] 85 T.C. 332, 347 (1985).

[274] *Id. See also Seykota v. Commissioner*, T.C. Memo 1991-234 at 93 ("A sham in substance, as opposed to a factual sham, exists when a series of transactions actually does take place but has no business or profit-making function apart from obtaining tax benefits.") (citing *Falsetti v. Commissioner*, 85 T.C. at 347).

[275] *Friedman v. Commissioner*, 869 F.2d at 792 (applying *Rice's Toyota's* two-prong test).

[276] 939 F.2d at 49.

[277] 869 F.2d at 792.

[278] *DeMartino v. Commissioner*, 862 F.2d 400, 406 (2d Cir. 1988). *See H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007) (application of sham transaction test to disallow capital losses where subsidiary acquired parent's stock with intent of subsequent redemption; no nontax business purpose).

[279] S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637). *See also* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005).

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> [B]efore a court can determine whether a transaction lacks economic substance, the court must first determine whether the transaction itself did in fact actually occur. Thus, a court will not inquire into whether a transaction's primary objective was for the production of income or to make a profit, until it determines that the transaction is bona fide and not a factual sham.[280]

Generally, a court will determine that a transaction is a "sham in fact" if the transaction never occurred, or was merely a paper transaction.[281] It is very hard, however, for the IRS to prevail on such an argument. In the COLI cases (*Dow Chemicals v. United States*,[282] *IRS v. CM Holdings, Inc.*,[283] *Winn-Dixie v. Commissioner*,[284] and *Am. Elec. Power Co. v. United States*[285] (discussed in greater detail herein)), the IRS had argued that several elements of the transactions were shams in fact. In *Dow Chemicals v. United States*,[286] the IRS argued that the loans and premiums in years 1–3 and 8–9, and the partial withdrawals and premiums in years 4–7, constituted "circular" cash-flows (and, therefore, factual shams). The district court held that "the policy loans were real transactions consistent with commercial norms, and therefore were not factual shams."[287]

The court, however, concluded that with respect to the partial withdrawals, the cash-flows were circular and therefore, this portion of the transaction was a sham in fact. As the district court elaborated:

> The problem with [the partial withdrawals] does not stem from the practice of netting the withdrawals against the premium obligation. Rather, the transaction was a sham because there was no value in the policy that could be withdrawn to pay the premium, according to the limitations in the respective insurance contracts. Unlike the policy loans, which were made from the insurance company's general funds, the source of the partial withdrawals must be the accessible cash value in the policies themselves… Since the unencumbered cash value in the policies at the beginning of the fourth through seventh years was zero, there was nothing available to withdraw or to offset against the premium obligation. There was no basis upon which the premiums for that year could be "deemed" paid, except for the 10% that did not look to the partial withdrawal as the source of payment. The "payment" of 90% of the premium was not real, since it essentially came from nothing. That portion of the transaction in each plan, therefore, was a sham in fact.[288]

Despite the latter conclusion, the district court concluded that the COLI transaction as a whole did not lack economic substance. However, the Sixth Circuit reversed and remanded the district court decision and held that the COLI plans were economic shams and that the IRS properly disallowed Dow's deductions.[289]

In *IRS v. CM Holdings, Inc.*,[290] and *Am. Elec. Power Co. v. United States*,[291] the trial courts held in both cases that the loading dividends in years 4–7 were factual shams. While in the latter case, the Sixth Circuit reversed this particular issue,[292] the Third Circuit, in *CM Holdings*, affirmed the lower court's determination on the factual sham component, primarily on the grounds that these loading dividends were inconsistent with industry practice.[293]

Subsequent to the Sixth Circuit's decision in *Am. Elec. Power Co. v. United States*,[294] the Government submitted a motion to amend the district court's decision in *Dow Chemicals*.[295] The district court reexamined its previous decision pertaining to the partial withdrawals. The district court observed that both the Sixth and Third Circuit have previously held that the factual sham analysis "focuses simply on whether the transactions actually occurred."[296] Although both circuits made this determination in dictum, the District Court stated that the similarity of facts in all COLI cases should provide support for following the Court of Appeals' dictum. Thus, the district court in *Dow Chemicals* amended its prior decision and held that "the transactions which comprised the partial withdrawals actually oc-

[280] Donald L. Korb, Chief Counsel for the Internal Revenue Service, Remarks at the 2005 University of Southern California Tax Institute, *The Economic Substance Doctrine in the Current Tax Shelter Environment*, Los Angeles, California (Jan. 25, 2005) (hereinafter "Korb (2005)") (citing *Mahoney v. Commissioner*, 808 F.2d at 1220 (The court noted that once a court determines a transaction is a factual sham, "such niceties as whether it was 'primarily' for profit, or whether the text is an objective or subjective one are simply not involved.")).

[281] *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003). *See also Brown v. Commissioner*, 85 T.C. at 1000 ("the disputed transactions constituted factual shams which were inspired, designed, and executed … for the sole purpose of attempting to achieve tax losses for their investors."); *Forseth v. Commissioner*, 85 T.C. at 165 ("After a careful review of the facts, we must conclude that the transactions before us were factual shams, inspired, designed, and executed by LMEI/LMEC, with the participation of InterAct, for the sole purpose of achieving for its investors capital and ordinary losses to offset their unrelated income in 1980 and 1981. Petitioners have failed to prove that there was any actual gold or platinum, that there was any real market or trading, or that there was any purpose, other than the avoidance of taxes, for any of the transactions in issue."); *Seykota v. Commissioner*, T.C. Memo 1991-234, at 83 ("In sum, the alleged trades on the Merit markets were not trades at all. They were only computerized bookkeeping entries that had no existence other than as justifications for the tax losses at issue. The Merit markets were, in effect, situations in which the broker simply scribbles prices in an account book which generate the desired pattern of losses and gains, and the investor reports these accordingly." Citing *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988)).

[282] *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003).

[283] 301 F.3d 96 (3d Cir. 2002).

[284] 254 F.3d 1313 (11th Cir. 2001).

[285] 136 F. Supp.2d 762 (S.D. Ohio 2001).

[286] *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003).

[287] *Id.* at 813.

[288] *Id.* at 815.

[289] *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007).

[290] 301 F.3d 96 (3d Cir. 2002).

[291] 136 F. Supp.2d 762 (S.D. Ohio 2001).

[292] 326 F.3d at 745 (stating that "there is nothing in the record indicating that [the dividends] did not actually occur. The district court's holding therefore seems to be extending the factual-sham doctrine beyond its generally accepted definition.").

[293] 301 F.3d at 108.

[294] 136 F. Supp.2d 762 (S.D. Ohio 2001).

[295] *Dow Chem. Co. v. United States*, 278 F. Supp.2d at 847.

[296] *Id.* at 849–50 (citing *Am. Elec. Power Co.*, 326 F.3d 737, 745 (6th Cir. 2003) and *IRS v. CM Holdings, Inc.*, 301 F.3d 96, 108 (3d Cir. 2002)).

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curred and caused real economic consequences." Accordingly, they do not fit within the revised definition of "sham in fact."[297]

Comment: Following the Sixth Circuit's decision in *Am. Elec. Power Co. v. United States*[298] and the district court's decision in *Dow Chemicals*[299] the Government's position regarding the treatment of certain elements of the COLI transactions as factual shams has not been affirmed by any court.

In *Sochin v. Commissioner*,[300] the taxpayers claimed losses from investments in straddles consisting of forward contracts to buy and sell certificates issued by the Government National Mortgage Association ("Ginnie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). The transaction in general worked as follows: The investors made a deposit (equal to the greater of $10,000 or 0.125% of the face value of the portfolio) and furnished GIM (the financial adviser) with an interest rate forecast. The investors gave GGS (the broker-dealer) power to liquidate any open position with or without notice to the investor and also authorized GIM to act for the investors. GIM prepared a portfolio of forward contracts on Ginnie Maes and Freddie Macs, which constituted a straddle, since 50% of the contracts were to purchase securities (long positions), and 50% were to deliver securities (short positions).

Accordingly, any significant change in the prevailing interest rate would result in a loss on one "leg" of the straddle, which would be canceled to create an ordinary loss for the investor in the year of cancellation. GGS then replaced the canceled contracts with similar contracts, thus reestablishing the straddle and also entered into new contracts with the investors to offset the existing contracts to "lock in" the gain from the non-canceled leg of the original straddle. Finally, after the gain was deferred for a sufficient period of time, the contracts were assigned to a third party, to allow the investors to realize their gain. The amount payable to GGS from the initial cancellation of the loss leg was offset against the receivable due the investors in approximately the same amount as a result of the assignment of the gain leg.

For Sochin, the cash flows were as follows: $10,000 investment generated a $100,160 ordinary loss in 1979 and a $106,382 net long-term capital gain in 1981. The net gain of $6,222 before taxes was reduced to a net overall profit of $122 after the deduction of $6,100 in fees. Sochin's $2,000 portion of the group investment generated a $20,080 ordinary loss in 1979 and a $21,961 net long-term capital gain in 1981. The net gain of $1,881 before taxes was reduced to a net overall profit of $461 after the deduction of $1,420 in fees.

The Tax Court asserted that "[i]t seems self-evident that, in any commodity straddle, a legitimate investor must have some potential of making money as a result of various market forces and, by the same token, be [at] risk of losing money."[301] The Tax Court concluded, and the Sixth Circuit affirmed, that the transaction had no practical economic effect, despite the expected minimal profit from it. The Tax Court specifically addressed the factual sham principle and held that:

> We conclude, therefore, that the losses claimed by petitioners are not allowable because the disputed transactions constituted factual shams which were inspired, designed, and executed by Mr. Gregory and the two corporations controlled by him for the sole purpose of attempting to achieve tax losses for their investors. [footnote omitted][302]

The Tax Court, therefore, concluded that the disputed transaction was a sham in fact. The Ninth Circuit affirmed the decision, although it declined to treat the disputed transaction as a factual sham.[303]

D. Step Transaction

1. Overview

The step-transaction doctrine is a variation on the substance-over-form doctrine, the purpose of which is to ensure that transactions are taxed according to their substance and not their outward form.[304] Accordingly, a court will not apply the

[297] *Id.* at 850.

[298] 136 F. Supp.2d 762 (S.D. Ohio 2001).

[299] *Dow Chem. Co. v. United States*, 278 F. Supp.2d 844, 847 (E.D. Mich. 2003).

[300] 843 F.2d 351 (9th Cir. 1988), *aff'g Brown v. Commissioner*, 85 T.C. 968 (1985).

[301] *Brown v. Commissioner*, 85 T.C. 968, 999 (1985).

[302] *Id.* at 1000.

[303] 843 F.2d at 356 ("The tax court concluded that 'the losses claimed by [Taxpayers] are not allowable because the disputed transactions constituted factual shams which were inspired, designed, and executed by Mr. Gregory and the two corporations controlled by him for the sole purpose of attempting to achieve tax losses for their investors.' *Brown*, 85 T.C. at 1000. This conclusion is not clearly erroneous."). In *Krumhorn v. Commissioner*, 103 T.C. at 46, another case involving losses from commodities straddles, the Tax Court asserted that the disputed transactions were factual shams "[g]iven the lack of business formalities, the irregularities in the documentation of the purported trades, the correlation of losses and gains with tax needs, the lack of margin payments, and the zeroing out of account balances".

[304] *Commissioner v. Clark*, 489 U.S. at 738 ("Under [the step transaction] doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction."); *Brown v. United States*, 329 F.3d 664, 671 (9th Cir. 2003) ("The [step transaction] doctrine is part of the broader tax concept that substance should prevail over form.") (quoting *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991)); *Kanawha Gas & Utils. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954) ("[substance-over-form] is particularly pertinent to cases involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation. The series of closely related steps in such a plan are merely the means by which to carry out the plan and will not be separated."); *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) ("The step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form."); *True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999) (the step transaction doctrine is an "incarnation of the basic substance over form principle"); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983) ("The step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form."); *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994) ("By emphasizing substance over form, the step transaction doctrine prevents a taxpayer from escaping taxation. The doctrine treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked."); *Penrod v. Commissioner*, 88 T.C. 1415, 1428–30 ("The step transaction doctrine is in effect another rule of substance over form; it treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."); *Teong-Chan Gaw v. Commissioner*, T.C. Memo 1995-531 at 124 ("The step transaction doctrine developed from the substance over form doctrine.") (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1521).

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step transaction doctrine if the substance of the transaction does not differ from its form.[305]

As early as 1938, the Supreme Court indicated that "a given result at the end of a straight path is not made a different result because reached by following a devious path."[306] Under the step-transaction doctrine, separate transactions or steps may be treated as a single, unified transaction for tax purposes.[307] Courts apply the step transaction doctrine in cases where taxing the individual steps of a transaction rather than the transaction as a whole would eviscerate the substance of the transaction resulting in improper tax treatment of the whole transaction.[308] As a result, such individual steps would be disregarded for tax purposes, and the transaction would be taxed as a single unified transaction as opposed to separate steps.[309]

In *Smith v. Commissioner*,[310] the Tax Court illustrated the application of the step transaction doctrine:

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. [Citation omitted.][311]

The step transaction doctrine is frequently raised by the IRS in cases of a transfer of property. In *Greene v. United States*,[312] the taxpayers formed a tax-exempt private foundation in the early 1970s. From 1974 to 1980, the taxpayers donated futures contracts to the institute and reported on their tax returns charitable contributions equal to the fair market value of the contracts at the time when they were donated.

The effect of the enactment of §1256 and §170 in 1981 on the taxpayers was that if they would continue donating their entire interest in futures contracts to the institute, they would only be entitled to claim a charitable deduction for 60% of the contracts' fair market value — the amount equal to the long-term gain portion. To avoid this result, the taxpayers changed the manner in which they made their contributions and conveyed only the "right, title and interest in the long term capital gain of the futures contracts" to the institute, specifically retaining the short-term capital gain. The contracts were then transferred to a special account held with Merrill Lynch and were sold the same day or shortly after each gift was made. The part of the proceeds representing the long-term capital gains was transferred to the institute's account, and the part representing the short-term capital gains was transferred to taxpayer's personal account. The taxpayers reported and paid income taxes on the short-term capital gains and took a deduction for their charitable donation of the long-term capital.

The government argued that under the step transaction doctrine, the taxpayers' donation of appreciated futures contracts should be disregarded, and the transaction should be treated as a sale by the taxpayers of the contracts followed by a gift of a portion of the cash proceeds to the tax-exempt foundation. The Second Circuit applied the end result and interdependence tests (two of the three alternative tests, which are discussed in greater detail below), and disagreed with the Government. The Second Circuit first indicated that:

> [t]he doctrine treats the steps in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan.[313]

The Second Circuit, however, found that the end-result test was inapplicable because it found no evidence that a prearranged plan to dispose of the futures contract existed at the time of donation. In addition, the Second Circuit found that the two steps were independent from each other. Thus, the Second Circuit held for the taxpayer.

Comment: Courts have generally held that there are two prerequisites for applying the step transaction doctrine: (i) the substance of the transaction must differ from the form, and (ii) such a difference has to be viewed as abusive for tax purposes.

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[305] *MAS One LP v. United States*, 271 F. Supp.2d 1061 (S.D. Ohio 2003), aff'd, 390 F.3d 427 (6th Cir. 2004) ("The step transaction doctrine is inapplicable in this case because the substance and the form of the transactions in question do not differ in any meaningful way."); *Tracinda Corp. v. Commissioner*, 111 T.C. 315, 326 (1998) ("in order to apply either the substance-over-form doctrine or the step-transaction doctrine, we must determine that the substance of the transaction differs from its form."). *See also* FAA 20123401F (where substance of installment sale followed by loan monetizing installment sale notes was determined to be consistent with form, step transaction doctrine did not apply).

[306] *Minn. Tea Co. v. Helvering*, 302 U.S. 609 (1938) ("The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time."). *See also Commissioner v. Clark*, 489 U.S. 726 (1989).

[307] *D'Angelo Assocs., Inc. v. Commissioner*, 70 T.C. 121, 129 (1978) ("Where a series of closely related steps are taken pursuant to a plan to achieve an intended result, the transaction must be viewed as an integrated whole for tax purposes."); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 98, *aff'd in part and rem'd in part*, 331 F.3d 972 (D.C. Cir. 2003) ("Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result.").

[308] *Del Commercial Props., Inc. v. Commissioner*, 251 F.3d 210, 213–14 (D.C. Cir. 2001), aff'g T.C. Memo 1999-411 ("a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes."); *Grove v. Commissioner*, 490 F.2d 241, 246 (2d Cir. 1973) (the step transaction doctrine applies to "meaningless intervening steps in a single, integrated transaction designed to avoid tax liability by the use of mere formalisms.").

[309] *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 658 (5th Cir. 1968) ("a tax-free exchange cannot be transformed into two sales by the arbitrary separation of time and exchange of cash."). *See also IRS Chief Counsel Offers Historical Overview of Shelters*, 2005 TNT 29-61 ("A business transaction often does not have a sharply defined beginning or ending. One step in a transactional sequence often bears a strong relationship to that which came before it and that which follows it. For analytical purposes, however, it is often necessary to examine a transaction as an organic whole. To that end, the IRS and courts often fuse formally separate transactional steps to determine the tax consequences of the overall transaction.").

[310] 78 T.C. 350, 389 (1982).

[311] *See also Andantech, LLC v. Commissioner*, T.C. Memo 2002-97 at 97 (quoting *Smith v. Commissioner*).

[312] *Greene v. United States*, 13 F.3d 577 (2d Cir. 1994).

[313] *Id.* at 583.

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2. Application of the Step Transaction Doctrine

As a practical matter, if a court finds that applying the step transaction doctrine is appropriate it can either (i) disregard transactions or steps in a transaction that it believes are unnecessary,[314] or (ii) change the order of such transactions or steps.[315] In most cases, the former action is made, and several transactions or steps are integrated into a single transaction.[316] On the other hand, as the Tax Court has indicated, the IRS may not "generate events which never took place just so an additional tax liability might be asserted."[317] Thus, as the Government has indicated:

> As a general rule, courts have held that in order to collapse a transaction, the Government must have a logically plausible alternative explanation that accounts for all the results of the transaction.[318]

Because the step transaction doctrine is a variation of the substance-over-form doctrine, courts have generally held that the taxpayer's ability to invoke the step transaction doctrine by challenging its own transaction steps is limited, in accordance with the Danielson or "strong proof" standards discussed herein.[319] Nevertheless, although in most cases the Government raises the step transaction doctrine to disallow tax benefits, several courts have held that the taxpayer is allowed to use the doctrine as well.[320] In *MAS One LP v. United States*,[321] the court held that: "the step transaction doctrine is not merely a method preventing tax avoidance, but can also be used for a taxpayer's benefit."[322]

In some instances, taxpayers enter into a series of steps or transactions, each of which might be valid under the economic substance and/or business purpose tests. Several courts have held that the existence of business purposes and economic substance for each individual step in a series of steps or transactions does not preclude the application of the step transaction doctrine.[323] As the Tenth Circuit explained in *True v. United States*:

> To ratify a step transaction that exalts form over substance merely because the taxpayer can either (1) articulate some business purpose allegedly motivating the indirect nature of the transaction or (2) point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle. Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus, we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.[324]

Nevertheless, other courts have refused to collapse a series of steps or transactions if all of them had legitimate tax consequences.[325] In *Vest v. Commissioner*,[326] the taxpayers organized a corporation for the purpose of correcting certain title problems in some land interests and to develop the mineral interests in the land. At the time of incorporation, the taxpayers were unaware that an exchange of stock was being contemplated between the formed corporation and an unrelated corporation that was interested in a lease of the oil and gas rights on the taxpayers' land. The corporation was incorporated on July 21, 1965, and on August 25, 1965 it signed a plan of reorganization with the unrelated party that provided for an exchange of stock. The corporation did not engage in any business operations and was dissolved shortly after the reorganization occurred. Despite the

[314] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 98.

[315] *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) ("To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.").

[316] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 98. *See also CNT Investors, LLC v. Commissioner*, 144 T.C. No. 11 (2015) ("'[I]n cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C,' we apply the step transaction doctrine to ignore the interim stops, not to return the taxpayer to point A.") (quoting *Smith v. Commissioner*, 78 T.C. 350, 389 (1982)).

[317] *Grove v. Commissioner*, 490 F.2d at 247 ("[u]seful as the step transaction doctrine may be … it cannot generate events which never took place just so an additional tax liability might be asserted."); *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988) (citing *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973) and quoting *Sheppard v. United States*, 361 F.2d 972 (Ct. Cl. 1966)); *Greene v. United States*, 13 F.3d at 583 ("Of course, the [step transaction] doctrine cannot manufacture facts that never occurred to create an otherwise nonexistent tax liability.").

[318] *Coordinated Issue Paper Addresses Partnership Straddle Tax Shelters*, 2005 TNT 91-27 (May 9, 2005) citing *Del Commercial Props., Inc. v. Commissioner*, 251 F.3d at 213–14; *Penrod v. Commissioner*, at 1428–30; *Tarcinda Corp. v. Commissioner*, 111 T.C. at 327. Effective Jan. 21, 2014, all current Coordinated Issue Papers are decoordinated, and any guidance or tools relevant to addressing an issue or transaction that were provided in a Coordinated Issue Paper will be made available through LB&I directives or other guidance. The decoordination of any coordinated issue has no effect on whether the issue will continue to be pursued by LB&I in a taxpayer examination or on the IRS's views regarding any transaction, including listed transactions. LB&I-04-0114-002 (Jan. 21, 2014).

[319] *Estate of Durkin. v. Commissioner*, 99 T.C. 561, 573 (1992).

[320] *S. Bay Corp. v. Commissioner*, 345 F.2d 698, 703 (2d Cir. 1965) ("The 'step analysis' of transactions does not operate in terms of an estoppel of taxpayers to deny the forms of their transactions but in terms of the reality of the transactions.").

[321] 271 F. Supp.2d 1061 (S.D. Ohio 2003), aff'd, 390 F.3d 427 (6th Cir. 2004).

[322] *Id.* (citing *Commissioner v. Clark*, 489 U.S. at 738 (applying the step transaction doctrine to reject the "counterintuitive conclusion urged by the Commissioner.")).

[323] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 97–98 ("The existence of business purposes and economic effects relating to the individual steps in a complex series of transactions does not preclude application of the step transaction doctrine.") (citing *True v. United States*, 190 F.3d 1165 1176–77 (10th Cir. 1999)).

[324] *True v. United States*, 190 F.3d at 1176–77 ("To ratify a step transaction doctrine that exalts form over substance merely because the taxpayer can … point to an economic effect resulting from the series of steps, would frequently defeat the purpose of the substance over form principle."); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1526–27). *See also Long Term Capital Holdings v. United States*, 150 Fed. Appx. 40 (2d Cir. 2005) ("any economic effects that may have resulted from the partnership do not preclude the imposition of the step transaction doctrine.").

[325] *MAS One LP v. United States*, 271 F. Supp.2d 1071 (S.D. Ohio 2003), aff'd 390 F.3d 427 (6th Cir. 2004).

[326] 57 T.C. 128 (1971), aff'd in part and rev'd in part on other grounds, 481 F.2d 238 (5th Cir. 1973).

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close proximity of the incorporation to the exchange of stock, the Tax Court held that the step-transaction doctrine was inapplicable because there was a business purpose for the formation of the corporation, (i.e., to develop the mineral rights of the taxpayers' properties and to resolve the title problems inherent in those properties).

Similarly, the district court in *MAS One Limited* indicated that:

> MAS One makes no attempt to avoid taxation in this case by focusing on isolated steps of a transaction rather than a whole transaction. Instead, each of the "steps" of Midland's divestment of its interest in the Partnership had its own legitimate tax consequences. In fact, the tax consequences of each step of the transaction would be the same regardless of whether the Court views the transaction as a whole or as a series of isolated steps.[327]

Comment: It appears that the meaning of the phrase "legitimate tax consequences" for this purpose is that each "step," standing alone, had economic substance and business purpose. The court, therefore, refused to apply the step transaction and disregard the separate steps. Under this approach, the step transaction doctrine is inapplicable whenever the taxpayer can show that each step could sustain the economic substance examination. This could be viewed as a variation on the bifurcation approach, as discussed in greater detail below.

3. The Three Alternative Threshold Tests

The courts have articulated three different threshold tests for determining when it is appropriate to apply the step transaction doctrine:

- The "binding commitment" test;
- The "end result test"; and
- The "mutual interdependence" test.[328]

Frequently, courts applying the step transaction doctrine have applied more than one of these three tests.[329] The IRS has applied all three of these tests in applying the step transaction doctrine.[330] Some courts, however, have determined that the government can satisfy *any* of the above standards in order for the step transaction doctrine to operate.[331] As the Tax Court indicated in *Associated Wholesale Grocers v. United States*:[332]

> More than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate.

Comment: Satisfying only one of the alternative tests may not be enough for the government to prevail.[333] Frequently, courts conclude that more than one of the alternative tests should be satisfied in determining whether the steps ought to be collapsed under the step transaction doctrine.[334]

a. The Binding-Commitment Test

Under the binding commitment test, separate steps will be collapsed into a single transaction only if, at the time the first step takes place, the taxpayer was under a *commitment* to complete the remaining steps.[335] Stated differently, "[i]f there were a moment in the series of the transactions during which the parties were not under a binding obligation, the steps cannot be collapsed under this test."[336]

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[327] *MAS One LP v. United States*, 271 F. Supp.2d 1061 (S.D. Ohio 2003), aff'd, 390 F.3d 427 (6th Cir. 2004).

[328] *True v. United States*, 190 F.3d at 1174–75 ("Courts have developed three tests for determining when the step transaction doctrine should operate to collapse the individual steps of a complex transaction into a single integrated transaction for tax purposes: (1) end result, (2) interdependence, and (3) binding commitment."); *Redding v. Commissioner*, 630 F.2d at 1175 ("The commentators have attempted to synthesize from judicial decisions several tests to determine whether the step transaction doctrine is applicable to a particular set of circumstances in order to combine a series of steps into one transaction for tax purposes."); *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d 520, 524 (7th Cir. 1982) (citing *Redding v. Commissioner*); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1244–45; *Cornfeld v. Commissioner*, 137 F.3d 1231, 1235 (10th Cir. 1998), aff'g T.C. Memo 1996-472; *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517 (10th Cir. 1991)); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 99–100 (citing *Penrod v. Commissioner*, 88 T.C. at 1428–30).

[329] *True v. United States*, 190 F.3d at 1175 ("More than one test might be appropriate under any given set of circumstances."). *See also Greene v. Commissioner*, 13 F.3d 577 (2d Cir. 1994) (the Second Circuit applied the end result and interdependence tests and held that under both tests, the step transaction should not apply); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97 (the Tax Court applied the end result and interdependence tests and held that under either test, the steps should be collapsed into a single transaction).

[330] *See* CCA 200826004 (after finding that all three tests had been satisfied, IRS concluded that payment of full list price with subsequent repayment of spread between list price and negotiated discount price should be treated as single transaction).

[331] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97 ("the circumstances need only satisfy one of the tests in order for the step transaction doctrine to operate." citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1527–28); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d at 193–94 (The government contended that under either the end result test or the interdependence test, OTC's contributions of preferred stock to LTCP in exchange for a partnership interest and OTC's subsequent sale of that partnership interest to LTCM must be stepped together into a single sale transaction with the result that LTCM acquired the preferred stock for a cost basis pursuant to §1012. The court agreed that this result follows from application of the end result test and therefore did not undertake an application of the interdependence test). *Cf. Redding v. Commissioner*, 630 F.2d at 1178 ("the lack of 'binding commitment' is simply one factor to which we give appropriate consideration here. Certainly, it is not necessary for us to rely on this factor to reach our result.").

[332] 927 F.2d 1517 (10th Cir. 1991) (finding end result test inappropriate but applying the step transaction doctrine using the interdependence test). *See also Greene*, 13 F.3d at 583–85 (finding both end result test and interdependence test inapplicable).

[333] *Redding v. Commissioner*, 630 F.2d at 1178 ("the lack of 'binding commitment' is simply one factor to which we give appropriate consideration here. Certainly, it is not necessary for us to rely on this factor to reach our result.").

[334] *See Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 99–100 (applying both the end result and interdependence tests).

[335] *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968) (the step transaction doctrine should not apply unless "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps."); *Penrod v. Commissioner*, 88 T.C. at 1428–30; *Redding v. Commissioner*, 630 F.2d at 1178; *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 525; *King Enters., Inc. v. United States*, 418 F.2d at 517–18; *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1245 ("Thus the 'binding commitment' test requires telescoping several steps into one transaction only if a binding commitment existed as to the second step at the time the first step was taken."); *Merrill Lynch & Co. v. Commissioner*, 120 T.C. 12, 95–100 (2003), aff'd in part and remanded in part on other issue, 386 F.3d 464 (2d Cir. 2004).

[336] *Coordinated Issue Paper Addresses Partnership Straddle Tax Shelters*, 2005 TNT 91-27 (May 9, 2005) citing *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004). Effective Jan. 21, 2014, all current Coordinated Issue Papers are decoordinated, and any guidance or tools rele-

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As the Tax Court indicated in *Andantech LLC v. Commissioner*, this standard is the most rigorous standard of the three:

> The purpose of the binding commitment test is to promote certainty in tax planning; it is the most rigorous limitation of the step transaction doctrine. It is seldom used and is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny.[337]

Thus, when the steps are more closely related in time, courts may refuse to apply the binding commitment test.[338] As indicated by the Tax Court in *Penrod v. Commissioner*, "there have been objections to [the binding commitment] test on the ground that the result is easily manipulable by taxpayers."[339] The Fifth Circuit has elaborated in *Sec. Indus. Ins. Co. v. United States* that:

> Subsequent decisions, however, have tended to confine *Gordon* [391 U.S. 83 (1961)] to its facts. The Seventh Circuit, for example, has concluded that lack of a "binding commitment" should be determinative only in cases involving multiyear transactions; in other situations, the presence or absence of a "binding commitment" is simply one factor to be considered.[340]

As a result, the binding commitment test is seldom used.[341] By definition, a court applying the binding commitment test will normally search for a formal commitment, typically in the form of an agreement between the parties to complete the remaining steps.[342] Nevertheless, the existence of a formal agreement is not a prerequisite; the Tax Court has held in *Merrill Lynch & Co. v. Commissioner* that:

> [a] binding commitment or even an agreement in principle that each step of a plan will occur is not a prerequisite for finding that a firm and fixed plan existed, although uncertainty regarding one or more steps of the plan is a factor we must consider.[343]

b. The End-Result Test

Separate steps will also be integrated if they are a part of a single scheme designed to achieve a single result.[344] As the Court of Claims indicated, the step transaction doctrine should apply to "purportedly separate transactions … [that] were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[345] The end result test combines separate steps or events that appear to be components of an action undertaken to reach a particular result into a single transaction.[346] Accordingly, under the end result test, if a court finds that a series of closely related steps or events is merely the means to achieve a particular end result, it treats the steps as a single transaction.[347]

The end result test is the test most often invoked in connection with the step transaction doctrine.[348] As the Tax Court indicated in *Andantech LLC v. Commissioner*:

> Under the end result test, there is no independent tax recognition of the individual steps unless the taxpay-

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vant to addressing an issue or transaction that were provided in a Coordinated Issue Paper will be made available through LB&I directives or other guidance. The decoordination of any coordinated issue has no effect on whether the issue will continue to be pursued by LB&I in a taxpayer examination or on the IRS's views regarding any transaction, including listed transactions. LB&I-04-0114-002 (Jan. 21, 2014).

[337] *See Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 100–101 (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1522, n. 6 (rejecting the use of the binding commitment test because the case did not involve a series of transactions spanning several years)); *Penrod v. Commissioner*, 88 T.C. at 1428–30 ("The narrowest alternative is the 'binding commitment' test, under which a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step."); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1245 ("The third and most restrictive test permitting invocation of the step transaction doctrine is the 'binding commitment' test."); *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 525.

[338] *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 525 ("the 'binding commitment' test is the most rigorous limitation on the step-transaction doctrine because it was formulated to deal with the characterization of a transaction that in fact spanned several tax years and could have remained not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen." Citing *Commissioner v. Gordon*, 391 U.S. at 96); *CNT Investors, LLC v. Commissioner*, 144 T.C. No. 11 (2015) ("Because all steps here occurred within little over one month, the binding commitment test is likely inappropriate to these circumstances"). *Cf. Redding v. Commissioner*, 630 F.2d at 1178 ("We cannot say that the Court intended that the failure to satisfy the test in the circumstance of a much shorter period would automatically preclude application of the step transaction doctrine. Hence, the lack of 'binding commitment' is simply one factor to which we give appropriate consideration here. Certainly, it is not necessary for us to rely on this factor to reach our result.").

[339] *Penrod v. Commissioner*, 88 T.C. at 1428–30 (citing *King Enters., Inc. v. United States*, 418 F.2d at 518 ("the step transaction doctrine would be a dead letter if restricted to situations where the parties were bound to take certain steps." (emphasis in original)).

[340] *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1245 (citing *King Enters., Inc. v. United States*, 418 F.2d at 517–18 and *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 525).

[341] *Cornfeld v. Commissioner*, 137 F.3d at 1235, *aff'g* T.C. Memo 1996-472 (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1522, n. 6).

[342] *Penrod v. Commissioner*, 88 T.C. at 1429.

[343] *Merrill Lynch & Co. v. Commissioner*, 120 T.C. 12, 100 (2003), aff'd in part and remanded in part on other issue, 386 F.3d 464 (2d Cir. 2004). *See also Roebling v. Commissioner*, 77 T.C. 30, 49 (1981) (We do not believe the requirement of a firm and fixed plan for redemptions need be as rigid under the circumstances here involved."); *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 525 ("The Tax Court found the test unsatisfied because the Garb-Stern group was not legally obliged to sell its McDonald's stock. We think it misconceived the purpose of the test and misapplied it to the facts of this case.").

[344] *Cornfeld v. Commissioner*, 137 F.3d at 1235; *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 524; *King Enters. Inc. v. United States*, 418 F.2d at 516–18. *See also* Bowen, "The End Result Test," 72 Taxes 722 (1994).

[345] *King Enters. Inc. v. United States*, 418 F.2d at 516–18. *See also McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 524 (citing *King Enters.*); *Redding v. Commissioner*, 630 F.2d at 1175 ("one of the tests which the parties ask us to consider is the 'end result' test, whereby purportedly separate transactions will be amalgamated into a single transaction when it appears that the successive steps were made 'in furtherance of, and for the purpose of executing and putting into effect, the plan of reorganization.'"); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1244 (citing *King Enters.*).

[346] *Greene v. United States*, 13 F.3d at 583 ("Under the end result test, the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result."); *Cornfeld v. Commissioner*, 137 F.3d at 1235 ("The 'end result' test amalgamates into a single transaction separate events which appear to be component parts of something undertaken to reach a particular result," citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1523).

[347] *Minn. Tea Co. v. Helvering*, 302 U.S. 609 (1938).

[348] *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1244. *See also Penrod v. Commissioner*, 88 T.C. at 1429 ("At the other extreme [of the binding commitment test], the most far-reaching alternative is the 'end result' test.").

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> er shows that at the time the parties engaged in the individual step, its result was the intended end result in and of itself… If this is not what was intended, then we collapse the series of steps and give tax consideration only to the intended end result. The doctrine derives vitality, rather, from its application where the form of a transaction does not require a particular further step be taken; but, once taken, the substance of the transaction reveals that the ultimate result was intended from the outset.[349]

Similar to the binding commitment test, "a prerequisite to application of the end result test is, therefore, a proof of an agreement or understanding between the transacting parties to bring about the ultimate result."[350] As the Tax Court indicated in *Packard v. Commissioner*:[351]

> Where an interrelated series of steps are taken pursuant to a *plan* to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole.[352] (emphasis added)

The difference between the two tests, however, is that while the binding commitment test is an objective test, the end result test is a subjective test because it focuses on the parties' actual intent at the time the transaction was entered into.[353] Nevertheless, as opposed to the business purpose test, where the court focuses on the taxpayer's *intent to avoid taxes*, a court applying the end result focuses on a different intention, namely the *intent to reach the end result*. As the Tenth Circuit indicated in *True v. United States*:

> The intent we focus on under the end result test is not whether the taxpayer intended to avoid taxes … . Instead, the end result test focuses on whether the taxpayer intended to reach a particular result by structuring a series of transactions in a certain way.[354]

The Tenth Circuit further elaborated that:

> [w]e emphasize that under the end result test, our focus is not on the legitimacy of the intended result, but instead on whether the taxpayer undertook multiple steps to achieve a particular result. Thus, if a taxpayer engages in a series of steps that achieve a particular result, he cannot request independent tax recognition of the individual steps unless he shows that at the time he engaged in the individual step, its result was the intended end result in and of itself. If this is not what the taxpayer intended, then we collapse the series of steps and only give tax consideration to the intended end result.[355]

Thus, the parties' intent for each event is examined separately, and if the intent of the parties pertaining to a particular event is that such an event will merely serve as another step in achieving an end result, the court will disregard the event.[356]

c. The Mutual-Interdependence Test

Pursuant to the third alternative test, separate steps will be collapsed if, under a reasonable interpretation of the objectively stated facts, the steps are interdependent on one another.[357] Stated differently, under the mutual interdependence test, the step transaction doctrine applies if "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[358]

Thus, as opposed to the end result test, the mutual interdependence test concentrates on the relationship between the steps, rather than on their "end result."[359] The court must, therefore, examine whether the individual steps or events have independent significance or merely have meaning as part of the larger transaction.[360] Accordingly, if the steps have "reasoned economic justification standing alone," then applying the mutual interdependence test is inappropriate.[361] By contrast, when "it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts … step trans-

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[349] *See Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 101–03 (citing *King Enters., Inc. v. United States*, 418 F.2d at 518).

[350] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (citing *Greene v. United States*, 13 F.3d at 583 ("For the government's characterization of the transaction to be accurate, the record facts would have to demonstrate that a prearranged plan for disposition of the futures contracts existed.")).

[351] 85 T.C. 397 (1985).

[352] *Id.* at 420.

[353] *True v. United States*, 190 F.3d at 1175 ("The taxpayer's subjective intent is especially relevant under this test because it allows us to determine whether the taxpayer directed a series of transactions to an intended purpose."); *Brown v. United States*, 782 F.2d 559, 563 (6th Cir. 1986) ("end result test" for determining when to apply "step transaction doctrine" makes intent a necessary element for application of doctrine).

[354] *True v. United States*, 190 F.3d at 1175.

[355] 190 F.3d at 1175, n. 9.

[356] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) ("Relevant to this inquiry is the taxpayer's subjective intent to reach a particular result by directing a series of transactions to an intended purpose or structuring them in a certain way," citing *True v. United States*, 190 F.3d at 1175). *See H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007) (application of end result test to disallow capital losses where subsidiary acquired parent's stock with intent of subsequent redemption) (citing *Falconwood Corp. v. United States*, 422 F.3d 1339, 1350 (Fed. Cir. 2005)).

[357] *Kass v. Commissioner*, 60 T.C. 218 (1973) ("The second 'test' for determining whether the step transaction doctrine applies is the so-called 'interdependence test,' which requires an evaluation whether on a reasonable interpretation of objective facts the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1244 ("A second test for determining whether the step transaction doctrine applies is labelled the 'interdependence' test. This test focuses on whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."); *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d at 524–25; *Cornfeld v. Commissioner*, 137 F.3d at 1235 ("The 'interdependence test' focuses on the relationship between the steps, whether under a reasonably objective view the steps were so interdependent that the legal relations created by one of the transactions seem fruitless without completion of the series." citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1523); *King Enters. Inc. v. United States*, 418 F.2d at 516 ("The 'interdependence test' requires an inquiry as to 'whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.'").

[358] *Redding v. Commissioner*, 630 F.2d at 1177; *True v. United States*, 190 F.3d at 1175 ("The interdependence test takes a slightly different approach. Under this test, we disregard the tax effects of individual transactional steps if 'it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts.'").

[359] *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1245.

[360] *Id. See also Penrod v. Commissioner*, 88 T.C. at 1429–30.

[361] *True v. United States*, 190 F.3d at 1178 (citing *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1247; *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 106).

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action treatment may be deemed appropriate."[362] In order to apply the mutual interdependence test objectively, courts may compare the disputed transaction with those usually expected to occur in otherwise bona fide business settings.[363]

The interdependence test has been applied frequently in cases involving corporate transactions.[364] For example, in *Kuper v. Commissioner*,[365] shareholders of a realty-owning corporation contributed all of their shares to an automobile dealership corporation owned by the same shareholders, which, in turn, made a cash capital contribution on the same day to the realty corporation, and on the following day the automobile corporation exchanged the realty corporation's shares for one stockholder's one-third ownership of the automobile corporation. The Fifth Circuit affirmed the Tax Court's finding that these steps were mere steps to disguise a stock-for-stock transaction at the shareholder level, and therefore it treated the steps as a taxable exchange of stock.[366]

4. The Timing Difference Between Each Step

As set forth herein, the essence of the step-transaction doctrine involves evaluating whether several steps, typically made within a short period, ought to be collapsed into a single transaction.[367] The Tax Court held that lapse of time between each step may indicate whether such steps ought to be collapsed under the step transaction doctrine.[368]

In *Litton Indus. v. Commissioner*,[369] a target corporation paid a dividend to its sole shareholder prior to its acquisition by a third party. The Tax Court held that the dividend and acquisition constituted two separate transactions rather than a single transaction, partially on the grounds that a period of six months had elapsed between the dividend and the subsidiary's purchase. The Tax Court also indicated, however, that that at the time of dividend, the sale was not prearranged.

In contrast, in *Waterman S.S. Corp. v. Commissioner*,[370] all of the steps took place within one hour and a half. As a result, the court collapsed the steps, applying the step transaction doctrine.[371] Similarly, in *D'Angelo Assocs., Inc. v. Commissioner*,[372] the Tax Court held that:

> Petitioner has failed to convince us that a sale took place. The events significant to the creation of petitioner occurred almost simultaneously. The formation of petitioner, the transfer of $15,000 cash to petitioner for the issuance of 60 shares of stock, and the transfer of the rental property to petitioner for the return of the $15,000 in cash and the notes all occurred within an interval of less than 10 days. See sec. 1.351-1(a)(1), Income Tax Regs. The evidence demonstrates that these steps were integral parts of a plan designed by [the taxpayer] to transfer the assets used primarily in his dental practice from individual to corporate ownership.

Comment: As discussed herein, the lapse of time between the steps is also relevant for determining which alternative test is to be applied. In the case the steps took place within a relatively long period, the IRS may attempt to apply the binding commitment test, pursuant to which steps might be collapsed into a single transaction even if the time lapsed between each step is long.[373]

E. Business Purpose

The business purpose doctrine predated the economic substance doctrine.[374] Courts and commentators generally agree that the "original" business purpose doctrine was the doctrine applied by the Supreme Court in *Gregory v. Helvering* and subsequent cases, and that until *Frank Lyon Co. v. United States*, it had stood on its own.[375] In early cases, therefore, courts con-

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[362] *Sec. Indus. Ins. Co. v. United States*, 702 F.2d at 1245; *Kuper v. Commissioner*, 533 F.2d at 156 ("[the step transaction] approach is especially proper where, as here, it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts, all of which when seen together substantively form a taxpayer level stock swap.").

[363] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 106 ("In order to maintain this objectivity and ensure the steps have independent significance, it is useful to compare the transactions in question with those usually expected to occur in otherwise bona fide business settings." (citing *Merryman v. Commissioner*, 873 F.2d 879, 881 (5th Cir. 1989), aff'g T.C. Memo 1988-72)).

[364] *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517 (10th Cir. 1991) (merger and reorganization followed by transfer of subsidiary treated as complete liquidation); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983) (acquisitions and reorganizations followed by transfer treated as complete liquidations); *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982) (merger and stock transfer followed by sale of stock treated as liquidation); *S. Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1965) (purchase of controlling interest in corporations followed by merger into principal corporation treated as purchase by principal corporation of controlling interests); *King Enters. Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969) (stock acquisition followed by merger treated as reorganization); *H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007) (on application of interdependence test, subsidiary's acquisition of parent's stock with intent of subsequent redemption treated as parent acquiring stock from third party).

[365] 533 F.2d 152 (5th Cir. 1976).

[366] *Id.*

[367] *See generally Andantech, LLC v. Commissioner*, T.C. Memo 2002-97.

[368] *D'Angelo Assocs., Inc. v. Commissioner*, 70 T.C. 121, 129 (1978). *See also* Reg. §1.368-2(c), pursuant to which the step transaction doctrine may apply if the relevant steps take place "over a relatively short period of time such as twelve months."

[369] 89 T.C. 1086 (1987).

[370] 50 T.C. 650 (1968), rev'd, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971).

[371] *Cf. Uniroyal v. Commissioner*, 65 T.C.M. 2690 (1993) (the steps took place closely in time, but the court did not collapse them).

[372] *D'Angelo Assocs., Inc. v. Commissioner*, 70 T.C. at 129.

[373] *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 100–101 (citing *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1522, n. 6 (rejecting the use of the binding commitment test because the case did not involve a series of transactions spanning several years)).

[374] *IRS v. CM Holdings*, 301 F.3d at 102, n. 4 ("Th[e] subjective inquiry [of the two prong test] appears to be an heir to the 'business purpose' requirement applied in early cases. *See Gregory v. Helvering*, 293 U.S. at 467. Whether it is a direct descendent, it does play the same basic role of evaluating whether the taxpayer had a business reason, aside from tax avoidance, for engaging in the transaction."); *ACM P'ship v. Commissioner*, T.C. Memo 1997-115, at 106, ("The [United States Supreme] Court [in *Gregory v. Helvering*] stressed that the transaction had 'no business or corporate purpose'… In the 60 years since the U.S. Supreme Court first expounded this doctrine of 'business purpose', the doctrine's application has proved a perennial challenge to the courts to set boundaries between acceptable tax planning and abuse, while taking into account the importance of maintaining public confidence in the integrity of the tax system.").

[375] *Weller v. Commissioner*, 270 F.2d at 297 (The Third Circuit observed that "the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally." Accordingly, the Third Circuit concluded that "interest payments are not deductible where the underlying transaction has no purpose other than tax avoidance."). *See also* Wolfman, *Why Economic Substance is Better Left Uncod-*

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sidered *economic substance* part of a broader business purpose standard.[376]

In *Brooke v. United States*,[377] the Government relied on the business purpose doctrine to deny the taxpayer's benefits from the transaction. Citing *Gregory v. Helvering*, the court concluded that "[A] transfer solely to avoid taxes will not be recognized."[378]

On the other hand, as early as 1957, the business purpose doctrine was criticized by the Second Circuit in *Nassau Lens Co. v. Commissioner*:

> A cautious approach in this particular area of tax law is not entirely unjustified. To have each case turn solely on the existence or lack of a business purpose might ultimately involve the courts in inquiries as to what is a justifying business purpose and what is not. And since a law taxing a practice is often little different from a law prohibiting it, the result might be a degree of ad hoc judicial regulation of business practices without legislative guidance.[379]

Consistent with *Frank Lyon Co. v. United States*[380] and subsequent cases set forth herein applying the two-prong test, the economic substance doctrine, codified on March 30, 2010, incorporates the business purpose test.[381] Specifically, since the United States Supreme Court's decision in *Frank Lyon*, courts have explicitly held that the subjective leg of the economic substance doctrine has become the business purpose doctrine.[382] As discussed in greater detail herein, the subjective prong of the economic substance doctrine looks to the taxpayer's expectations and motives.[383] The determination of what constitutes a legitimate business purpose for entering into a transaction involves a subjective analysis of the taxpayer's intent.[384] Under the business purpose test, the court determines whether the taxpayers have shown that they had a business purpose for engaging in the transaction other than tax avoidance.[385] Put broadly, a transaction lacks business purpose if there is no independent non-tax purpose for the transaction (i.e., no benefit from the transaction apart from the desired tax consequences).[386]

As the district court illustrated in *Dow Chem. Co. v. United States*:

> The taxpayer's intent provides the context; to meet its burden, the taxpayer must articulate a legitimate business purpose for placing its assets at risk. For example, a taxpayer who states that it seeks to generate an immediate stream of current income but enters into a transaction which is structured to return only long-term gains will have a basic difficulty in proof.[387]

Nevertheless, the Eleventh Circuit in *United Parcel Serv. of Am., Inc. v. Commissioner* explicitly acknowledged that choosing one transaction form over another solely for tax purposes may still be valid.[388] As the Eleventh Circuit indicated:

> The Code treats lots of categories of economically similar behavior differently. For instance, two ways to infuse capital into a corporation, borrowing and sale of equity, have different tax consequences; interest is usually deductible and distributions to equity holders are not. There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a "business purpose." To conclude otherwise would prohibit tax-planning.

The Eleventh Circuit distinguished the facts in this case from the facts in other cases involving economic substance analysis on the grounds that "[m]any of the cases where no business purpose appears are about individual income tax returns, when the individual meant to evade taxes on income probably destined for personal consumption; obviously, it is difficult in such a case to articulate any *business* purpose to the transaction."[389] In addition, another group of cases that were

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ified, 104 Tax Notes 445 (July 26, 2004) ("The *Gregory* doctrine used to be known as the 'business purpose' doctrine, and often it still is.").

[376] *Zmuda v. Commissioner*, 731 F.2d at 1421 ("Economic substance may be an element of business purpose. A finding that 'no real change in the economic relation' between the parties occurred establishes that no partnership exists for business purposes.").

[377] 468 F.2d 1155, 1158 (9th Cir. 1972).

[378] *Id.* Citing *Gregory v. Helvering*, 293 U.S. at 466. *See also Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949) ("The doctrine of *Gregory v. Helvering*, …, which we here hold to be controlling, is not limited to cases of corporate reorganizations. It has a much wider scope; it means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.").

[379] *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 45 (2d Cir. 1962). The Second Circuit concluded in this case that "we have held that non-arm's-length loans by a stockholder to a corporation are to be recognized or disregarded for tax purposes according to the extent to which they comply with arm's-length standards, not the extent to which the taxpayer has a business purpose." *See also Fabreeka Products Co. v. Commissioner*, 294 F.2d 876, 878 (1st Cir. 1961) ("unless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple.").

[380] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[381] *See* §7701(o)(1)(B). *Accord* Senate Report on the JOBS Act of 2004, S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637) ("Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine") (hereinafter, "Senate Report (2004)").

[382] *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[383] *Bail Bonds v. Commissioner*, 820 F.2d at 1549 ("The business purpose factor often involves an examination of the subjective factors which motivated a taxpayer to make the transaction at issue.").

[384] *Kirchman v. Commissioner*, 862 F.2d at 1492.

[385] *Id. See also* Senate Report (2004) ("The business purpose test is a subjective inquiry into the motives of the taxpayer — that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose.").

[386] *United States v. Wexler*, 31 F.3d at 122 ("Where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes"). *See H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007) (no nontax business purpose where subsidiary acquired parent's stock with intent of subsequent redemption to produce capital losses).

[387] *Dow Chem. Co. v. United States*, 250 F. Supp.2d at 799 (E.D. Mich. 2003).

[388] 254 F.3d 1014, 1019 (11th Cir. 2001). *Accord Austin v. Commissioner*, T.C. Memo 2017-69 (revising a business structure in response to a change in tax law, while in a sense tax-motivated, is a legitimate business purpose; rejecting argument that ESOP structure lacked economic substance because other options existed), *aff'd sub nom. Estate of Kechijian v. Commissioner*, 962 F.2d 800 (4th Cir. 2020), petition for rehearing and rehearing en banc *denied*, No. 18-2277, 2020 BL 322332 (4th Cir. Aug. 21, 2020).

[389] *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1019 (11th Cir. 2001) (citing for this view *Gregory v. Helvering*, 293 U.S. 465 (1935); *Knetsch v. United States*, 364 U.S. 361 (1960); *Neely v. United States*, 775 F.2d 792 (9th Cir. 1985) (taxpayers formed a trust, controlled by them, and diverted personal earnings to it)).

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identified by the Eleventh Circuit as having no business purpose were "tax-shelter transactions or investments by a business or investor that would not have occurred, *in any form*, but for tax-avoidance reasons."[390] (emphasis in original)

The Eleventh Circuit concluded that:

> The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive. True, UPS's restructuring was more sophisticated and complex than the usual tax-influenced form-of-business election or a choice of debt over equity financing. But its sophistication does not change the fact that there was a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure. We therefore conclude that UPS's restructuring of its excess-value business had both real economic effects and a business purpose, and it therefore under our precedent had sufficient economic substance to merit respect in taxation.[391]

The business purpose standard is also contained in various other statutory and regulatory provisions. For example, pursuant to §269, the IRS may disallow a tax benefit resulting from an acquisition of control in a corporation, or certain acquisitions of property from a non-controlled corporation, when the acquisition's *principal purpose* is to evade or avoid federal income tax.[392]

Section 269(a) provides that (i) if: (x) any person or persons acquire control of a corporation, or (y) any corporation acquires property of another corporation not controlled directly or indirectly immediately before such acquisition by the acquiring corporation or its shareholders and the acquiring corporation's basis in such property is determined by reference to its basis in the hands of the transferor corporation; (ii) with the principal purpose of avoiding federal income tax; (iii) by securing the benefit of a deduction, credit or other allowance; (iv) which such person would not otherwise enjoy, then the Treasury may disallow such deduction, credit or allowance. "Control" means possession of at least 50% of the combined voting power of all classes of stock entitled to a vote or at least 50% of the total value of all classes of stock in the acquired corporation. A taxpayer's principal purpose is to evade or avoid tax if such purpose "exceeds in importance any other purpose" for the acquisition.[393]

Similarly, §357(b) incorporates the "principal business purpose test" in the context of assumption of liabilities in a reorganization.[394]

In *Coltec Indus. Inc. v. United States*,[395] the IRS tried to invoke the §357(b)(1) anti-abuse provision (the rule that treats a liability assumption otherwise falling under the §357(a) general nonrecognition rule as "money received" if it appears that the taxpayer's principal purpose in assuming the liability was to avoid federal income tax or was not a bona fide business purpose). The Federal Circuit determined that the anti-abuse provision was irrelevant to the facts of the case, because §357(b)(1) is an exception to the operation of §357(a) and does not affect the strictly definitional reference to §357(c)(3) in §358(d)(2).[396]

However, despite agreeing with the taxpayer on all matters of statutory interpretation, the Federal Circuit vacated the taxpayer-favorable Court of Federal Claims decision on the basis that the transaction lacked economic substance. The Federal Circuit explained that the economic substance doctrine is a judicial tool to execute the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits are not obtained based on transactions lacking in economic substance.[397]

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[390] *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1020 (11th Cir. 2001) (citing for this view *ACM P'ship v. Commissioner*, 157 F.3d at 252; *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Karr v. Commissioner*, 924 F.2d at 1023; *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 91).

[391] *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1020 (11th Cir. 2001). *See also Compaq Computers Corp. v. Commissioner*, 113 T.C. at 224 ("[The business purpose] inquiry takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction." (citing *UPS of Am. v. Commissioner*, T.C. Memo 1999-268)).

[392] §269(a). A comprehensive discussion on §269 is beyond the scope of this Portfolio. For a discussion on the application of §269, see 750 T.M., *Corporate Overview*.

[393] Reg. §1.269-3(a)(2).

[394] Under §357(a):

> if (1) the taxpayer receives property which would be permitted to be received under §351 or §361 without the recognition of gain if it were the sole consideration, and (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of §351 or §361, as the case may be.

Under §357(b)(1):

> If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a): (A) was a purpose to avoid Federal income tax on the exchange, or (B) if not such purpose, was not a bona fide business purpose, then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of §351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.

Thus, §357(b), provides that in determining the principal purpose of the taxpayer there should be taken "into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made." *See Drybrough v. Commissioner*, 376 F.2d at 354–55. A comprehensive discussion on §357(b) is beyond the scope of this Portfolio. For a comprehensive discussion on §357(b), see 758 T.M., *Transfers to Controlled Corporations: In General.*

[395] 454 F.3d 1340 (Fed. Cir. 2006), vacating 62 Fed. Cl. 716 (2004), cert. denied, 127 S. Ct. 1261 (2007).

[396] The Federal Circuit explained that the Fourth Circuit in *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006), aff'g in part, rev'g in part and rem'g 340 F. Supp.2d 621 (D. Md. 2004), reached the "identical" conclusion regarding the anti-abuse provision "by a somewhat different interpretive path." In *WFC Holdings Corp. v. United States*, 728 F.3d 736 (8th Cir. 2013), cert. denied, 134 S. Ct. 2724 (2014), which was decided on business purpose principles, the court, citing *Coltec Indus., Inc.* and *Black & Decker*, held that §357(b) did not apply in determining stock basis under §358.

[397] 454 F.3d 1340 (Fed. Cir. 2006), vacating, 62 Fed. Cl. 716 (2004), cert. denied, 127 S. Ct. 1261 (2007).

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The business purpose doctrine requires that a taxpayer would have a business reason, other than avoidance of tax liability, for entering into a given transaction.[398] For example, in determining whether a taxpayer had a valid business purpose for entering into a transaction, taxpayers have successfully asserted that financial accounting benefits can satisfy the business purpose test.[399] As set forth in greater detail herein, a taxpayer may still prevail if it had tax considerations, even significant ones, so long as the taxpayer can show a non-tax purpose besides the tax motive.[400] As a consequence, one of the main practical controversies in applying the business purpose doctrine is determining the extent to which a business purpose must exist.[401] For example, if a particular transaction demonstrates a business purpose but also provides tax benefits, should this transaction pass the test? The JCT Report (2005)[402] suggested that "a taxpayer's non-tax purpose for entering into an applicable transaction must be *'substantial'*" (emphasis added) to satisfy the business purpose prong,[403] and the requirement that the taxpayer's non-tax purpose must be substantial was codified in §7701(o)(1)(B), effective for transactions entered into after March 30, 2010. The question of how much business purpose is enough is considered in V., below.

F. The Relationship Between the Economic Substance Doctrine and the Other Common Law Doctrines

An important feature of the common law doctrines discussed herein is that they overlap each other in many cases.[404] Most notably, courts frequently observe that the economic substance and sham transaction doctrines (in particular sham in substance, or substantive sham) contain similar features.[405] As the JCT Report (2005) indicated, the economic substance and sham transaction doctrines are "closely related doctrines" or even "interchangeable."[406]

As a consequence, it is not uncommon that a court decides to deny or not to deny benefits based on more than one doctrine.[407] Several courts have indicated that all of these doctrines serve a similar purpose, namely, to look beyond the form of the transaction and search for its economic reality.[408] For example, in *Coltec Indus.*, the court began by stating the principle that the economic substance doctrine is "a composite of the 'business purpose,' 'substance over form,' and 'sham transaction' doctrines."[409] Thus, in one sentence, the court collapsed all four common law doctrines into a single standard.

It has generally been accepted that the substance-over-form doctrine created by the United States Supreme Court in *Gregory v. Helvering* is the more general doctrine.[410] From this basic principle, three main offshoots have emerged: (i) the economic substance/sham transaction doctrine (which now incorporates the business purpose test);[411] (ii) the business purpose

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[398] Isenbergh, *Musing on Form and Substance and Form in Taxation*, at 866.

[399] *See Frank Lyon Co. v. United States*, 435 U.S. at 577–78; *Newman v. Commissioner*, 902 F.2d at 163. *Cf. Am. Elec. Power Co. v. United States*, 136 F. Supp.2d at 791–92.

[400] *United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 739 (1977) ("Tax considerations well may have had a good deal to do with the specific terms of the [transactions] but even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction."); *UPS of Am., Inc. v. Commissioner*, 254 F.3d at 1019 ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business."); *Fender v. United States*, 577 F.2d 934, 936 (5th Cir. 1978) ("In deciding to sell the Bender Bonds, the taxpayers were motivated by the possibility of tax avoidance. Standing alone such a motive is an insufficient basis for disallowing a deduction.").

[401] As the Tax Court indicated in *ACM P'ship v. Commissioner*, "transactions will only be recognized for tax purposes if there is some 'tax-independent purpose' for the entire transaction."). *See* 73 T.C.M. at 2215.

[402] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005).

[403] *Id.*

[404] *See* the Senate Report on the JOBS Act of 2004, S. Rep. No. 108-192, at 83 (2003) (to accompany S. 1637) ("The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS"). *See also King Enters., Inc. v. United States*, 418 F.2d 511, 516, n. 6 (Ct. Cl. 1969) ("In coping with this and related problems, courts have enunciated a variety of doctrines, such as step transaction, business purpose, and substance over form. Although the various doctrines overlap and it is not always clear in a particular case which one is most appropriate, their common premise is that the substantive realities of a transaction determine its tax consequences.").

[405] *Karr v. Commissioner*, 924 F.2d 1018, 1022–23 (11th Cir. 1991) ("A sham transaction is one which, though it may be proper in form, lacks economic substance beyond the creation of tax benefits."); *Jacobson v. Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990) ("The question whether a transaction is devoid of economic substance is often analyzed in terms of its being 'sham.'"); *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("This economic-substance doctrine, also called the sham-transaction doctrine, provides that a transaction ceases to merit tax respect when it has no 'economic effects other than the creation of tax benefits.'"); *Rogers v. United States*, 281 F.3d 1108, 1114, n. 2 (10th Cir. 2002) ("… we choose to employ the term 'economic substance doctrine' in place of the term used most often by the taxpayers in this case (i.e., 'substantive sham doctrine')").

[406] Jt. Comm. on Tax'n, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 29, 2005), at n. 39.

[407] For example, in *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003), the district court decided to validate the transaction utilizing both the economic substance and sham transaction doctrines. In *Long Term Capital Holdings*, 330 F. Supp.2d 122 (D. Conn. 2004), the court applied the economic substance test to disallow the benefits and, alternatively, applied the step transaction (end result) doctrine to collapse the several steps in the transaction. *See also Andantech, LLC v. Commissioner*, T.C. Memo 2002-97 (the Tax Court applied both the economic substance and step transaction doctrines). *See also* Jt. Comm. on Tax'n, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 29, 2005) ("The common law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS").

[408] *See, e.g., CNT Investors, LLC v. Commissioner*, 144 T.C. 161 (2015) ("Although these doctrines' distinct names might suggest corresponding substantive distinctions, the lines between and among them blur upon examination. … The doctrines' substantive similarities would not, alone, generate uncertainty for taxpayers (or tenure opportunities for tax academics) if courts applying the doctrines did so using consistent terminology. We have not."); *United States v. Ingredient Tech. Corp.*, 698 F.2d 88, 94 (2d Cir. 1983) ("We agree with Judge Learned Hand in dissent in *Gilbert v. Commissioner*, 248 F.2d 399, 412 (2d Cir. 1957) that it is immaterial whether we are talking about 'substantial economic reality,' 'substance over form,' 'sham' transactions, or the like; rather the question is whether under the statute and regulations here involved the transaction affects a beneficial interest other than the reduction of taxes."). The Tax Court in *CNT Investors* concluded: "Attempts to parse and define the doctrines merely intellectualize what is, ultimately, an equitable exercise."

[409] *Coltec Indus. v. United States*, 62 Fed. Cl. 716, 752 (2004), vacated, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1261 (2007).

[410] *IRS v. CM Holdings, Inc.*, 301 F.3d 96, 102 (3d Cir. 2002) ("The rationale behind the *Gregory* and *Knetsch* line of cases is that courts should not elevate form over substance by rewarding taxpayers who have engaged in transactions that lack any purpose save that of tax savings.").

[411] *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987) ("The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction."); *CMA Consol. Inc. v. Commissioner*, T.C. Memo 2005-16 ("If a transaction is found not to have economic

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doctrine;[412] and (iii) the step transaction doctrine.[413] As Donald Korb, the IRS Chief Counsel, indicated:

> [O]ftentimes people also lump together the judicially created doctrines of economic substance, business purpose, step transaction, and sham transaction. These are all really just subcategories of the "substance-over-form" doctrine which provides that where the form of a taxpayer's transaction may satisfy the literal requirements of the relevant statutory or regulatory language, a court can still examine whether the substance of that transaction was consistent with its form, for the simple reason that a transaction lacking such substance should not be accorded the tax treatment prescribed for the form of the transaction. Thus, for example, in situations where there is no substance other than the creation of unintended tax benefits, the courts may apply the economic substance doctrine to deny the purported tax benefits.[414]

Mr. Korb further elaborated that:

> In all substance-over-form inquiries, a court will examine whether the substance of the transaction was consistent with the form, and give effect only to the substance. "Economic substance" is the substance-over-form inquiry most particularly adapted to transactions devoid of substance. In a system designed to measure and tax income, transactions that do not change the taxpayer's economic position should have no effect at all.[415]

Nevertheless, not all courts agree that economic substance and sham transaction are similar doctrines.[416] In *Rogers v. United States*,[417] the Tenth Circuit thoroughly discussed the relationship among the various common law doctrines. In this case, the part-owner (Fogelman) of a professional baseball team that was organized as an S corporation borrowed money from the S corporation. The nonrecourse loan was secured by Fogelman's ownership interest in the corporation and his existing option to purchase the rest of the shares from the taxpayer (Kauffman), the other owner of the team. Fogelman also granted the corporation an option to purchase both his shares and his existing option to buy Kauffman's shares. The option price was equal to the outstanding loan balance. The corporation exercised its option immediately but deferred closing until the due date of Fogelman's loan, five months later. On that date, Fogelman transferred his shares in the corporation to the corporation in lieu of its foreclosure on the loan. The corporation claimed that the shares had no value at that time and deducted the loan amount as a bad debt, which was passed through to Kauffman.

The court applied the substance-over-form doctrine to collapse the loan and the option transaction into a redemption of Fogelman's stock in exchange for cash. The court first observed that:

> The terms used in dealing with tax-avoidance cases are often confusing. As one court has noted, "'economic shams' — that is, transactions which actually occurred but which exploit a feature of the tax code without any attendant economic risk … [— stand opposed to] 'factual shams' — transactions which either did not occur, did not occur as reported or were performed in violation of some of the background assumptions of commercial dealing … ." Horn v. Commissioner, 296 U.S. App D.C. 358, 968 F.2d 1229, 1236 n. 8 (D.C. Cir. 1992). In order to avoid confusing economic/substantive shams with factual shams, we note at the outset that we choose to employ the term "economic substance doctrine" in place of the term used most often by the taxpayers in this case (*i.e.*, "substantive sham doctrine").[418]

Thus, the court confirmed that the economic substance doctrine and the sham in substance (or substantive sham) doctrine are similar, and distinguishable from the sham in fact (or factual sham) doctrine.[419] The court concluded, however, that although more than one doctrine may be used to achieve a similar result, the common law anti-abuse doctrines differ from each other.[420]

In addition, the court also reviewed the differences between the broader substance-over-form doctrine and the narrower economic substance doctrine. The Tenth Circuit asserted that the purpose of the substance-over-form doctrine is to reclassify transactions in accordance with their substance rather than their form, while the economic substance doctrine is generally applied to deny tax benefits on the ground that the transaction had no economic substance.[421] The court also determined that applying the economic substance doctrine is the first step: "the court does not apply the substance over form analysis where the transaction is not bona fide; rather, if the transaction lacks economic reality, it is analyzed using the economic substance doctrine."[422]

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substance, the form of the transaction may be disregarded in determining the proper tax treatment to be accorded that transaction.").

[412] *Teong-Chan Gaw v. Commissioner*, T.C. Memo 1995-531 at 128 ("A very important consideration in applying substance over form and related principles relates to the presence or the absence of a non-tax, business purpose for the form of a transaction." Citing *Packard v. Commissioner*, 85 T.C. 397, 419–22 (1985).

[413] *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) ("The step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form.").

[414] Donald L. Korb, Chief Counsel for the Internal Revenue Service, Remarks at the 2005 University of Southern California Tax Institute, *The Economic Substance Doctrine in the Current Tax Shelter Environment*, Los Angeles, California (Jan. 25, 2005), *reprinted in* 2005 TNT 16-2 (hereinafter "Korb (2005)").

[415] *Id.* at n. 4.

[416] *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988) ("The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.").

[417] 281 F.3d 1108 (10th Cir. 2002).

[418] *Rogers v. United States*, 281 F.3d 1108, 1114 n. 2 (10th Cir. 2002).

[419] *See* Korb (2005), *reprinted in* 2005 TNT 16-2.

[420] *Id.* at 1115.

[421] *Id.* (citing Warner, *Statutory, Regulatory, and Common Law Anti-Abuse Weapons*, 485 PLI/Tax 883, 889 (2000), and Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. Rev. 47, 65 (2001)).

[422] *Id.* at 116 (citing Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 12 (2000) (the author's statement that a "detailed discussion" of other common-law doctrines, including substance over form, is "beyond the scope" of an article on economic substance makes clear that there are distinctions between the two)); Treasury Report (1999) (discussing the judicial responses available when addressing tax avoidance schemes, and clearly indicat-

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By contrast, as set forth above, in *Coltec Indus. Inc. v. United States*,[423] the United States Federal Court of Claims indicated that the economic substance doctrine is "a composite of the 'business purpose' doctrine, the, 'substance over form' doctrine, and the 'sham transaction' doctrine." Thus, the Court of Claims viewed the economic substance doctrine as the broader doctrine. Finally, many courts, particularly the ones that apply a flexible (or "unitary") two-prong analysis, have argued that it really does not matter how the doctrine is named, as long as its application would be to disallow tax benefits, when appropriate.[424] As the district court in *Long-Term Capital Holdings* indicated:

> The terminology used, whether sham, profit motivation, or economic substance, is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance, and a finding of either a lack of a business purpose other than tax avoidance or an absence of economic substance beyond the creation of tax benefits can be but is not necessarily sufficient to conclude the transaction a sham.[425]

Comment: The codified economic substance doctrine, discussed in I.B., above, states that the determination of whether the economic substance doctrine is relevant to a transaction will be made in the same manner as if the doctrine had never been codified, and the legislative history accompanying previous codification proposals states that other common law doctrines would not be affected by the codification of the economic substance doctrine.[426] Nevertheless, as explained herein, there is a strong relationship between the economic substance doctrine and other common law doctrines such as the substance-over-form, sham transaction, and business purpose doctrines. Thus, it is unclear to what extent these doctrines are affected by the codification of the economic substance doctrine.

G. Conclusion

The economic substance doctrine is strongly related to the other four common law doctrines in several ways. First, the economic substance doctrine has been viewed as a more specific variation of the substance-over-form doctrine because applying both doctrines will generally result in disallowing tax benefits that arise from a transaction the form of which differs from its substance.[427] Second, the economic substance doctrine is generally similar to the sham-in-substance doctrine because the purpose of both doctrines is to examine whether the disputed transaction has any substance apart from tax benefits. Furthermore, the business purpose doctrine has been viewed as one prong in the economic substance's two-prong test.[428] Finally, as discussed herein, in the majority of cases involving the economic substance doctrine, the courts applied more than one common law doctrine in their decisions.[429]

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ing the different roles of the substance-over-form and economic substance doctrines); Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235, 238–39 (1999) (suggesting three separate methods that may be used by the IRS to challenge transactions: (i) applying subjective rules set out in the statutes and regulations; (ii) re-characterizing the form of the transaction under the substance over form doctrine; and (iii) applying the economic substance doctrine in cases where the economic or business purpose of a transaction is relatively insignificant in relation to the comparatively large tax benefits.).

[423] 62 Fed. Cl. 716 (2004), vacated, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1261 (2007). In vacating the decision, the Federal Circuit emphasized that the transaction to be analyzed for economic substance is the one that gave rise to the alleged tax benefit, and that transaction must be disregarded if it lacked economic substance. 454 F.3d at 1347. *See also GSS Holdings (Liberty) Inc. v. United States*, 81 F.4th 1378 (Fed. Cir. 2023) (concluding the Court of Federal Claims, in analyzing an investment company's financial arrangements, conflated the step transaction and economic substance doctrines in upholding the IRS's treatment of the sale of a note in 2006 and 2007 and subsequent $24 million payment in 2011 as a single transaction, and remanding for determination whether the step transaction doctrine applies).

[424] *Zmuda v. Commissioner*, 731 F.2d 1417, 1420 (9th Cir. 1984).

[425] *See Long-Term Capital Holdings, LP v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[426] §7701(o)(5)(C); Jt. Comm. on Tax'n, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 29, 2005). *See also* Jt. Comm. on Tax'n, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10 (March 21, 2010).

[427] In addition, the step transaction doctrine can be viewed as a "sister" doctrine because it also has developed from the substance-over-form doctrine. *See Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d at 1521.

[428] *See* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) ("Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine.").

[429] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (applying the economic substance and step transaction doctrines), *aff'd*, 150 Fed. Appx. 40.

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IV. The Pre-Codification Circuit Splits

A. In General

Under the economic substance doctrine, a court may deny tax benefits arising from transactions that do not result in a meaningful change in the taxpayer's economic position other than a purported reduction in federal income tax.[430] A transaction that would otherwise result in beneficial tax treatment to a taxpayer will be disregarded if the transaction lacks economic substance.[431] Nevertheless, as numerous courts have indicated, taxpayers are generally free to structure their affairs so as to minimize their tax liability; therefore, a transaction does not lack economic substance merely because it is tax-motivated.[432]

A finding that a transaction lacks economic substance will result in disallowance of any tax benefits from the transaction.[433] As the Tax Court stated in *Glass v. Commissioner:*

> In conclusion, we hold that the London Option Transaction — petitioners' multiple and complex tax straddle scheme encompassing prearranged results — lacked economic substance and was a sham. Petitioners consequently may not deduct the losses claimed by them in Year One of their straddle transactions. It follows, of course, that since the straddle transactions were a sham, gains reported by petitioners in Year Two and thereafter do not constitute taxable income to them, and we so hold.[434]

In determining whether a certain benefit ought to be disallowed, "[t]he relevant inquiry is whether *the transaction* that generated the claimed deductions … had economic substance" (emphasis added).[435] Thus, a taxpayer may not combine a valid transaction with the disputed transaction to assert that the overall position had economic substance. (See the discussion in VII., below).[436] Although many courts have applied (and, in some cases, specifically declined to apply) the economic substance doctrine, they have not applied the doctrine uniformly.[437]

Section 7701(o)(5)(C) now clarifies that the determination of whether the economic substance doctrine is relevant to a transaction will continue to be made by the courts in the same manner as it was before §7701(o) was enacted. Section 7701(o) is discussed above in I.B. The cases discussed throughout this Portfolio continue to apply to transactions entered into on or before March 30, 2010.

Frank Lyon Co. v. United States[438] has been construed to establish a two-prong standard for determining whether a transaction entered into on or before March 30, 2010 lacks economic substance.[439] Under the general two-prong test set forth in *Frank Lyon*, the economic substance doctrine is based on an objective and subjective determination of whether a transaction has real, non-tax economic benefits.[440] Before the econom-

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[430] *Killingsworth v. Commissioner*, 864 F.2d at 1216 ("Since *Gregory* was decided, courts have consistently held that although a transaction may, on its face, satisfy applicable Internal Revenue Code criteria, it will nevertheless remain unrecognized for tax purposes if it is lacking in economic substance."); *Karr v. Commissioner*, 924 F.2d at 1023 ("expenses incurred in connection with a sham transaction are not deductible."); *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) ("The economic sham doctrine generally works to prevent taxpayers from claiming the tax benefits of transactions, which, although they may be within the language of the Code, are not the type of transaction Congress intended to favor."); *Yosha v. Commissioner*, 861 F.2d at 497 ("There is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer [a tax] advantage."); *Ferguson v. Commissioner*, 29 F.3d 98, 101 (2d Cir. 1994) (per curiam) ("An activity will not provide the basis for deductions if it lacks economic substance."); Treasury Report (1999), at 56 ("the third, and final, way the IRS can use non-statutory standards to challenge the tax benefits of a particular tax-advantaged transaction is through the application of the economic substance doctrine. This doctrine allows the IRS to deny tax benefits if the economic substance of a transaction is insignificant relative to the tax benefits obtained.") *See also W.E.R. v. Commissioner*, No. 11-13758 (11th Cir. Mar. 15, 2013) (unpub. op.) (minor child not eligible to claim first-time homebuyer credit for purchase of home from parents, even though parents first transferred home to guardian, who then transferred it to child; court found that guardian was mere conduit and intermediate transfer to guardian lacked economic substance, and held that child was not eligible for credit under §36(c)(5)); *Rodriguez v. Commissioner*, T.C. Memo 2011-122 (same).

[431] *Killingsworth v. Commissioner*, 864 F.2d at 1216 ("It is a well settled rule of law that transactions that lack economic substance will not be recognized for tax purposes."); *Boynton v. Commissioner*, 649 F.2d 1168, 1172 (5th Cir. 1981) cert. denied, 454 U.S. 1146 (1982) ("Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized.").

[432] *UPS of Am., Inc. v. Commissioner*, 254 F.3d at 1019 ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations."); *Salina P'ship LP v. Commissioner*, T.C. Memo 2000-352 ("It is well settled that taxpayers generally are free to structure their business transactions as they please, even if motivated by tax avoidance considerations." citing *Gregory v. Helvering*, 293 U.S. 465 (1935) and *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 196); *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury"); *Rosenfeld v. Commissioner*, 706 F.2d at 1281 ("a transaction which is otherwise legitimate, is not unlawful merely because an individual seeks to minimize the tax consequences of his activities."); *Owens v. Commissioner*, 568 F.2d 1233, 1237 (6th Cir. 1977) ("We begin with the principle that a taxpayer, working within the law, may legitimately seek to avoid taxes."); *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 511 ("A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes."); *Yosha v. Commissioner*, 861 F.2d at 497 ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."); *Aiken Indus., Inc. v. Commissioner*, 56 T.C. at 933, ("The fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention."); *Bass v. Commissioner*, 50 T.C. at 600 ("[A] taxpayer may adopt any form he desires for the conduct of his business, and … the chosen form cannot be ignored merely because it results in a tax saving."). *Cf. Saviano v. Commissioner*, 765 F.2d at 654 ("the freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of the transactions to their economic substance and to apply the tax laws accordingly.").

[433] *United States v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994) ("The general rule on sham transactions in [the Third] circuit is well-established: 'If a transaction is devoid of economic substance … it simply is not recognized for federal taxation purposes, for better or for worse.' This denial of recognition means that a sham transaction, devoid of economic substance, cannot be the basis for a deductible loss."). *See also Karr v. Commissioner*, 924 F.2d at 1023.

[434] 87 T.C. at 1177.

[435] *See Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (citing *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282, 284 (2d Cir. 2002)).

[436] *ACM P'ship v. Commissioner*, 157 F.3d 231, 256 n. 48 (3d Cir. 1998).

[437] *Collins v. Commissioner*, 857 F.2d at 1386.

[438] *Frank Lyon Co. v. United States*, 435 U.S. at 583–84.

[439] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[440] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (United States Supreme Court set forth the two-prong test); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 90 (stating that a transaction will be treated as hav-

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ic substance doctrine was codified as §7701(o), courts applied various tests to evaluate whether a transaction lacked such non-tax economic benefits.[441] The Joint Committee on Taxation summarized the variations as follows:

> Some courts apply a conjunctive test that requires a taxpayer to establish the presence of *both* economic substance (i.e., the objective component that there be a meaningful change in the taxpayer's economic position) *and* business purpose (i.e., the subjective component that there be a useful non-tax purpose for the taxpayer's course of action) in order for the transaction to survive judicial scrutiny. A narrower approach is to conclude that *either* a business purpose *or* economic substance is sufficient. A third approach regards economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits. (Footnotes omitted.)[442]

For example, several courts compared the disputed transaction with transactions that might normally be expected to occur in bona fide business settings.[443] Other courts compared cost to potential profit to determine the existence or lack of economic substance.[444] A minority of courts applied the opportunity costs analysis, pursuant to which a transaction is deemed to have no business purpose if the taxpayer could have earned the same benefit without the disputed complex structure.[445]

Generally, the taxpayer carries the burden of proof to show that he/she/it has not been acting solely to avoid taxes.[446] As set forth above, courts found a business purpose in many cases even though the taxpayer may have been primarily or predominantly motivated by tax benefits.[447] Under this approach, a transaction lacks a business purpose only if the taxpayer's *sole* motivation is tax avoidance.[448] As the Eleventh Circuit indicated in *UPS*, "no-business-purpose cases concern tax-shelter transactions or investments by a business or investor that would not have occurred, *in any form*, but for tax-avoidance reasons." (Emphasis in original).[449]

B. The Role of the Economic Substance Doctrine and Its Relationship with the Legislative Purpose

As noted above, §7701(o)(5)(C) clarifies that the determination of whether the economic substance doctrine is relevant to a transaction will continue to be made by the courts in the same manner as it was before §7701(o) was enacted. In interim guidance,[450] the IRS indicated that it will continue to analyze when the economic substance doctrine applies in the same fashion as it did before the enactment of §7701(o). If authorities before the enactment of §7701(o) provided that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the IRS will continue to take the position that the doctrine is not relevant to those benefits. The IRS anticipates that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop. Consistent with §7701(o)(5)(C), codification of the economic substance doctrine should not affect the ongoing development of authorities on this issue. The Treasury Department and the IRS 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, and 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 §7701(o).

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ing no economic substance if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."). *See also ACM P'ship v. Commissioner*, 157 F.3d 231, 248 (3d Cir. 1998).

[441] *Sochin v. Commissioner*, 843 F.2d at 354 (articulating the objective analysis as whether "the transaction had 'economic substance' beyond the generation of tax benefits").

[442] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005).

[443] *Merryman v. Commissioner*, 873 F.2d at 881 ("Courts … compare the transaction in question with transactions that might usually be expected to occur in bona fide business settings."); *IRS v. CM Holdings, Inc.*, 254 B.R. at 600 (to satisfy [the sham transaction] standard, "[the taxpayer] must prove the purported transaction actually took place in a manner which did not deviate from relevant commercial norms."); *IRS v. CM Holdings*, 301 F.3d at 108 (affirming that a transaction may be viewed as a factual sham if it is inconsistent with the industry practice); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 106 ("In order to maintain this objectivity and ensure the steps have independent significance, it is useful to compare the transactions in question with those usually expected to occur in otherwise bona fide business settings") (citing *Merryman v. Commissioner*, 873 F.2d at 881).

[444] *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[445] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004), citing *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003) ("defies common sense from an economic standpoint" to execute an investment indirectly through a partnership and not directly where indirect method diminishes profits by adding millions in transaction costs). This standard was not accepted in the JOBS Act of 2004, as discussed below.

[446] *IRS v. CM Holdings*, 301 F.3d at 102 ("The taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible."); *Merryman v. Commissioner*, 873 F.2d at 882 ("the Commissioner's determination that the partnership lacked economic substance was presumptively correct and the taxpayers bore the burden of proving the determination erroneous."); *Estate of Baron v. Commissioner*, 798 F.2d at 72 ("It was Baron's burden to represent and demonstrate that [he] expected to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions."); *Robertson v. Commissioner*, T.C. Memo 1994-424 ("Petitioners bear the burden of proving that the transactions at issue are not shams. Rule 142(a).").

[447] *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 511 ("A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes.").

[448] *Zmuda v. Commissioner*, 731 F.2d at 1421 ("Although the taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation."); *Friedman v. Commissioner*, 869 F.2d at 792 ("this prong [business purpose] requires a showing that the *only* purpose for entering into the transaction was the tax consequences."); *Ockels v. Commissioner*, 54 T.C.M. 785, 796 (1987) ("Where a transaction is entered into without any purpose other than to obtain tax benefits, the form of the transaction will be disregarded and the tax benefits denied. … However, the fact that a transaction generates tax benefits for investor does not necessarily mean that the transaction lacks economic substance."); *UPS*, 254 F.3d at 1019 ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations.").

[449] *UPS*, 254 F.3d at 1020, citing for this proposition *ACM P'ship v. Commissioner*, 157 F.3d at 252; *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Karr v. Commissioner*, 924 F.2d at 1023; *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 91.

[450] Notice 2010-62, 2010-40 I.R.B. 411, applicable to transactions entered into on or after Mar. 31, 2010.

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Numerous courts and commentators have indicated that the IRS should not challenge transactions under the economic substance doctrine too excessively.[451] In general, as IRS Chief Counsel Donald Korb observed, in the vast majority of cases, the IRS can prevail on technical grounds rather than applying common law doctrines.[452] Nevertheless, as the JCT indicated in its 2005 Report:

> [i]t is not possible to set forth in advance an appropriate outcome for every conceivable transaction or uncommon combination of steps that might be devised, nor would it be efficient for the government to try to do so. For this reason, most courts have long recognized the need for anti-tax avoidance standards, such as the economic substance doctrine, to ensure that Congressional objectives are appropriately achieved.[453]

Some courts have viewed the economic substance doctrine as a principle of statutory interpretation — if a transaction satisfies the literal requirements of the Code and/or regulations, the court can still disallow the benefits arising from the transaction under the economic substance doctrine if the result of the transaction is inconsistent with the purpose of the legislation.[454] This principle was established by the Supreme Court in *Gregory v. Helvering* in its final conclusion:

> The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[455]

In *ACM P'ship v. Commissioner*, the Tax Court described the role of the economic substance doctrine as follows:

> The tax law … requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[456]

The Tax Court indicated that the economic substance test must be analyzed before the court examines the relevant Code provisions.[457]

In its 2005 report, the Joint Committee observed that:

> Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by the Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining overall respect for the tax system. A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-tax-avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. Application of this doctrine to certain categories of transactions having the characteristics of tax shelters should be clarified and strengthened in order to improve its effectiveness at deterring unintended consequences and to promote greater uniformity.[458]

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[451] *See* Yin, *A Cautionary Note on the Use of Antiabuse Doctrines*, 2002 TNT 43-26 (March 4, 2002) ("perhaps one reason for the government's defeats in *Compaq* and *IES* was its litigation strategy, including its 'vigorous' invocation of the economic substance doctrine.").

[452] Korb (2005).

[453] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005). *See also JCT Releases Summary of Report on Tax Compliance Proposals* (JCX-19-05R), 2005 TNT 72-32 (Apr. 12, 2005); *Davant v. Commissioner*, 366 F.2d 874, 887 n. 27 (5th Cir. 1966) ("Petitioners have cited us to a number of cases where the courts have construed the reorganization provisions with strict literalness without regard to the fact that it defeated the purpose of the tax statute. Each time, Congress acted to close the judicially created loophole. From this interchange of events, petitioner asks us to draw the conclusion that the courts should always permit tax evasion when a literal application of the Code will minimize tax consequences regardless of the true economic realities. We draw just the opposite conclusion. Having been consistently rebuked by Congress in this area whenever we departed from the inherent purpose of the statutory scheme, we should avoid making the same mistakes and, instead, utilize all our efforts to apply the Code as Congress intended. The problem created for Congress if the courts adopt any other approach to the reorganization provisions is made painfully apparent by this litigation. The statute must be narrow enough to prevent sales being made to look like reorganizations and broad enough to prevent reorganizations being made to look like sales. Had the courts adhered to obvious legislative intent and not felt restricted to a literal and rather restrained interpretation, there would have been no necessity for Congress to enact the detailed, almost impossible to follow, complicated reorganization provisions which now confront us. The rules could be simple: (1) those who genuinely participate in reorganizations would get the tax deferment Congress intended; (2) those who sell property or withdraw earnings would be taxed as Congress intended. The considerations underlying the reorganization provisions were not cast in terms of form but of substance. Courts in performing their judicial duty must take notice of this fact.").

[454] *Knetsch v. United States*, 364 U.S. at 367 ("We, therefore, look to the statute and materials relevant to its construction for evidence that Congress meant in §264(a)(2) to authorize the deduction of payments made under sham transactions entered into before 1954.").

[455] *Gregory v. Helvering*, 293 U.S. at 470.

[456] 73 T.C.M. at 2215, citing *Yosha v. Commissioner*, 861 F.2d at 498–99 ("in both cases (*Gregory* more clearly than *Goldstein*) the taxpayer was trying to take advantage of a loophole inadvertently created by the framers of the tax code; in closing such loopholes the courts could not rightly be accused of having disregarded congressional intent or overreached.").

[457] *Id.* ("Only after we conclude that a transaction has economic substance will we consider the transaction's tax consequences under the Code."). *See also United States v. Wexler*, 31 F.3d at 122–23 ("It is true, as *Wexler* argues, that other code sections expressly require that the deductions they provide for arise from transactions having a business purpose or profit motive, whereas §163 does not. [footnote omitted] Nonetheless, the case law construing §163 clearly establishes that the sham transaction doctrine also bars interest deductions under that section of the code.").

[458] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005). *See also JCT Releases Summary of Report on Tax Compliance Proposals* (JCX-19-05R), 2005 TNT 72-32 (Apr. 12, 2005); Shaviro and Weisbach, *The Fifth Circuit Gets It Wrong In* Compaq v. Commissioner, 94 Tax Notes 511, 512–13 (2002) ("Anti-abuse doctrines are needed to impede transactions like those in Knetsch and Gold-

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According to Professor Bernard Wolfman, this principle should apply equally to the IRS and taxpayers:

> The [economic substance] doctrine has assured us that neither the government nor practitioners will succeed in their roles if they are excessively literal and mechanical in their reading of the statute; if they fail to read it as part of a statutory scheme through which Congress seeks to accomplish a goal that has breadth and durability.[459]

Several commentators and government officials have warned that the excessive use by the government of the economic substance doctrine is undesirable.

For example, George Yin, former Chief of Staff, Joint Committee on Taxation (in his previous role as a law school professor), indicated that "[t]ools such as 'economic substance' and 'business purpose' should be reserved to combat transactions that are more unambiguously objectionable than the ones involved in those cases."[460] The government's indiscriminate use of those judicial doctrines "has backfired and left [the] doctrines in shambles … . [W]e have less understanding of when these doctrines should apply and what they mean when they do. Taxpayers may now feel emboldened to try more and more creative tax-reduction strategies."[461]

Thus, a taxpayer can prove that the transaction has substance if it can show "that his treatment of the transaction does not conflict with the meaning the Congress had in mind when it formulated the section sub judice."[462] As the Second Circuit summarized in *Nassau Lens Co. v. Commissioner*:

> [T]he courts have not attributed to Congress a general purpose underlying the entire Code to deprive the taxpayer in each case of freedom to choose between legal forms similar in a broad economic sense but having disparate tax consequences. [footnote omitted] *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956). They have, instead, when confronted with a statutory provision not explicitly turning on the relationship between parties to a transaction [footnote omitted] or requiring an underlying business purpose, adopted a cautious approach and asked merely whether the form superimposed upon the transaction has a result similar to the one Congress has [sic] in mind when it drafted the section involved.[463]

The Second Circuit illustrated the above statement with its own interpretation of *Gregory v. Helvering* and *Knetsch v. United States*. With respect to the *Gregory v. Helvering* case, the Second Circuit observed that "[t]he critical factor was not only the existence of a tax motive or lack of a 'business purpose' but also the incongruity of the tangible, observable result of the transaction when viewed in light of the congressional purpose underlying the reorganization provisions."[464]

Accordingly, as the Second Circuit observed, "Having found a lack of a business purpose and a disparity between the objective result and the ascertainable legislative purpose, the Court [in *Gregory v. Helvering*] could proceed to tax the transaction with assurance."[465]

With respect to the *Knetsch v. United States* case, the Second Circuit stated that, "even though the tax motive was undoubtedly present, and a critical factor, the Court [in *Knetsch v. United States*] could certainly find that Congress, when drafting the particular sections, was concerned only with transactions entered into with some hope of profit apart from tax savings and not with transparent schemes objectively demonstrated to be ridiculous business propositions."[466]

The Second Circuit concluded:

> [W]hile the existence of a tax motive or the lack of a business purpose is the starting point for a challenge to the form of a transaction adopted by a taxpayer, it is, in the absence of legislative intent to the contrary, not the finish line, for if the substantive result is of the general type considered by Congress to be within the particular provisions involved, the fact that a different but equally feasible form would have resulted in a greater tax is of no consequence. And since legislative intent must oftentimes be unclear, the form adopted will usually be recognized except where it is a patent distortion of normal business practice, as it was in *Gregory* and *Knetsch*.[467]

In *Coltec Indus. v. United States*, the government provided the court with the usual list of "binding precedents," including *Gregory v. Helvering* and *Commissioner v. Court Holding Co.*, that "support the principle that economic substance, and not mere formal compliance with the Code, must inform the interpretation and application of the tax law."[468] The court first agreed that "it is certainly true that the [Supreme] Court has decided tax cases invoking [the economic substance] doctrine," but countered that "[a] careful reading of other cases cited by the Government, however, reveals that the Court resolved the

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stein because it is impossible for drafters of the tax law to anticipate each and every interaction of the various tax rules.").

[459] *See* Wolfman, *Why Economic Substance is Better Left Uncodified*, 104 Tax Notes 445 (July 26, 2004). Citing also *Horn v. Commissioner*, 968 F.2d at 1236 ("an important judicial device for preventing the misuse of the tax code, but the doctrine cannot be used to preempt congressional intent."). Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005), illustrates this issue as follows:

> Recent tax avoidance transactions have relied on the interaction of highly technical tax rules to produce results not intended by the Congress. For example, one such transaction, described at a recent Senate hearing, involved an attempt to combine the S corporation rules and those applicable to a special class of tax-exempt entities in order to shelter ordinary business income from taxation.

See id. at n. 57, description of "SC2" transaction, Appendix B.

[460] Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 Tax L. Rev. 405, 407 (2002).

[461] *Id.* at 426.

[462] *Gilbert v. Commissioner*, 248 F.2d at 406 (2d Cir. 1957). *See also Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 44 ("In the absence of statutory language or legislative history to the contrary, the desire to save taxes is not by itself sufficient cause to disregard the form adopted by the taxpayer, for 'the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.'") (quoting *Gregory v. Helvering*, 293 U.S. at 465). *See also Gitlitz v. Commissioner*, 531 U.S. 206, 220 (2001).

[463] *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 at 44–45.

[464] *Id.* at 45.

[465] *Id.*

[466] *Id.*

[467] *Id.*

[468] *Coltec Indus. v. United States*, 62 Fed. Cl. at 753.

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tax question at issue first by looking to the Code and utilized doctrinal language only to further support its conclusion."[469] Thus, the court held that it would apply common law doctrines only where the statute is unclear and open to several interpretations.[470]

The court, however, found that even if it were required to apply the economic substance test, Coltec had satisfied the test because it satisfied the business purpose of §357(b) and, therefore, "the 'economic substance' doctrine is satisfied, as that doctrine requires proof of at least one of these tests."[471] Thus, the court concluded:

> Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare. … Accordingly, the court has determined that where a 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."[472]

The court agreed with Professor Joseph Bankman's assertion that "Congress may have no choice but to engage in substantive law reform. Some shelter activity will take place under even the most utopian tax structure. However, the current tax treatment of capital needlessly multiplies shelter opportunities and provides a fertile breeding ground for shelter development."[473]

Professor Bankman observes that "the economic substance doctrine, like the other common law tax doctrines, can … be thought of as a method of statutory interpretation."[474] Furthermore, the doctrine also resembles, to some extent, "a substantive canon of interpretation; it has been part of the tax law for so long that it is accepted by jurists who would otherwise hew more closely to a textual reading of the applicable statute."[475]

As discussed in greater detail herein, litigation involving the economic substance doctrine frequently involves disputes over the text, intent, and purpose of the relevant statute.[476] Generally, the taxpayer will defend its position by arguing that the disputed transaction is supported by the statute's text, and in addition, by some combination of intent and purpose.[477] According to Professor Bankman, a transaction that is clearly supported by the text, intent, and purpose will withstand judicial scrutiny regardless of whether it otherwise meets the economic substance test.[478] On the other hand, if the text is inconsistent with intent and/or purpose, the result might be different.[479]

The Federal Circuit vacated the Court of Federal Claims decision, holding that the transaction lacked economic substance. The court determined that the economic substance doctrine is a judicial tool to execute the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits are not afforded based on transactions lacking in economic substance.[480]

In contrast, the government's determination, followed by the Tax Court's decision, to disallow the losses in *Santa Monica Pictures, LLC*, was based solely on common law grounds.[481] Thus, the government effectively used the economic substance doctrine as the primary weapon instead of the intended purpose of all common law doctrines, which is as a mere backstop to the statutory rules.[482]

The JCT Report (2005) attempted to reconcile these two inconsistent approaches by suggesting as follows:

> The proposal [to codify the economic substance doctrine] is not intended to modify the judicial determination of when to apply the [economic substance] doctrine, and does not apply to cases in which the taxpayer establishes the outcome of a transaction is clearly consistent with all applicable rules and Congressional purposes. The proposal does, however, constitute a legislative determination that the economic substance doctrine has an appropriate role to play in the tax system.[483]

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[469] *Id.* ("Our reading of the statute as requiring that the transaction be treated as a unified whole is reinforced by the well-established 'step-transaction' doctrine, a doctrine that the Government has applied in related contexts.") (quoting *Commissioner v. Clark*, 489 U.S. at 738).

[470] *Coltec Indus. v. United States*, 62 Fed. Cl. 716 (2004), vacated, 454 F.3d 1340 (Fed. Cir. 2006).

[471] *Coltec Indus. v. United States*, 62 Fed. Cl. at 754.

[472] *Id.* at 756. *See also Nassau Lens Co. v. Commissioner*, 308 F.2d 39 at 45–46 ("The well-spring of tax policy is Congress, not the federal courts. In the long run, the judicial gloss imposed upon the Code must be derived from the congressional purpose underlying the provisions involved in each case. And to the extent the Code grows in complexity and detail, the courts must be careful not to attribute to Congress overall purposes or meanings not reflected in the statutory language or clearly demonstrated in the legislative history.").

[473] *Id.* at 755–56 (quoting Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 29–30 (2000)).

[474] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 11 (2000).

[475] *Id.* at 11.

[476] *Id. See, e.g.*, *Coltec Indus. Inc. v. United States*, 62 Fed. Cl. 716 (2004), vacated, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1261 (2007).

[477] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 11 (2000). *See, e.g.*, *Neb. Dep't of Revenue v. Lowenstein*, 513 U.S. 123 (1994); *Clark*, 489 U.S. at 737; *Knetsch*, 364 U.S. at 367; *Lerman v. Commissioner*, 939 F.2d at 52; *ACM P'ship*, 157 F.3d at 261.

[478] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 11–12 (2000). Professor Bankman illustrates with the case of a corporate taxpayer investing in housing subject to low-income tax credit. The tax credit was enacted to stimulate investment in low-income housing. A taxpayer who makes the investment solely because of tax reasons is presumably doing just what the lawmakers who enacted the legislation would have wished. Thus, according to Bankman, the IRS cannot argue that the benefits should be denied even though the transaction was designed in a way to achieve a tax benefit; the economic substance doctrine should not be applicable to such investments, which the government wishes to encourage by providing tax incentives.

[479] *See ACM P'ship*, 73 T.C.M. at 2215.

[480] 454 F.3d 1340 (Fed. Cir. 2006), vacating, 62 Fed. Cl. 716 (2004), cert. denied, 127 S. Ct. 1261 (2007).

[481] T.C. Memo 2005-104.

[482] *Cf. Gitlitz v. Commissioner*, 531 U.S. at 220 (The court refused to rely on policy arguments in order to look beyond the plain words of the statute and deny tax benefits claimed by the taxpayer).

[483] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005). *See also JCT Releases Summary of Report on Tax Compliance Proposals* (JCX-19-05R), 2005 TNT 72-32 (Apr. 12, 2005).

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C. The Two-Prong Test

1. Overview

Even before the economic substance doctrine was codified as §7701(o), numerous courts had expressed the view that the inquiry into whether the taxpayer's transaction has sufficient economic substance to be respected for tax purposes turns on two related factors, the "objective economic substance of the transaction" and the "subjective business motivation" behind it.[484] The two-prong test was codified on March 30, 2010, as follows:[485]

> 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.

Before the economic substance doctrine was codified, the United States Supreme Court held, in *Frank Lyon Co. v. United States*,[486] that a transaction will be recognized for tax purposes only if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached."[487]

Frank Lyon Co. v. United States was construed to create the two-prong test for determining whether a transaction (entered into on or before March 30, 2010) is a "sham" to be disregarded for tax purposes entirely: (1) Has the taxpayer shown that it has a business purpose for engaging in the transaction, other than tax avoidance? (2) Has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?[488] The business purpose standard focuses on the motives of the taxpayer for entering into the transaction, while the economic substance standard (before codification of the economic substance doctrine) involves an objective analysis of the taxpayer's economic position before and after the transaction.[489]

Nevertheless, before codification of the economic substance doctrine, the two-prong test was interpreted differently in almost every circuit.[490] The Fourth Circuit in *Rice's Toyota World, Inc. v. Commissioner*[491] interpreted the two-prong inquiry as follows: A tax-favored transaction may be treated as an economic sham, and tax benefits would be denied, only if (i) the taxpayer has no business purpose other than obtaining tax benefits; *and* (ii) the transaction lacks economic substance because no reasonable possibility of a pre-tax profit exists.[492] While in *Rice's Toyota*,[493] the Fourth Circuit treated economic substance and business purpose as two prongs of a disjunctive test, a position also adopted by other U.S. circuits and Tax Courts,[494] other courts applied a conjunctive test pursuant to which the taxpayer must satisfy both prongs in order to be eligible for the tax benefits.[495] Finally, several circuits held that the objective and subjective prongs are related factors, "both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes."[496]

In addition, several courts incorporated the substance-over-form doctrine as a third prong of the economic substance doctrine.[497] As the Ninth Circuit elaborated in *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*:[498]

> The business purpose factor often involves an examination of the subjective factors which motivated a taxpayer to make the transaction at issue. The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction.[499]

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[484] *See ACM P'ship*, 157 F.3d at 247 (citing decisions by the Courts of Appeals for the Sixth, Ninth, and Tenth Circuits); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. at 285 (citing decisions by the Courts of Appeals for the Third, Eighth, and Eleventh Circuits).

[485] §7701(o)(1).

[486] *Frank Lyon Co. v. United States*, at 583–84.

[487] *Id.*

[488] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 91–95. *See also Casebeer v. Commissioner*, 909 F.2d at 1363 (citing *Frank Lyon Co. v. United States*, at 583–84; *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d at 1548–49).

[489] *See Sochin v. Commissioner*, 843 F.2d at 354 ("The application of the 'business purpose' prong is a subjective test, whereas the application of the 'economic substance' prong is an objective test.").

[490] *See Collins v. Commissioner*, 857 F.2d at 1386 ("The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify."); *Gerdau Macsteel, Inc. v. Commissioner*, 139 T.C. 67 (2012) ("The Courts of Appeals are split on the proper weight to be given to these prongs in deciding whether to respect a transaction under the economic substance doctrine, and alternative approaches have emerged.").

[491] 752 F.2d at 91–95.

[492] *Id. See also Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 88–89 ("A transaction may be treated as a sham where (1) the taxpayer is motivated by no business purpose other than obtaining tax benefits, and (2) the transaction has no economic substance because no reasonable possibility of a profit exists." Citing *Rice's Toyota*). *Cf. Shriver v. Commissioner*, 899 F.2d at 726 ("we do not read *Frank Lyon* to say anything that mandates a two-part analysis, and although *Rice's Toyota World* seems to conclude a two-part test is consistent with *Frank Lyon*, the Fourth Circuit opinion does not appear to hold that such a test is essential … . We find no rigidity or inflexibility in either *Frank Lyon* or *Rice's Toyota World*.").

[493] 752 F.2d at 91.

[494] *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) (the economic substance of a transaction can be established if the transaction at issue had objective economic substance or if there was a subjective non-tax business purpose); *Sanderson v. Commissioner*, T.C. Memo 1985-477; *Black & Decker Corp. v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part and rem'd, 436 F.3d 431 (4th Cir. 2006).

[495] *See Coltec Indus. Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), vacating 62 Fed. Cl. 716 (2004), cert. denied, 127 S. Ct. 1261 (2007) (lack of economic substance sufficient to disqualify transaction without proof that taxpayer's sole motive is tax avoidance). *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[496] *ACM P'ship*, 157 F.3d at 247 (citing decisions by the Courts of Appeals for the Sixth, Ninth, and Tenth Circuits); *Winn Dixie*, 113 T.C. at 42 (citing decisions in the Eleventh Circuit).

[497] *Kirchman v. Commissioner*, 862 F.2d at 1492 ("The analysis of whether a transaction is a substantive sham, however, addresses whether a transaction's substance is that which its form represents.").

[498] *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543 (9th Cir. 1987).

[499] *Bail Bonds*, 820 F.2d at 1549.

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Similarly, in *Johnson v. United States*,[500] the Court of Claims stated that:

> The determination of whether a transaction has economic substance is essentially a two-part analysis: (1) whether the substance of the transaction is reflected in its form, and (2) whether the transaction had a reasonable objective possibility of providing a profit aside from tax benefits.

Thus, the Court of Claims held that one of the prongs is the substance-over-form doctrine and the other is an objective profit potential test.[501]

2. Conjunctive/Disjunctive/Unitary

As noted above, before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, circuits were divided on how to apply the two-prong test.[502] Some circuits required that a transaction satisfy *both* the economic substance *and* business purpose (a conjunctive test) standards to validate a transaction.[503] Other circuits determined that the existence of *either* economic substance *or* business purpose (a disjunctive test) would validate a transaction.[504] In addition, some courts gave more weight to one prong than the other, and in several cases, focused primarily on one prong and disregarded the other.[505] For example, in applying the two-prong test, several courts gave more weight to the objective prong in determining the validity of a transaction, and gave no weight or minimal weight to the subjective prong.[506] Other courts, by contrast, focused more on the subjective intent of the taxpayer.[507] In addition, many courts frequently applied a subjective profit motive test similar to that under §183, in economic substance cases.[508]

Finally, some courts applied a more flexible test, generally referred to as the "unitary analysis," pursuant to which economic substance and business purpose were "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[509]

3. Objective or Subjective Test?

Before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, courts were divided on what each prong meant; although it was clear that one was objective and the other subjective, several variations emerged for each prong.[510] Regardless of whether the rigid two-prong or the less rigid unitary test was applied, however, most courts agreed that objective economic substance and subjective business purpose were two different standards.[511]

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[500] 32 Fed. Cl. 709, 716 (Fed. Cl. 1995).

[501] *See also Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004), aff'd, 150 Fed. Appx. 40 (2d Cir. 2005).

[502] See the Senate Report on the JOBS Act of 2004, S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637) and Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (both citing *Collins v. Commissioner*, 857 F.2d at 1386).

[503] *Id.* (both quoting *Pasternak v. Commissioner*, 990 F.2d at 898).

[504] *Id.* (both quoting *Rice's Toyota World v. Commissioner*, 752 F.2d at 91–92 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.")). *See also IES Indus. v. United States*, 253 F.3d at 358 ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists" (the economic substance test.); *Sanderson v. Commissioner*, T.C. Memo 1985-477 ("This Court has interpreted this language to mean that, to uphold the validity of a sale-leaseback transaction, the transaction must either satisfy a subjective 'business purpose' test, or satisfy an objective 'economic substance' test."); *Torres v. Commissioner*, 88 T.C. 702, 719 (1987) ("a finding of lack of economic substance is inappropriate if either a business purpose or a reasonable possibility of profit apart from expected tax benefits is found to have been present."); *Black & Decker Corp. v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part and rem'd, 436 F.3d 431 (4th Cir. 2006); *Pritired 1, LLC v. United States*, 816 F. Supp.2d 693 (S.D. Iowa 2011); *IES Indus.* and *Rice's Toyota World*).

[505] *See ACM P'ship*, 157 F.3d at 248, n. 31 ("Where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations."). *See also IRS v. CM Holdings*, 301 F.3d at 102 ("Although [the Third Circuit] has hinted that the objective analysis may be more important than the subjective, the latter analysis remains important." Citing *ACM P'ship*, 157 F.3d at 247, n. 31).

[506] *Lee v. Commissioner*, 155 F.3d at 586 (citing Reg. §1.183-2(a): "In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of intent."); *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004) ("In evaluating the economic substance of a transaction, courts are cautioned to give more weight to objective facts than self-serving testimony." (citing *Lee v. Commissioner*, 155 F.3d at 586). *See also Jacobson v. Commissioner*, 915 F.2d at 838; *Saba P'ship v. Commissioner*, T.C. Memo 1999-359 ("[A] transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a non-tax business purpose"); *Rose v. Commissioner*, 868 F.2d at 854 (the court held that the proper test to determine economic substance is whether the transaction has any practicable effects other than the creation of income tax losses.); *Kirchman v. Commissioner*, 862 F.2d at 1492 ("It is clear that transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer."). *Cf. Karr*, 924 F.2d at 1023 (noting that subjective intent is not irrelevant, despite *Kirchman*'s statement of the doctrine).

[507] *ACM P'ship v. Commissioner*, T.C. Memo 1997-115.

[508] *Smith v. Commissioner*, 91 T.C. 733 (1988) ("Section 183 initially served to distinguish between business objectives and personal objectives, but in recent years has been used frequently to compare business objectives with tax objectives."); *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. at 279.

[509] See the Senate Report on the JOBS Act of 2004, S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637) and Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (both quoting *ACM P'ship v. Commissioner*, 157 F.3d at 247 ("[The objective and subjective] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.")); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990) ("The better approach, in our view, holds that 'the consideration of business purpose and economic substance are simply more precise factors to consider in the [determination of] whether the transaction had any practical economic effects other than the creation of income tax losses'") (citing *Sochin v. Commissioner*, 843 F.2d at 351); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004)).

[510] *IRS v. CM Holdings*, 301 F.3d at 103.

[511] *Cherin v. Commissioner*, 89 T.C. at 993 ("The economic substance of a business transaction and the intent, purpose, or motive of an individual investor, while sometimes equated, are not identical."). *Cf. Zmuda v. Commissioner*, 731 F.2d at 1420 ("There is no real difference between the business purpose and the economic substance rules. Both simply state that the Commissioner may look beyond the form of an action to discover its substance."). *See also* AM 2012-009 (securities lending transaction failed the two prong test regardless of whether the objective or subjective analysis was used).

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In 1972, six years before *Frank Lyon Co. v. United States* was decided, the Ninth Circuit presented some of these competing views regarding the application of the business purpose doctrine in *Brooke v. United States*.[512] The court first discussed the government's view of the test as a subjective test: "The Government adamantly asserts that this transfer lacks a business purpose, which therefore disqualifies it for a business deduction. Several leading cases employ such language."[513] The court continued and presented the view that only the objective test is relevant: "Other cases require only that the transfer be grounded in substantial economic reality."[514] Finally, the court concluded that the subjective test should apply: "[A] transfer solely to avoid taxes will not be recognized."[515]

a. The Objective Prong

In general, before §7701(o), generally applicable to transactions entered into after March 30, 2010, was added to the Code, clarifying the application of the economic substance doctrine, there were several views regarding the application of the objective prong of the economic substance test.[516] As the Third Circuit summarized in *IRS v. CM Holdings, Inc.*:[517]

> There are several different formulations of the objective portion of the economic substance inquiry. *Knetsch* voided a transaction because it "did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax." 364 U.S. at 366 (internal citations omitted). In *United States v. Wexler* we held that "where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes." 31 F.3d 117, 122 (3d Cir. 1994). In *ACM P'ship* we required a "net economic effect on the taxpayer's economic position." 157 F.3d at 249.

The Third Circuit had set forth its own formulations of the objective test: "The main question these different formulations address is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way."[518]

Under the broadest view, courts focused on the taxpayer's *economic position* before and after the disputed transaction and require that the taxpayer's position be changed in order to satisfy the objective prong.[519] Stated differently, courts adopting that view determined economic substance by an objective evaluation of the changes in the taxpayer's economic position, aside from tax benefits.[520] The provision added to the Code on March 30, 2010, clarifying the application of the economic substance doctrine, adopts this broader view; specifically, a transaction will be viewed as satisfying the objective prong if the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position.[521] In Notice 2010-62,[522] the IRS indicated that, to determine whether a transaction satisfies the objective prong, it will take into account the taxpayer's profit motive only 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. In performing this calculation, the IRS will apply existing relevant case law and other published guidance.

In *Long-Term Capital Holdings v. United States*, the taxpayer argued that the objective test is whether the transaction has changed the economic positions/rights of the parties other than tax savings.[523] Relying on *Gilman v. Commissioner*,[524] the district court rejected the taxpayer's suggested standard and ap-

[512] 468 F.2d 1155, 1158 (9th Cir. 1972).

[513] *Id.* (citing *Gregory v. Helvering*, 293 U.S. at 469; *Van Zandt v. Commissioner*, 341 F.2d 440, 443–44 (5th Cir. 1965) (applying the business purpose test); *Commissioner v. Transp. Trading & Term Corp.*, 176 F.2d 570, 572 (2d Cir. 1949) (stating that the principle set forth in *Gregory v. Helvering* "means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.")).

[514] *Id.* (citing *Gilbert v. Commissioner*, 248 F.2d at 406 (applying an objective standard); *Oakes v. Commissioner*, 44 T.C. 524 (1965) (expressly eschewing the "business purpose" test); *Felix v. Commissioner*, 21 T.C. 794 (1954); *Skemp v. Commissioner*, 168 F.2d 598, 600 (7th Cir. 1948) (applying an objective standard and holding that "Nor can we agree with the Commissioner's contention that there was no change in the taxpayer's economic status.")).

[515] Citing *Gregory v. Helvering*, 293 U.S. 465 (1935) and *Audano v. United States*, 428 F.2d 251, 259 (5th Cir. 1970) ("Here, factors such as taxpayer's control of the affairs of the trusts, the short period in which legal title to the equipment was lodged in the trusts, the grossly excessive rentals, and the conveyance of the equipment to the partnership from the trusts for one dollar when taxpayer quit the partnership compel our conclusion that the trusts were not grounded in economic reality, but were instead simply the unavailing products of imaginative minds.").

[516] *ACM P'ship v. Commissioner*, 157 F.3d at 248 ("In assessing the economic substance of a taxpayer's transactions, the courts have examined 'whether the transaction has any practical economic effects other than the creation of income tax losses' … ." (quoting *Jacobson v. Commissioner*, 915 F.2d at 837)); *Sochin v. Commissioner*, 843 F.2d at 354 (articulating the objective analysis as whether "the transaction had 'economic substance' beyond the generation of tax benefits"); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 94 (stating that the economic substance inquiry is an objective inquiry into whether the transaction produced any non-tax benefit).

[517] 301 F.3d 96 (3d Cir. 2002).

[518] *Id.*

[519] *Gilbert v. Commissioner*, 248 F.2d at 411–12 ("If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. … [The *Gregory* doctrine] covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."); *Knetsch v. United States*, 364 U.S. at 366 (disallowing the deduction on the grounds that they "did not appreciably affect his beneficial interest except to reduce his tax."); *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 513; *ACM P'ship*, 157 F.3d at 248, n. 31; *Skemp v. Commissioner*, 168 F.2d at 600; *Bank of N.Y. Mellon Corp. v. Commissioner.*, 140 T.C. 14 (2013) (applying Second Circuit precedent), *supp. opin.*, *Bank of N.Y. Mellon Corp. v. Commissioner*, T.C. Memo 2013-225 (because bifurcated approach treated loan as separate from transaction at issue, interest paid on loan was deductible); *Salem Fin., Inc. v. United States*, 112 Fed. Cl. 543 (Fed. Cl. 2013) (transaction accomplishing nothing more than redirection of cash flows lacks economic substance).

[520] *Winn-Dixie Stores, Inc.*, 113 T.C. at 284. *Cf. Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (rejecting this test and applying cost v. reasonably expected profit test instead).

[521] §7701(o)(1)(A).

[522] 2010-40 I.R.B. 411, applicable to transactions entered into after March 30, 2010.

[523] 330 F. Supp.2d 122 (D. Conn 2004).

[524] 933 F.2d 143, 148 (2d Cir. 1991) ("The taxpayer relies on *Rosenfeld v. Commissioner*, 706 F.2d 1277 (2d Cir. 1983) …, to argue that where a transaction changes the beneficial and economic rights of the parties it cannot be a sham. But the Commissioner does not contend that Gilman does not own the computer equipment. Instead, the concern is that his entry into the transaction was motivated by tax consequences and not by business or economic concerns.").

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plied the narrower cost v. reasonably expected profits standard. (See below.)

A narrower view would focus on the taxpayer's expected *benefits* from the transaction.[525] In other words, under this approach, not only must the taxpayer's position change, it must be a change providing a benefit to the taxpayer.[526] Such a benefit does not have to be quantified in terms of "profit;" for example, sometimes a taxpayer derives a profit from the form of entity,[527] from incorporation (limited liability),[528] accounting benefits[529] and other benefits not specifically translated into "profit."[530]

Finally, the narrowest view would focus on the taxpayer's reasonably expected *profits* from the transaction.[531] In contrast to the previous views, this approach would require a *quantification* of benefits in the form of an economic profit.[532] Thus, this standard is narrower than the previous ones, because a meaningful change in the taxpayer's economic positions will include potential profit, but may also include other elements that are not reflected in the profit potential test. The profit requirement test is discussed in greater detail below.

In *Long-Term Capital Holdings v. United States*,[533] the district court concluded that the disputed transaction had no objective economic substance.[534] The court elaborated that "[t]he determination of whether a transaction has economic substance is essentially a two-part analysis: (1) whether the substance of the transaction is reflected in its form; and (2) whether the transaction had a reasonable objective possibility of providing a profit aside from tax benefits."[535] The court emphasized that this standard requires that the taxpayer act as a "prudent investor" in determining whether to enter into the disputed transaction to satisfy the objective prong.[536] A similar view was earlier expressed by the Second Circuit in *Gilman v. Commissioner*,[537] where the Second Circuit affirmed the Tax Court's economic substance analysis, which was approached from "the standpoint of a prudent investor."[538]

Comment: It is implicit that, in order to satisfy the economic substance test, the taxpayers must show a positive benefit from the transaction.[539] Thus, while the provision added to the Code on March 30, 2010, clarifying the application of the economic substance doctrine, adopts the broader approach (i.e., that a transaction will satisfy the objective prong if the transaction changes in a meaningful way, apart from federal tax effects, the taxpayer's economic position), the focus will be on the benefits from the transaction (mainly profit potential).

b. The Subjective Prong

The inquiry into whether there was a legitimate business purpose for a transaction involves a subjective analysis of the taxpayer's intent.[540] To satisfy this prong, the taxpayer must demonstrate a non-tax purpose for entering into the transaction or series of transactions.[541] As the Eighth Circuit indicated in *Shriver v. Commissioner*, the business purpose test examines "whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved."[542]

Thus, subjective intent may be demonstrated by the existence of a *general* non-tax motive (including business and regulatory considerations) *or* an objective pre-tax *profit potential* expected at the time the transactions were entered into.[543] In *Andantech, LLC v. Commissioner*, the Tax Court observed that in making the business purpose determination, several factors are important: (1) the presence or absence of arm's-length price negotiations; (2) the relationship between the asset's selling price and its fair market value; (3) the structure of the financing; (4) the degree of adherence to contractual terms; (5) the reasonableness of the income and residual value projections [pertain-

[525] *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987) ("The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction.").

[526] *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 285 (1999) (economic substance depends on whether the transaction "was likely to produce" non-tax economic benefits), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).

[527] *N. Ind. Pub. Serv. Co. v. Commissioner*, 105 T.C. 341 (1995).

[528] *Coltec Indus. v. United States*, 62 Fed. Cl. 716 (2004), vacated, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1261 (2007).

[529] *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991).

[530] For example, in *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004), the taxpayer claimed that it was motivated by other benefits, such as to raise capital and to demonstrate to investors, rating agencies, and its senior management, that it could raise capital.

[531] *Johnson v. United States*, 32 Fed. Cl. at 716–17.

[532] *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999).

[533] 330 F. Supp.2d 122 (D. Conn. 2004), aff'd, 150 Fed. Appx. 40 (2d Cir. 2005).

[534] *Id.* (relying on *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) and *Gilman v. Commissioner*, 933 F.2d 143, 147 (2d Cir. 1991)). *See also Cherin v. Commissioner*, 89 T.C. 986, 993 (1987) ("A business transaction by its very nature must have economic substance, that is, a realistic potential for profit."). For an in-depth discussion on how the profit test was applied by the court in this case, see Warren, *Understanding Long-Term Capital*, 2005 TNT 25-48 (Jan. 26, 2005).

[535] *Id. See also Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987); *Johnson v. United States*, 32 Fed. Cl. at 716–17.

[536] *Id. See also Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 209 ("This requires that we first analyze the transaction as a prudent businessman would to ascertain whether it had any economic substance apart from its beneficial tax consequences.").

[537] *Gilman v. Commissioner*, 933 F.2d at 148.

[538] *Id.* at 147.

[539] See the Senate Report on the JOBS Act of 2004, S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005).

[540] *Packard v. Commissioner*, 85 T.C. at 417 (1985) ("The first prong of the sham inquiry, the business purpose inquiry, is a subjective test and simply concerns the motives of the taxpayer in entering the transaction."); *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d at 1549 ("The business purpose factor often involves an examination of the subjective factors which motivated a taxpayer to make the transaction at issue."); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. at 278; *Lee v. Commissioner*, 155 F.3d at 587; *United States v. Wexler*, 31 F.3d at 125; *Shriver v. Commissioner*, 899 F.2d at 726.

[541] *Friedman v. Commissioner*, 869 F.2d at 792 ("[the subjective] prong requires a showing that the only purpose for entering into the transaction was the tax consequences."); *ACM P'ship*, T.C. Memo 1997-115 (to satisfy the business purpose requirement, "the transaction must be rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and … economic situation.").

[542] *Shriver v. Commissioner*, 899 F.2d at 726. A district court in the Fifth Circuit concluded that a transaction would not be invalid even if the primary motivating factor for the transaction was tax benefits, so long as another tax-independent business purpose existed. *Shell Petroleum Inc. v. United States*, 2008-2 USTC ¶ 50,422 (S.D. Tex. 2008).

[543] *Id. See also Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 131.

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ing to lease transactions]; and (6) the insertion of other entities.[544]

In the context of a business deduction under §162, courts held (before the economic substance doctrine was codified) that, in order for a taxpayer to be treated as carrying on a "trade or business," the taxpayer's profit seeking must be *primary*, i.e., of greater importance than tax benefits.[545] Some courts stated that the subjective prong "is similar to the 'primarily for profit' standard of §165 and §108."[546] Nevertheless, the fact that the principal (but not the only) purpose of a transaction is to obtain a favorable tax treatment was not a reason for disallowing such favorable treatment.[547] For example, in *UPS of Am. v. Commissioner*, the Eleventh Circuit held that: [a] 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business.[548]

By contrast, the D.C. Circuit acknowledged in both *Boca Investerings*[549] and *ASA Investerings*[550] that, while taxpayers are allowed to structure their business transactions in such a way as to minimize their tax, the transactions must have a legitimate non-tax purpose to be recognized as legitimate.[551]

The D.C. Circuit in *ASA Investerings*, elaborated that:

> A tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated — in every respect except for differing investments in tax avoidance.[552]

In *Long-Term Capital Holdings v. United States*,[553] the district court added another factor to the business purpose analysis — the "reasonable means" factor.[554] The court observed that "[t]aking fee-generating investments was Long Term's core business and was regularly executed without either complex machinations related to OTC's contributions or the attendant millions in transaction costs."[555] Under this rigid test, a court could disregard a valid non-tax business purpose if the taxpayer could have achieved the same result by entering into a more simple transaction, which is consistent with the taxpayer's core business. Congress later added a provision to the Code clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, which provides that the non-tax purpose must be substantial.[556] In Notice 2010-62,[557] the IRS indicated that, to determine whether a transaction satisfies the subjective prong, it will take into account the taxpayer's profit motive only 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. In performing this calculation, the IRS will apply existing relevant case law and other published guidance.

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[544] T.C. Memo 2002-97 at 131.

[545] *Ramsay v. Commissioner*, 83 T.C. 793, 810 (1984) ("The standard for determining whether an individual or a partnership is carrying on a trade or business so that expenses are deductible under section 162 is whether the individual or partnership is engaged in the activity with the predominant purpose and intention of making a profit."); *Surloff v. Commissioner*, 81 T.C. 210, 232–33 (1983) ("In order to constitute the carrying on of a trade or business, the partnerships must have entered into the coal venture, in good faith, with the dominant hope and intent of realizing a profit …"); *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984) ("Before any deduction is allowed under Section 162(a), it must be shown that the activity was entered into with the dominant hope and intent of realizing a profit.").

[546] *Friedman v. Commissioner*, 869 F.2d at 792.

[547] *Frank Lyon Co. v. United States*, 435 U.S. at 580; *Goldstein v. Commissioner*, 364 F.2d at 741 (a tax benefit should be permitted whenever it can be said that the taxpayer's desire to secure such benefit "is only one of mixed motives that prompts the taxpayer," while a tax benefit should be denied where the transaction "has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit"); *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 511 ("tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes."); *Yosha v. Commissioner*, 861 F.2d at 497 ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."); *Aiken Indus., Inc. v. Commissioner*, 56 T.C. at 933 ("The fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention."); *Bass v. Commissioner*, 50 T.C. at 600 ("[A] taxpayer may adopt any form he desires for the conduct of his business, and … the chosen form cannot be ignored merely because it results in a tax saving.").

[548] 254 F.3d at 1019.

[549] *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003).

[550] *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000).

[551] *Id.*

[552] *ASA Investerings*, 201 F.3d at 513.

[553] 330 F. Supp.2d 122 (D. Conn. 2004).

[554] Warren, *Understanding Long-Term Capital*, 2005 TNT 25-48 (Jan. 26, 2005), criticized this approach.

[555] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (citing *Boca Investerings P'ship v. United States*, 314 F.3d at 631 ("In the current case, the district court never made a finding of fact in regard to the necessity of AHP's acquisition of foreign partners in order to engage in the transactions. No official testified that AHP needed a partnership with a foreign corporation to invest in LIBOR notes or PPNs. AHP's participation in the partnership defies common sense from an economic standpoint, since it could have purchased the PPNs and the LIBOR notes directly, and avoided millions in transaction costs, including the $7 million fee it paid to Merrill Lynch and the 'premiums' paid to the foreign partners for the purchase of their ownership interests.")).

[556] §7701(o)(1)(B).

[557] 2010-40 I.R.B. 411, *amplified by* Notice 2014-58, 2014-44 I.R.B. 746 (guidance regarding the definition of "transaction" for purposes of applying the codified economic substance doctrine under §7701(o) and the meaning of "similar rule of law" as described in the accuracy-related penalty under §6662(b)(6); Notice 2014-58 is also relevant to the availability of the reasonable cause exceptions under §6664(c) and § 6664(d) and the reasonable basis exception under §6676 because those exceptions do not apply to transactions described in §6662(b)(6).).

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Nevertheless, in the circuits in which the *disjunctive* standard (which has since been rejected and superseded by the conjunctive standard set forth in §7701(o)(1) for transactions entered into after March 30, 2010) was applied, even if the *sole* purpose was to achieve tax benefits, the transaction could still be validated if it had economic substance.[558] In some cases, the objective economic substance could have been dispositive, and the transaction would have been validated if the amount of economic substance were significant enough, even in the absence of non-tax business purpose.[559]

Courts frequently focus on the profit motive of the taxpayer in applying the subjective test.[560] "The 'business purpose' test involves the consideration whether a taxpayer had an 'actual and honest profit objective' in engaging in the transactions at issue."[561] Thus, many taxpayers have attempted to prove that they entered into the disputed transaction to make a profit, in order to satisfy this prong.[562] In other cases, such as *TIFD III-E Inc. v. United States*,[563] however, the court did not have to apply the profit motive test, and found that the transaction had a legitimate business purpose.[564] Specifically, the district court accepted the taxpayer's argument that it entered into the partnership agreement to raise capital and, more importantly, to demonstrate to investors, rating agencies, and its senior management, that it *could* raise capital.

In *Cottage Sav. Ass'n v. Commissioner*,[565] the exchange of mortgages was motivated by regulatory obligations, namely, to avoid risk of closure by the Federal Home Loan Bank Board. That agency's accounting regulations required the taxpayer to book losses sustained due to rising interest rates. The Supreme Court held that this was a valid business purpose.[566]

For transactions entered into after March 30, 2010, §7701(o)(1)(B) requires the taxpayer to have a substantial purpose (apart from federal income tax effects) for entering into the transaction. A transaction's profit potential will be taken into account in determining whether the transaction has economic substance 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.[567] Fees and other transaction expenses, as well as foreign taxes in appropriate cases, must be treated as expenses in determining pre-tax profit.[568] State and local tax effects related to federal income tax effects are disregarded in determining whether a transaction has economic substance,[569] and achievement of a financial accounting benefit arising out of federal income tax benefits does not count as a valid purpose for entering into a transaction (or series of transactions).[570]

D. The Conjunctive Test

Congress adopted the conjunctive test in §7701(o)(1), applicable to transactions entered into after March 30, 2010. Under the conjunctive standard, if a court finds the lack of one of the prongs of the two-prong test, presumably it may invalidate the transaction without examining the other prong.[571] In other words, a taxpayer must establish the presence of both prongs for the transaction to withstand court scrutiny.[572]

In Notice 2010-62,[573] providing interim guidance on the codification of the economic substance doctrine, the IRS indicated it will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in §7701(o)(1). Thus, in determining whether a transaction sufficiently affects the taxpayer's economic position to satisfy the requirements of §7701(o)(1)(A), the IRS will apply cases under the common-law economic substance doctrine (as identified in §7701(o)(5)(A)) pertaining to whether the tax benefits of a transaction are not allowable because the transaction does not satisfy the economic substance prong of the economic substance doctrine. Similarly, in determining whether a transaction has a sufficient nontax purpose to satisfy the requirements of §7701(o)(1)(B), the IRS will apply cases under the common-law economic substance doctrine pertaining to whether the tax benefits of a transaction are not allowable because the transaction lacks a business purpose. The IRS noted that, for all transactions subject to §7701(o) that otherwise would have been subject to a common-law economic substance analysis that treated a transaction as having economic substance merely because it satisfies one or the other of the

[558] In *Black & Decker Corp. v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), the parties stipulated that there was no business purpose, but the court still upheld the transaction on the grounds that it had economic substance. This decision was remanded by the Fourth Circuit. *See Black & Decker Corp.*, 436 F.3d 431 (4th Cir. 2006).

[559] *Saba P'ship v. Commissioner*, T.C. Memo 1999-359 ("[A] transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a non-tax business purpose"); *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 512 (economic substance doctrine "do[es] not allow the Commissioner to disregard economic transactions … which result in actual, non-tax-related changes in economic position.").

[560] *ACM P'ship v. Commissioner*, T.C. Memo 1997-115.

[561] *Coffey v. Commissioner*, T.C. Memo 1991-516.

[562] *See, e.g.*, *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), and *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), in both of which the taxpayer's arguments focused on the profit potential from the transactions.

[563] 342 F. Supp.2d 94 (D. Conn. 2004). This decision was reversed by the Second Circuit.

[564] *See also Bass v. Commissioner*, 50 T.C. 595 (1968) (court accepted the taxpayer's position that the formation of the foreign target corporation had business purpose, namely to hold oil and gas leases for development).

[565] 499 U.S. 554 (1991).

[566] *See also Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978).

[567] §7701(o)(2)(A).

[568] §7701(o)(2)(B).

[569] *See* §7701(o)(3).

[570] §7701(o)(4).

[571] *Illes v. Commissioner*, 982 F.2d 165 ("To be valid, an asserted deduction must satisfy both components of a two-part test. The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."); *Pasternak v. Commissioner*, 990 F.2d at 898 ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction. … If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made."); *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp.2d 885 (E.D. Tex. 2007) ("If these transactions fail the economic substance test, then the court will disregard those transactions for federal tax purposes."), *aff'd*, 568 F.3d 537 (5th Cir. 2009) (holding that lack of economic substance is sufficient to invalidate transaction regardless of whether taxpayer has motives other than tax avoidance).

[572] §7701(o)(1).

[573] 2010-40 I.R.B. 411, applicable to transactions entered into after March 30, 2010.

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two tests, the IRS will apply a two-prong conjunctive test consistent with §7701(o).

The conjunctive test mandates that a transaction must satisfy both prongs, objective and subjective; nevertheless, as discussed below, some courts have given more weight to one prong over the other, while others have treated them equally.[574] Most courts have first tested the objective prong, and if the court found that the transaction lacked objective economic substance, it would stop its analysis there and invalidate the transaction.[575]

Stated differently, if the court finds economic substance, it must continue and examine whether the taxpayer had a non-tax business purpose.[576] As the Eleventh Circuit indicated in *UPS of Am. v. Commissioner*, "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance."[577]

Accordingly, under the conjunctive test, if the court begins with the objective prong and finds that the transaction *had* economic substance, it will next examine if the transaction had business purpose.[578] In *Ferguson v. Commissioner*,[579] the court held that:

> Having concluded that the partnerships' Koppelman Process activities lacked economic substance, those activities must be disregarded for tax purposes and cannot form the basis of any deductions. It is unnecessary, therefore, for us to analyze the tax court's findings with respect to the partnerships' profit motive.[580]

Other courts applying the conjunctive test have begun with the subjective prong (usually by evaluating the profit motive).[581] Because the taxpayer must satisfy both prongs to prevail under the conjunctive test, simply showing an honest non-tax business purpose does not suffice.[582] As the Tax Court indicated in *Cherin v. Commissioner*:

> Subjective intent cannot supply economic substance to a business transaction. Where, as in the case at bar, we examine the transaction and conclude as we do in this case that Southern Star's herd investment packages lack any realistic potential for profit, we need not examine the investor's state of mind.[583]

The Tax Court in *Sheldon*[584] and *ACM P'ship*[585] also started with the subjective standard, which was basically a profit motive test. In *Sheldon*, the Tax Court observed that: "We first address whether the transactions involving the purported T-Bill and repo transactions were fictitious or real."[586] The Tax Court explained that "Although fictitious transactions or those lacking in economic substance have, in different cases, been alternately labeled as a 'sham,' in this opinion the term 'fictitious' will refer to nonexistent transactions and transactions lacking economic substance will be so described."[587]

The Tax Court applied a comprehensive profit potential analysis and concluded that, "[h]aving found that 10 of the 11 repos and related transactions were not fictitious, we must now consider whether, within the meaning of *Goldstein*, any of the transactions had economic substance."[588] Consistent with *Knetsch v. United States* [589] and *Goldstein v. Commissioner*,[590] the Tax Court held that: "With these principles in mind, we find that the 11 repo transactions, although 10 of them are not fictitious, lacked tax-independent purpose. We therefore hold that interest claimed on all repos may not be deducted."[591]

In *ACM P'ship v. Commissioner*,[592] the Tax Court acknowledged that "The CINS transaction was not a sham in the sense that it was fictitious but it was a sham in the sense that the section 453 investment strategy lacked economic substance."[593] The Tax Court first examined the profit potential from the transaction and observed that: "Considering the high costs of the financial engineering it required and ABN's unwillingness to have Kannex share any of these costs or be exposed to any of the entrepreneurial risks it entailed, the section 453

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[574] *See ACM P'ship*, 157 F.3d at 248, n. 31 (giving more weight to the objective determination). *See Chemtech Royalty Assocs. v. United States*, No. 05-944-BAJ-DLD, 2013 BL 50409 (M.D. La. 2013) (objective and subjective factors applied equally to determine "special limited investment partnerships" (SLIPs) lacked economic substance), aff'd, 766 F.3d 453 (5th Cir. 2014), *cert. denied*, No. 16-347 (Jan. 9, 2017).

[575] *Kirchman v. Commissioner*, 862 F.2d at 1492 ("The analysis of whether a transaction is a substantive sham, however, addresses whether a transaction's substance is that which its form represents. That does not necessarily require an analysis of a taxpayer's subjective intent. Once a court determines a transaction is a sham, no further inquiry into intent is necessary."); *Lee v. Commissioner*, 155 F.3d at 586 (citing *Jacobson v. Commissioner*, 915 F.2d at 839); *Mahoney v. Commissioner*, 808 F.2d at 1220 ("Here, the Tax Court in a lengthy and well-reasoned opinion decided the transactions were a sham, thus making it unnecessary to directly reach the 'entered for profit issue.'").

[576] *Gilman v. Commissioner*, 933 F.2d at 148, n. 5 ("section 183 applies after a transaction has been determined to have economic substance.").

[577] *UPS of Am. v. Commissioner*, 254 F.3d at 1018. *See also Dow Chem. Co. v. United States*, 250 F. Supp.2d at 799 ("courts have held that a proper business purpose alone will not 'breathe substance' into a transaction that objectively has no reasonable prospect of profitability absent tax considerations.").

[578] *Id. See also Pasternak v. Commissioner*, 990 F.2d at 898 ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."); *Dow Chem. Co. v. United States*, 250 F. Supp.2d at 800 ("If the transaction is objectively economically viable, the Court must determine whether the taxpayer had a legitimate profit motive in entering into the transaction. However, the subjective component does not become determinative unless the transaction has satisfied the objective requirement of the sham test.").

[579] 29 F.3d at 102.

[580] *Id. See also Karr v. Commissioner*, 924 F.2d at 1025, n. 8 ("Because we affirm the Tax Court's holding that POGA's Koppelman process activity is a sham, we need not determine whether the losses sustained from that activity are otherwise deductible under the Internal Revenue Code.").

[581] *ACM P'ship*, T.C. Memo 1997-115.

[582] *Gardner v. Commissioner*, 954 F.2d 836, 839 (2d Cir. 1992) ("Since the taxpayers concede that their straddle transactions lacked economic substance, and since it is well established that a subjective profit motive can not save a transaction that objectively lacks economic substance … we agree with the Tax Court and the Third Circuit that the straddle transactions did not create any recognizable losses.").

[583] 89 T.C. at 994. *See also Kirchman v. Commissioner*, 862 F.2d at 1492 ("It is clear that transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer.").

[584] *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[585] 73 T.C.M. 2189 (1997).

[586] 94 T.C. at 753.

[587] *Id.* at 753, n. 8.

[588] *Id.* at 760.

[589] 364 U.S. 361 (1960).

[590] 364 F.2d 734 (2d Cir. 1966).

[591] 94 T.C. at 762.

[592] T.C. Memo 1997-115 (1997).

[593] *Id.* at 113–114, n. 21.

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investment strategy would not have been consistent with rational profit-motivated behavior in the absence of the expected tax benefits."[594] Subsequently, the Tax Court dismissed the taxpayer's second argument that the LIBOR notes served as a hedging tool.[595] Accordingly, the Tax Court concluded that: "But for the $100 million of tax losses it generated for Colgate, the section 453 investment strategy would not have been consistent with rational economic behavior. The section 453 investment strategy lacked economic substance. It served no useful non-tax purpose."[596]

Comment: In both *ACM P'ship* and *Sheldon*, the Tax Court considered the profit potential to be probative of the taxpayer's motive; because it found the potential for profit to be insignificant, the Tax Court concluded in both cases that the taxpayer was motivated solely by tax benefits. In general, if the court applies the conjunctive test to a transaction entered into on or before March 30, 2010, begins with the profit potential standard, and finds it to be no more than de minimis, the court can stop and hold that the transaction should be invalidated and tax benefits be denied. Nevertheless, in these two cases, the courts also performed the objective analysis.

As mentioned above and as set forth above in I.B., a conjunctive test has been added to the Code and applies to transactions entered into after March 30, 2010.[597] More specifically, a transaction entered into after March 30, 2010 has economic substance only if (i) the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position, *and* (ii) the taxpayer has a substantial non-tax purpose for entering into such transaction.[598]

E. Applying Only the Objective Test (Before Enactment of §7701(o))

In several cases decided before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine for transactions entered into after March 30, 2010, the objective prong was the primary or even the sole basis for the courts' disregard of the form of the transaction where the taxpayer's only claimed business purpose was to earn a profit.[599] Some courts disregarded the subjective standard completely and focused primarily on the objective standard.[600] As Professor Bernard Wolfman indicated in expressing his view against the codification of the economic substance doctrine:

> [T]he business purpose (now economic substance) doctrine does not seek to ascertain what was inside the head of the actor, but whether the transaction as consummated played a role in carrying on or changing the corporate business. The doctrine asks whether the transaction as undertaken is cognate to the corporation's business activities, this because the reorganization provisions of the statute make sense when they are understood to provide their deferral benefits only when such a transaction has occurred.[601]

A similar view was expressed in 1999 by both Treasury and the Joint Committee on Taxation.[602] Specifically, Treasury suggested to codify the economic substance doctrine and for this purpose, suggested that:

> [a] tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction are insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income.[603]

This resembled the test applied by the IRS in Notice 98-5.[604] In both Notice 98-5 and the Treasury's proposed definition, the subjective motives of the taxpayer would not have been taken into account.[605] Rather, the motives of the taxpayer would have been analyzed objectively based on whether the taxpayer reasonably expects an economic profit from the transaction in question. In the 1999 Report, Treasury explained that a subjective test would likely prove inadequate for the following reasons.[606] First, corporations exist to make a profit, and therefore would be presumed to satisfy the potential for profit test even if its expectation of profit is unreasonable.[607] Second, permitting corporate taxpayers to enter into transactions with unreasonable expectations of profit would permit corporations to engage in transactions solely for tax benefits.[608]

Similarly, in 1999, the Joint Committee on Taxation also suggested codification of the economic substance doctrine.[609] According to the Joint Committee, a transaction will not be recognized for tax purposes if "[t]he reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected tax benefits."[610]

Several courts followed the same view.[611] As the Second Circuit indicated in *Rosenfeld v. Commissioner*:[612]

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[594] *Id.* at 137.

[595] *Id.* at 160–61.

[596] *Id.* at 171.

[597] §7701(o)(1).

[598] *Id.*

[599] *Saba P'ship v. Commissioner*, T.C. Memo 1999-359; *Kirchman v. Commissioner*, 862 F.2d at 1492; *Rose v. Commissioner*, 868 F.2d at 854. *Cf. Karr v. Commissioner*, 924 F.2d at 1023.

[600] *Id. Cf. McCrary v. Commissioner*, 92 T.C. 827, 845 (1989) ("A taxpayer's subjective intent, however, is a factor to be considered in determining whether the transaction had economic substance.").

[601] Wolfman, *Why Economic Substance is Better Left Uncodified*, 104 Tax Notes 445 (July 26, 2004).

[602] JCT Report (1999) at 229.

[603] Treasury Report (1999).

[604] Notice 98-5, 1998-3 I.R.B. 49 ("The regulations [under section 901(k)] will emphasize an objective approach to calculating expected economic profit and credits, and will require that the determination of expected economic profit reflect the likelihood of realizing both potential gain and potential loss (including loss in excess of the taxpayer's investment.").

[605] *Id.*

[606] Treasury Report (1999).

[607] *Id.*

[608] *Id.*

[609] JCT Report (1999) at 226. *Cf.* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (suggesting a conjunctive two-prong test).

[610] *Id.*

[611] *Kirchman v. Commissioner*, 862 F.2d at 1492.

[612] 706 F.2d 1277, 1282 (2d Cir. 1983).

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> [W]e decline appellant's invitation to adopt a business purpose standard of review. Rather, we believe our inquiry should focus on whether there has been a change in the economic interests of the relevant parties. If their legal rights and beneficial interests have changed, there is no basis for labeling a transaction a "sham" and ignoring it for tax purposes. Indeed, our prior decisions have indicated that this is the relevant inquiry.[613]

In *Carlson v. Commissioner*,[614] a case involving a purchase of a cable television system, the Tax Court elaborated and stated that:

> [W]e are not unaware of the proposition that where a taxpayer mistakenly believes there existed a potential for profit, a transaction devoid of economic substance may not be disregarded entirely (sometimes called the subjective business purpose test). See *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 203 n.17. Under the circumstances of this case, however, [the taxpayer] should have known that the transaction at issue could not achieve a non-tax profit [footnote omitted]. We refuse to allow a sophisticated businessman who has not taken adequate steps to form a reasoned assessment of an investment to rely on his failure to take such steps and on his resulting ignorance [footnote omitted]. To do so would encourage "tax shelter charlatans," and discourage taxpayers from independently evaluating transactions and making informed business judgments, thereby putting a premium on gullibility.[615]

On the other hand, in *IRS v. CM Holdings, Inc.*,[616] on appeal, the taxpayer argued that subjective intent is irrelevant for purposes of the economic substance test. The Third Circuit disagreed, however, and held that "From the time of *Gregory*'s analysis of the 'rational business purpose,' courts have evaluated taxpayers' purposes when determining whether a transaction has economic substance."[617] Thus, the Third Circuit concluded that the objective prong alone was insufficient to satisfy the economic substance test.

In *Coltec*, the Federal Circuit also stated that "the economic substance of a transaction must be viewed objectively rather than subjectively."

Comment: This pre-§7701(o) standard of review may be viewed as a variation of the disjunctive test, because the existence of one prong, namely the objective prong, would have validated a transaction.[618] Although, technically, the disjunctive test discussed in the next chapter (which has since been rejected by §7701(o), adopting the conjunctive test) would have allowed a taxpayer to demonstrate either economic substance or business purpose, as a practical matter, most taxpayers focused on showing objective substance under the disjunctive test.[619]

The rationale behind applying only the objective prong was that if the claimed business purpose of the taxpayer is to earn a profit by entering into the transaction, unlike the transaction in *Frank Lyon Co. v. United States*, for example, which was also guided by accounting and regulatory concerns, then the two prongs of the test overlap to a large extent.[620] Subjective intent is frequently demonstrated by the existence of an objective pre-tax profit potential expected at the time the transactions were entered into and other business and regulatory considerations.[621] In *IES Indus.*, the Eighth Circuit observed that "the business purpose test is a subjective economic substance test."[622] Thus, as a practical matter, the court applies objective analysis under both prongs.

F. The Disjunctive Test (Before Enactment of §7701(o))

1. General

A standard applied by several Circuits (primarily the D.C., Federal, and Fourth Circuits, and occasionally the First, Second, and Eighth Circuits) and several tax courts before §7701(o) was added to the Code, adopting the conjunctive test, was a disjunctive test pursuant to which the economic substance doctrine would apply to disallow a tax benefit only after a decision that the transaction lacked *both* a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).[623] Because a taxpayer was required under the disjunctive test to satisfy only one prong, even if a court found

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[613] *Id.* Citing *Gilbert v. Commissioner*, 248 F.2d at 411 ("If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose."); *United States v. Ingredient Tech. Corp.*, 698 F.2d at 94 ("we agree with Judge Learned Hand in dissent in *Gilbert v. Commissioner*, 248 F.2d 399, 412 (2d Cir. 1957) that it is immaterial whether we are talking about 'substantial economic reality,' 'substance over form,' 'sham' transactions, or the like; rather the question is whether under the statute and regulations here involved the transaction affects a beneficial interest other than the reduction of taxes.").

[614] T.C. Memo 1987-306.

[615] *Id.* (citing *James v. Commissioner*, 87 T.C. at 924 n. 5).

[616] 301 F.3d 96 (3d Cir. 2002).

[617] *Id.* at 105–06.

[618] *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. 1054, 1062–63 (1988) ("A two-pronged test has emerged. Under this test, we must disregard such transactions if we find "that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." [footnote omitted] Petitioner does not seriously contend that the transaction had a purpose apart from tax savings. Petitioner's witnesses all protested that tax considerations were not a major or primary factor in petitioner's decision to invest in the equipment. They did not, however, identify any other motivating consideration that can be given credence. Thus we give greater weight to objective factors and conclude that petitioner's tax objective was the only real purpose of the transaction.").

[619] *Cf. Black & Decker Corp. v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part and rem'd, 436 F.3d 431 (4th Cir. 2006).

[620] *Hines v. United States*, 912 F.2d at 739 (citing *Rice's Toyota World*, 752 F.2d 96 and *Faulconer v. Commissioner*, 748 F.2d at 894).

[621] *Freidman v. Commissioner*, 869 F.2d at 792 ("Under applicable Fourth Circuit law, it is proper to draw from objective facts inferences regarding a subjective intent").

[622] 253 F.3d. at 355. *See also Compaq Computers Corp v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) (the Fifth Circuit relied on the profit requirement test for establishing both economic substance and business purposes).

[623] *Rice's Toyota World v. Commissioner*, 752 F.2d at 91–2; *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) (the economic substance of a transaction can be established if the transaction at issue had objective economic substance or if there was a subjective non-tax business purpose); *Friendship Dairies, Inc. v. Commissioner*, 90 T.C. at 1062–63. *See also* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (describing the disjunctive test as a "narrower approach.").

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that the taxpayer had no, or insignificant, non-tax motivation, it would validate a transaction if it found the transaction had objective economic substance.[624]

2. Fourth Circuit

The leading case cited in support of the disjunctive test (before §7701(o), which adopts a conjunctive test, was added to the Code) was *Rice's Toyota World Inc. v. Commissioner*[625] Generally, in the Fourth Circuit, a transaction was treated as a sham (or as having no economic substance) if the court found "that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."[626]

As the Fourth Circuit elaborated in *Hunt v. Commissioner*:

> The purpose of this test is to ascertain both the subjective motivations of the taxpayer and the objective reasonableness of the investment to determine whether the transaction contained economic substance aside from the tax benefits.[627]

In *Hines v. Commissioner*, the Fourth Circuit followed this standard and held that:

> Under the test in *Rice's Toyota*, however, a transaction with an expected loss may not be a sham if the taxpayer was motivated by some legitimate business reason other than to obtain tax benefits.[628]

Citing *Faulconer v. Commissioner*,[629] the Fourth Circuit in *Hines v. Commissioner* implied that the subjective prong is tested on an objective basis, so there is some overlap between both prongs:

> [T]he ultimate determination of whether an activity is engaged in for profit is to be made … by reference to objective standards, taking into account all of the facts and circumstances of each case. A taxpayer's mere statement of intent is given less weight than objective facts.

The Fourth Circuit, however, held that "[t]he mere assertion of such a belief, particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham."[630]

In *Black & Decker Corp. v. United States*, the district court followed the Fourth Circuit's disjunctive standard and stated that "[t]he court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes."[631] The district court applied a combination of the *Moline Props. v. United States*[632] doctrine (see below) and objective economic substance analysis to conclude that a corporation *and its transactions* are objectively valid, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically based business transactions.[633]

The district court looked at the facts and noted:

> that [the subsidiary] (1) "assumed the responsibility for the management, servicing, and administration of plaintiff's employee and retiree health plans;" [footnote omitted] (2) has considered and proposed numerous healthcare cost containment strategies since its inception in 1998, many of which have been implemented by B&D; [footnote omitted] and (3) has always maintained salaried employees. [footnote omitted]. Moreover, as a result of the BDHMI transaction, BDHMI became responsible for paying the healthcare claims of B&D employees, and such claims are paid with BDHMI assets.[634]

As a result, the court held that "[t]he BDHMI transaction, therefore, had very real economic implications for every beneficiary of B&D's employee benefits program, as well as for the parties to the transaction." Applying the disjunctive test, therefore, the court held for the taxpayer.[635] The decision, however, was remanded by the Fourth Circuit to determine whether the transaction had a reasonable possibility of profit, disregarding the tax benefits.[636]

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[624] *Sanderson v. Commissioner*, T.C. Memo 1985-477.

[625] 752 F.2d at 89 (4th Cir. 1985). *See also Black & Decker Corp.v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part and rem'd, 436 F.3d 431 (4th Cir. 2006) (confirming that the Fourth Circuit applies the disjunctive standard. The district court relied also on *Hunt v. Commissioner*, 938 F.2d at 471 and *Hines v. United States*, 912 F.2d at 738–39 for its decision). For other cases in the Fourth Circuit applying the disjunctive test, see *Friedman v. Commissioner*, 869 F.2d at 792; *Georgetowne Sound v. United States*, 856 F. Supp. 1056, 1057 (D. Md. 1993), aff'd 1994 U.S. App. Lexis 4126 (4th Cir. 1994); *Duke Energy Corp. v. United States*, 49 F. Supp.2d 837, 842 (W.D.N.C. 1999).

[626] *Rice's Toyota World*, 752 F.2d at 90.

[627] *Hunt v. Commissioner*, 938 F.2d 466.

[628] *Hines v. United States*, 912 F.2d at 740 (citing *Rice's Toyota World*, 752 F.2d 96).

[629] 748 F.2d 890, 894 (4th Cir. 1984).

[630] *Hines v. United States*, 912 F.2d at 740.

[631] 340 F. Supp.2d 621 (D. Md. 2004).

[632] 319 U.S. 436 (1943).

[633] Citing *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 512; *Moline Props. Inc. v. Commissioner*, 319 U.S. at 438–39; *Frank Lyon Co. v. United States*, 435 U.S. at 583–84.

[634] *Id.*

[635] *Cf. ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000), where the D.C. Court noted that satisfying the "business activity" test under *Moline* is not enough — the transaction entered into by the entity must also have substance. The D.C. Circuit explained that "Because ASA 'engaged in more than sufficient business activity to be respected as a genuine entity,' petitioner argues that ASA was a partnership under the second alternative… We agree if engaging in business activity were sufficient to validate a partnership ASA would qualify. It was infused with a substantial amount in capital ($1.1 billion), and invested it in PPNs, LIBOR notes, and other short-term notes over a period of two years. In fact, however, courts have understood the 'business activity' reference in *Moline* to exclude activity whose sole purpose is tax avoidance. This reading treats 'sham entity' cases the same way the law treats 'sham transaction' cases, in which the existence of formal business activity is a given but the inquiry turns on the existence of a non-tax business motive. *See Knetsch v. United States*, 364 U.S. 361, 364–65, 5 L.Ed. 2d 128, 81 S. Ct. 132 (1960). Thus, what the petitioner alleges to be a two-pronged inquiry is in fact a unitary test — whether the 'sham' be in the entity or the transaction — under which the absence of a non-tax business purpose is fatal." *See also TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004) (the court examined both the economic substance of the transaction and the economic substance of the entity (partnership) and concluded that both were valid); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 115 (the Tax Court applied a separate analysis with respect to the validity of the partnership, and reached a different conclusion than *TIFD III-E Inc. v. United States*). The Second Circuit reversed the district court's holding in the TIFD case.

[636] *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006), aff'g in part, rev'g in part and rem'g, 340 F. Supp.2d 621 (D. Md. 2004).

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3. D.C. Circuit

In general, the D.C. Circuit had also adopted the disjunctive standard before §7701(o), which adopts a conjunctive test, was added to the Code.[637] In *Horn v. Commissioner*, the D.C. Circuit held that to treat a transaction as a sham, the court must find that (i) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (ii) that the transaction has no economic substance because no reasonable possibility of profit exists.[638] The court cited *United States v. Consumer Life Ins. Co.*,[639] where the Supreme Court had affirmed the lower courts' decisions that the two types of reinsurance arrangements were not shams because they "served [other] valid and substantial non-tax purposes," specifically, risk allocation.[640] The D.C. Circuit concluded that "… a transaction will not be considered a sham if it is undertaken for profit *or* for other legitimate non-tax business purposes."[641] Thus, the D.C. Circuit held that establishing that the transaction was undertaken for profit (presumably under the objective prong) or any legitimate non-tax business purpose (under the subjective prong) would validate the transaction.[642]

In *Boca Investerings P'ship v. Commissioner*,[643] the district court followed the D.C. Circuit's decision in *Horn v. Commissioner*,[644] and held that the economic substance test should be disjunctive.[645] The court stated that "A transaction is not a sham and will be recognized for tax purposes if the taxpayer satisfies either part of the test for economic substance — if either (1) using a subjective analysis, the transaction has a non-tax business purpose, or (2) using an objective analysis, the transaction has a reasonable possibility of generating a profit, ex-ante."[646] Although this decision was reversed by D.C. Circuit, the reversal was not based on the disjunctive standard applied by the district court but rather on the grounds that, in the view of the D.C. Circuit, the partnership had neither business purpose nor economic substance.[647]

In *Andantech, LLC v. Commissioner*,[648] in evaluating the economic substance of the sale leaseback transactions, the Tax Court also followed *Horn v. Commissioner*[649] and concluded that: "the sale-leaseback should not be respected for tax purposes because (1) no reasonable possibility for profit existed, and (2) RD Leasing was not motivated by any business purpose other than obtaining tax benefits."[650] The Tax Court applied a separate analysis with respect to the validity of the *partnership*, as discussed in greater detail below.[651] The Court of Appeals for the D.C. Circuit affirmed only the decision with respect to the validity of the partnership, and did not conduct a separate economic substance analysis with respect to the sale-leaseback transactions.[652]

4. Federal Circuit

The Federal Court of Claims, in *Coltec Indus. Inc. v. United States*,[653] also followed the disjunctive standard before §7701(o) was added to the Code. However, the Federal Circuit vacated the lower court decision, holding that the test should be conjunctive and not disjunctive.[654]

5. Eighth Circuit

Before §7701(o) was added to the Code, adopting a conjunctive two-prong test, the Eighth Circuit followed *Rice's Toyota World Inc. v. Commissioner*[655] and applied the disjunctive test in *Shriver v. Commissioner*:[656]

> For the reasons set out above, we determine that the tax court found *both* a lack of business purpose and a lack of economic substance, thereby performing the necessary analysis to determine that the transaction was actually a sham under *Rice's Toyota World*.[657] (emphasis in original)

The Eighth Circuit, however, also asserted that "we do not read *Frank Lyon* to say anything that mandates a two-part analysis. And although *Rice's Toyota World* seems to conclude a two-part test is consistent with *Frank Lyon*, the Fourth Circuit opinion does not appear to hold that such a test is essential."[658]

Applying the unitary analysis, the Eighth Circuit affirmed the Tax Court's decision.

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[637] *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992); *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003); *Saba P'ship v. Commissioner*, 273 F.3d 1135 (D. C. Cir. 2001); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97.

[638] 968 F.2d 1229 (D.C. Cir. 1992).

[639] *United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 736–39 (1977).

[640] *Id.* at 739.

[641] 968 F.2d at 1238. The court cited Schneider & Englebrecht, *The Tax Court's Unified Approach to Analyzing Generic Tax Shelters*, 6 J. Tax'n Investments 308, 309–10 (1989), and Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 Fla. L. Rev. 659, 670 (1989).

[642] *Id.*

[643] *Boca Investerings P'ship v. United States*, 167 F. Supp.2d 298 (D.D.C. 2001)).

[644] 968 F.2d 1229 (D.C. Cir, 1992).

[645] *Boca Investerings P'ship v. United States*, 167 F. Supp.2d 298 (D.D.C. 2001). *See also Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 115.

[646] *See generally* Humphreys, Gouwar, & Holder, *Boca Investerings and the Future of the Economic Substance Doctrine*, Derivatives Report Vol. 3(5) (2001) at 9–10.

[647] *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003). *See also Saba P'ship v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001), and *ASA P'ship v. Commissioner*, both decided in the D.C. Circuit, and in both, the court applied the disjunctive test but found neither economic substance nor business purpose.

[648] T.C. Memo 2002-97, at 115.

[649] 968 F.2d 1229 (D.C. Cir, 1992).

[650] T.C. Memo 2002-97, at 116. *See also Friedman v. Commissioner*, 869 F.2d at 792 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists.") (quoting *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 91–92).

[651] *See also TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004). For a full discussion of *TIFD III-E*, including the procedural history, see VIII.E., below.

[652] 331 F.3d 972 (D.C. Cir. 2003).

[653] 62 Fed. Cl. 716 (2004). *See also Drobny v. United States*, 86 F.3d 1174 (Fed. Cir. 1996).

[654] *Coltec Indus. Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1261 (2007).

[655] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[656] *Shriver v. Commissioner*, 899 F.2d at 726.

[657] *Shriver v. Commissioner*, 899 F.2d at 726.

[658] *Id.* at 727.

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In *IES Indus., Inc. v. United States*, the Eighth Circuit did exactly the same.[659] First, it stated the general rule:

> [i]n determining whether a transaction is a sham for tax purposes, the Eighth Circuit has applied a two-part test set forth in *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91–92 (4th Cir. 1985), which the Fourth Circuit ostensibly found in the Supreme Court's opinion in *Frank Lyon Co.* See *Shriver v. Commissioner*, 899 F.2d 724, 725–26 (8th Cir. 1990). Applying that test, a transaction will be characterized as a sham if "it is not motivated by any economic purpose outside of tax considerations" (the business purpose test), and if it "is without economic substance because no real potential for profit exists" (the economic substance test). *Id.* at 725, 725–26.

Nevertheless, the Eighth Circuit acknowledged in *IES Indus., Inc. v. United States* (as it did in *Shriver v. Commissioner*) that it did not need to apply the disjunctive test:

> [t]he Shriver Court analyzed the transaction at issue in that case under both parts of the test, but then said in dictum, "[W]e do not read Frank Lyon to say anything that mandates a two-part analysis." *Id.* at 727. The Court suggested that a failure to demonstrate either economic substance *or* business purpose — both not required — would result in the conclusion that the transaction in question was a sham for tax purposes. As in Shriver, we do not decide whether the Rice's Toyota World test requires a two-part analysis because we conclude that the ADR trades here had both economic substance and business purpose.[660]

In *Xcel Energy Inc. et al. v. United States* (a fifth COLI case), the taxpayer attempted to argue that, in accordance with the decision in *IES Indus., Inc. v. United States*,[661] the test in the Eighth Circuit was disjunctive.[662] The district court (whose decision is appealable to the Eighth Circuit) clarified as follows:

> [The taxpayer] asserts that either a non-tax economic effect or a non-tax business purpose is sufficient to negate sham transaction treatment, pursuant to the Eighth Circuit's holding in *IES Indus.*. 253 F.3d at 353. However, Xcel's logic is misplaced. In *IES*, the Eighth Circuit reiterated the court's holding in *Shriver*, stating that "a failure to demonstrate either economic substance or business purpose — both not required — would result in the conclusion that the transaction in question was a sham for tax purposes." *Id.* However, it does not follow logically that if *either* business purpose *or* economic substance is present, then no sham exists. Moreover, the *IES* court stated that it need not consider whether a two-part test was required, because the court found that the trades at issue there had both a business purpose and economic substance. *Id.*[663]

6. Second Circuit

Similarly, it was unclear which standard prevailed in the Second Circuit before §7701(o) was added to the Code. The court in *Long-Term Capital Holdings v. United States*[664] asserted that the Second Circuit applied the unitary test (contrary to the taxpayer's argument that the disjunctive test should apply). The taxpayer in *TIFD III-E Inc. v. United States*[665] also urged the court to apply the disjunctive test, and the court implied that the disjunctive test might be acceptable in the Second Circuit (although the court held that it did not matter for the particular case, because the taxpayer had satisfied both prongs).[666]

Support for the taxpayers' arguments in both cases was found in the Second Circuit's decision in *Gilman v. Commissioner*.[667] In *Gilman*, the taxpayer paid $45,000 in cash and signed an interest bearing note with a principal amount of $2,955,000. In form, almost $2 million of this long-term note was recourse, but it was secured by the equipment and rental income. The taxpayer's monthly payments of $65,619.32 on the note began in January 1983. Simultaneously, the taxpayer was scheduled to receive $66,319.32 monthly from the leasing company on its lease. Therefore, the monthly rental income from the leased equipment covered, with some excess, the note payments. In addition, the notes provided that the taxpayer could defer payment up to 14 years if he failed to receive his corresponding lease payments. The interest that accrued on the note in 1981 and 1982 was paid in the form of two short-term recourse notes with a total face value of $375,000 plus interest thereon of $49,597. The notes were secured by letters of credit from the taxpayer's bank. In summary, the taxpayer's total cash investment was $469,597, comprising his $45,000 down payment, the $375,000 face amount of the short-term notes, and the $49,597 interest thereon.

In his 1980 and 1981 tax returns, the taxpayer reported this lease transaction as a $3 million purchase, took deductions for depreciation and interest, and included as income the rent received. The IRS disallowed these tax deductions and excluded the rental income.

The Tax Court applied the *Rice's Toyota's* disjunctive test, examined each prong separately, and concluded that the disputed transaction lacked a business purpose and economic

[659] 253 F.3d at 353.

[660] *Id.* at 353–54. *See also Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 ("In *Rice's Toyota World*, the court held that after *Frank Lyon Co.*, it is appropriate for a court to engage in a two-part inquiry to determine whether a transaction has economic substance or is a sham that should not be recognized for income tax purposes … . Other courts have said that business purpose and reasonable possibility of profit are merely factors to be considered in determining whether a transaction is a sham … . Because we conclude that the ADR transaction in this case had both economic substance and a business purpose, we do not need to decide today which of these views to adopt.").

[661] 253 F.3d at 353.

[662] *Xcel Energy Inc. v. United States*, No. 0:04-cv-01449, 2005 BL 42037, 36 EBC 2294 (D. Minn. Oct. 12, 2005).

[663] *Id.* at n. 5.

[664] 330 F. Supp.2d 122 (D. Conn. 2004).

[665] *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004). Note that this case was overturned by the Second Circuit. For a full discussion of TIFD III-E, including the procedural history, see VIII.E., below.

[666] As Lee Sheppard indicates, "In the Second Circuit Court of Appeals, to which Castle Harbour can be appealed, the economic substance test is disjunctive. Under *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991) cert. denied, 502 U.S. 1031 (1992), the taxpayer must show either a business purpose or a profit potential, both of which must be shown by objective evidence. But tax avoidance purpose is irrelevant, which is not a good thing, because it keeps motive out of evidence." *News Analysis: Drafting Economic Substance, Part 3*, 2005 TNT 39-6 (Feb. 23, 2005).

[667] *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991).

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substance.[668] On appeal, the taxpayer challenged the Tax Court's use of the disjunctive test and argued that the "relevant standard for determining economic substance is 'whether the transaction may cause any change in the economic positions of the parties (other than tax savings),' and 'that the 'profit motive/business purpose' inquiry should be based on the criteria in the regulations under section 183.'"[669]

The Second Circuit supported the *Rice's Toyota*'s disjunctive test, rejected the taxpayer's argument, and held that:

> [T]he Tax Court did not demand that the taxpayer demonstrate both business purpose and economic substance. Rather, the Court examined each prong separately and concluded that Gilman lacked a business purpose and that the transaction lacked economic substance.[670]

In *Jacobson v. Commissioner*, relying also on *Rice's Toyota World Inc. v. Commissioner*,[671] the Second Circuit stated that "[e]ven if the motive for a transaction is to avoid taxes, interest incurred therein may still be deductible if it relates to economically substantive indebtedness."[672] By contrast, the Second Circuit in *Ferguson v. Commissioner* clearly applied a different test, stating that:

> Having concluded that the partnerships' Koppelman Process activities lacked economic substance, those activities must be disregarded for tax purposes and cannot form the basis of any deductions. It is unnecessary, therefore, for us to analyze the tax court's findings with respect to the partnerships' profit motive.[673]

7. Third Circuit

Before §7701(o) was added to the Code, the Third Circuit, in *United States v. Wexler*, cited *Jacobson v. Commissioner*[674] with approval.[675] In that case, the taxpayer, a managing partner of a limited partnership that was engaged in securities trading, entered into numerous repo-to-maturity transactions that paid out more in market interest than they received in coupon interest. The government filed criminal charges against the taxpayer. The taxpayer argued, and the government did not quarrel, that the disjunctive test should apply. Specifically, the Third Circuit observed:

> [T]he two-part definition of a sham transaction proposed by the government and adopted by the district court [in *Wexler*] would require the jury, in order to "find the transactions were sham transactions," to "determine two things beyond a reasonable doubt". First, that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and [s]econd, that there was no economic substance to the transaction, that is there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits. Thus, what Jacobson holds is that interest will be deductible where the government proves lack of business purpose, but cannot prove lack of economic substance — i.e., if the underlying transaction is not a "sham" as defined by the district court's order in Wexler's case.[676]

The Third Circuit also acknowledged in *ACM P'ship v. Commissioner* that, even though it applied the unitary analysis: "it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations."[677]

In footnote 31 of the *ACM P'ship v. Commissioner* opinion, the Third Circuit cited for this view the Seventh Circuit's decision in *N. Ind. Pub. Serv. Co. v. Commissioner*:[678]

> *Gregory* and its progeny "do not allow the Commissioner to disregard economic transactions … which result in actual, non-tax-related changes in economic position" regardless of "tax-avoidance motive" and refusing to disregard role of taxpayer's foreign subsidiary which performed a "recognizable business activity" of securing loans and processing payments for parent in foreign markets in exchange for legitimate profit.[679]

8. First Circuit

Before §7701(o) was added to the Code, the First Circuit had been "particularly wary of inquiring into the subjective motivations of taxpayers."[680] Where the court found that the objective assessment established that the transaction lacked economic substance independent of tax considerations, the subjective inquiry could be dispensed with.[681]

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[668] T.C. Memo 1989-684.

[669] 933 F.2d at 147.

[670] *Id.* at 147–48. *Cf. DeMartino v. Commissioner*, 862 F. 2d 400, 406 (2d Cir. 1988) ("A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions.").

[671] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[672] 915 F.2d 832, 840 (2d Cir. 1990).

[673] 29 F.3d at 102.

[674] 915 F.2d 832 (2d Cir. 1990).

[675] *United States v. Wexler*, 31 F.3d at 126 (citing *Jacobson v. Commissioner*, 915 F.2d at 840). *See also Lieber v. Commissioner*, T.C. Memo 1993-424, at 33–4 (following *Jacobson v. Commissioner*). *Cf. Lee v. Commissioner*, 155 F.3d at 586 (rejecting the taxpayer's interpretation of Jacobson as a disjunctive test and stating that: "had the *Jacobson* court concluded that the underlying transaction in the case before it was devoid of economic substance, the question of whether the interest expenses at issue were deductible would have been answered in the negative without any need to inquire into the reality of the debt itself.").

[676] *Id.*

[677] *ACM P'ship v. Commissioner*, 157 F.3d at 248, n. 31.

[678] 115 F.3d at 512 (7th Cir. 1997).

[679] 157 F.3d at 248, n. 31. Note, however, that *N. Ind. Pub. Serv. Co. v. Commissioner* is inconsistent with the Seventh Circuit's decision in *Yosha v. Commissioner*, 861 F.2d at 494, where the Seventh Circuit explicitly applied the conjunctive test. (The Seventh Circuit in *Yosha* stated that the economic substance of a transaction can be established if the transaction had objective economic substance and there was a subjective non-tax business purpose.).

[680] *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016), cert. denied, No. 16-1130 (U.S. June 26, 2017). *See also Fabreeka Prods. Co. v. Commissioner*, 294 F.2d 876 (1st Cir. 1961) ("[U]nless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple.").

[681] *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989).

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9. Tax Court

Before §7701(o) was added to the Code, several tax courts followed the disjunctive test as well, generally quoting *Rice's Toyota World Inc. v. Commissioner*[682] and *Frank Lyon Co. v. United States*[683] In *Packard v. Commissioner*, the Tax Court relied on these two cases and held that:

> A taxpayer's failure to establish that a transaction was motivated by a business purpose rather than by tax avoidance is not conclusive, however, that the transaction was a sham. Rather, if an objective analysis of the transaction indicates that a reasonable possibility of profit existed apart from tax benefits, the transaction will not be classified as a sham.[684]

The Tax Court in *Torres v. Commissioner*[685] followed the same standard and held that under the *Rice's Toyota* standard:

> [A] finding of lack of economic substance is inappropriate if either a business purpose or a reasonable possibility of profit apart from expected tax benefits is found to have been present… The record herein convincingly demonstrates that not only did petitioner have a reasonable possibility of realizing a profit apart from tax benefits but also that petitioner was virtually assured of realizing such a profit.[686]

In *Sanderson v. Commissioner*, the Tax Court held that:

> In the instant case, while we have little doubt that tax benefits were a significant aspect of this transaction, the record establishes the fact that the investment in the buildings provided a realistic opportunity for economic profit apart from tax benefits.[687]

Similarly, the Tax Court in *Saba P'ship v. Commissioner* (whose appeal was to the D.C. Circuit) relied on *Horn v. Commissioner*[688] and asserted that "a transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a non-tax business purpose."[689]

The Tax Court in *Saba* also cited *Larsen v. Commissioner*[690] in support of this view. In *Larsen v. Commissioner*, four different lease transactions were reviewed by the court. The Tax Court clearly stated that "We are satisfied that petitioner did not manifest the requisite business purpose necessary to justify the form of the transaction."[691] Nevertheless, reviewing the objective economic substance of the transactions, the Tax Court held that:

> [T]he four transactions were not motivated by a business purpose, and that the Hon and Anaconda transactions were devoid of economic substance and are to be disregarded for Federal income tax purposes. We further find that the record provides sufficient evidence that the Irving transactions were transactions imbued with economic substance. Consequently, the Irving transactions are accorded recognition for Federal income tax purposes.[692]

Although in most cases in which the court applied the disjunctive test, the taxpayer prevailed by showing objective economic substance, a taxpayer was still able to prevail under the disjunctive test by having subjective business purpose, and did not have to show objective economic substance. Citing *Rice's Toyota World Inc. v. Commissioner*,[693] the Tax Court indicated in *Mukerji v. Commissioner* that:[694]

> Once business purpose is established, the transaction should not be classified a "sham." A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some modicum of economic substance. Conversely, transactions devoid of economic substance are not always shams such as where a taxpayer mistakenly believes there existed a potential for profit. But when there is a finding that the taxpayer entered into the transaction for tax reasons only, then it is proper to subject the transaction to an objective economic analysis to determine whether there could have been an opportunity for profit.[695]

Comment: The disjunctive test was clearly more favorable to taxpayers than the conjunctive test. Taxpayers, therefore, generally attempted to convince the court that it should apply the disjunctive test, while the government, naturally, attempted to convince the court that either the conjunctive test or the unitary analysis was appropriate.[696]

10. The Disjunctive Test Under the Moline Properties Doctrine

Before §7701(o) was added to the Code, the *Moline Properties*[697] doctrine generally applied to cases where the validity of an entity was questioned.[698] The doctrine applied not only to

[682] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[683] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[684] 85 T.C. at 417 (1985).

[685] 88 T.C. at 718–19.

[686] *Id.* (citing *Packard v. Commissioner*). *See also Friendship Dairies, Inc. v. Commissioner*, 90 T.C. at 1062–63; *Estate of Thomas v. Commissioner*, 84 T.C. 412, 439 (1985) (a decision of the Tax Court subsequent to the Tax Court's decision in *Rice's Toyota*, where the Tax Court followed the disjunctive test, and concluded that the transaction had neither business purpose nor economic substance); *McCrary v. Commissioner*, 92 T.C. at 845 ("A transaction that has a business purpose or profit objective will survive the *Rose* analysis of economic substance.").

[687] T.C. Memo 1985-477.

[688] 968 F.2d 1229 (D.C. Cir. 1992).

[689] T.C. Memo 1999-359.

[690] 89 T.C. 1229, 1253 (1987).

[691] *Id.*

[692] *Id. See also Black & Decker Corp. v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part and rem'd, 436 F.3d 431 (4th Cir. 2006).

[693] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[694] 87 T.C. 926, 960 (1986).

[695] *Id. Cf. Hines v. United States*, 912 F.2d at 739 (The Fourth Circuit held that: "[t]he mere assertion of such a belief, particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham.").

[696] *See, e.g.*, *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004); *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004). *Cf. Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991) (taxpayer challenged the Tax Court's use of the disjunctive test).

[697] *Moline Props. v. United States*, 319 U.S. 436 (1943).

[698] *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 513 ("Transactions involving a foreign corporation are to be disregarded for lack of meaningful economic activity if the corporation is merely transitory, engaging in absolutely

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corporations, but also to other entities such as partnerships[699] and trusts.[700] Nevertheless, the doctrine was applied in broader contexts, particularly in cases involving economic substance analysis.[701] An in-depth discussion of the *Moline Properties* doctrine is set forth in VI., below. The following discussion will focus on the disjunctive two-prong standard that was established by the Supreme Court in *Moline Properties*.[702]

In *Moline Properties*, the Supreme Court set forth the standards for recognizing an entity for federal income tax purposes.[703] The Supreme Court held that the taxpayer could not disregard the corporate form of his business organization unless such form was a "sham or unreal."[704] Courts have consistently applied this standard in determining whether a corporation qualifies as a separate entity for tax purposes.[705]

Moline Properties[706] set forth a two-prong disjunctive test in determining whether a separate corporate entity should be recognized.[707] The first prong applied a subjective standard requiring the taxpayer to demonstrate a legitimate, non-tax business purpose that is served by the selection of the corporate form as a separate and independent vehicle for owning and conducting the activity in question.[708] The second prong applied an objective standard requiring that the entity has engaged in sufficient business activity.[709] If *either prong was satisfied*, the entity would be recognized as a separate entity.[710] Thus, this standard is equivalent to the disjunctive economic substance two-prong test.[711]

As previously explained, before §7701(o) was added to the Code, the district court in *Black & Decker Corp. v. United States* had relied on both *Moline Props. v. United States*[712] and *N. Ind. Pub. Serv. Co. v. Commissioner*[713] (along with *Frank Lyon Co. v. United States*[714] and *Hunt v. Commissioner*[715] for the view that the economic substance standard is disjunctive.[716] By contrast, the D.C. Circuit in *ASA Investerings P'ship v. Commissioner* had held that a taxpayer had to prove not only that the entity was engaged in a business activity, but also that the entity's transactions were not a sham.[717]

G. The Unitary Analysis (Before Enactment of §7701(o))

The origins of the unitary analysis (before §7701(o) was added to the Code, adopting a conjunctive two-prong test) are found in *Zmuda v. Commissioner*, where the Ninth Circuit indicated that there is no real distinction between the objective and subjective prongs, and that "[b]oth simply state that the Commissioner may look beyond the form of an action to discover its substance."[718] The court elaborated that "[t]he terminology of one rule may appear in the context of the other because they share the same rationale. Both rules elevate the substance of an action over its form."[719] The court observed, however, that the rule established in *Moline Props. v. United States*[720] and the economic substance doctrine "share the same rationale."[721]

Under the pre-§7701(o) unitary approach, "[a] taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to [the sham transaction] inquiry."[722] Thus, the two prongs are no more than other relevant factors in determining if the transaction ought to be respect-

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no business activity for profit — in other words, it is a 'mere skeleton.'"); *Zmuda v. Commissioner*, 731 F.2d at 1420–21 ("If the purpose of incorporation is a business activity, such as investment or profit, or if incorporation is followed by the conduct of business, then the corporation is a separate taxable entity.").

[699] *Commissioner v. Tower*, 327 U.S. at 286 ("When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both."); *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512 ("courts have understood the 'business activity' reference in *Moline* to exclude activity whose sole purpose is tax avoidance.").

[700] *Zmuda v. Commissioner*, 731 F.2d at 1421 ("the economic substance formula may be used to determine whether a family trust is valid … and whether a trust is a grantor trust for tax purposes.").

[701] *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97; *Black & Decker Corp. v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part and rem'd, 436 F.3d 431 (4th Cir. 2006).

[702] *Moline Props. v. United States*, 319 U.S. 436 (1943).

[703] *Id.*

[704] *Id.* at 438–39.

[705] *Bollinger v. Commissioner*, 485 U.S. 340, 346 (1988) (stating that "We agree with [the *Moline Properties*] principle …"); *Paymer v. Commissioner*, 150 F.2d 334, 336 (2d Cir. 1945) ("As a general rule a corporation is a taxpayer separate and distinct from its stockholders… And this applies to a corporation wholly owned by one stockholder… But there are exceptions and the corporate form will be disregarded where it serves no business purpose and is but a sham… So, too, a taxpayer may gain the advantage of doing his own business through a wholly owned corporation if he pleases, but the treasury may disregard the separate corporate entity where it serves but as a shield against taxation and treat the one who actually may take the benefit of the income as the owner of the property which produces it and tax him accordingly. … Yet the treasury may treat a corporation as a separate taxable entity when its organization 'is followed by the carrying on of business by the corporation.'"); *Nutt v. Commissioner*, 39 T.C. 231, 249 (1962), rem'd on another issue, 351 F.2d 452 (9th Cir. 1965), cert. denied, 384 U.S. 918 (1966), acq., 1964-2 C.B. 5; *Siegel v. Commissioner*, 45 T.C. at 576 ("Our concern is whether petitioner had any substantial bona fide business reason for forming a corporation to participate in the venture, or whether the corporation formed, Ainsley, did in fact conduct any 'business' in the ordinary meaning. If these questions may be answered in the affirmative, then the existence of Ainsley must be recognized for tax as well as corporate purposes."); *Bass v. Commissioner*, 50 T.C. at 600 ("The ground rules for the contest have been established by innumerable court decisions, which make it clear that a taxpayer may adopt any form he desires for the conduct of his business and that the chosen form cannot be ignored merely because it results in a tax saving. However, to be afforded recognition, the form the taxpayer chooses must be a viable business entity, that is, it must have been formed for a substantial business purpose or actually engage in substantive business activity.").

[706] 319 U.S. 436 (1943).

[707] *Rogers v. Commissioner*, 34 T.C.M. 1254, 1256 (1975) ("*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity … . Business purpose or business activity are alternative requirements."). *See also Bertoli v. Commissioner*, 103 T.C. 501, 511–12 (1994).

[708] *Id. See also Siegel v. Commissioner*, 45 T.C. at 576.

[709] *Id.*

[710] *Id.*

[711] *Id.*

[712] 319 U.S. 436 (1943).

[713] 115 F.3d at 513–14.

[714] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[715] *Hunt v. Commissioner*, 938 F.2d at 471.

[716] 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part and rem'd, 436 F.3d 431 (4th Cir. 2006).

[717] *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000).

[718] 731 F.2d at 1420.

[719] *Id.*

[720] 319 U.S. 436 (1943).

[721] 731 F.2d. at 1421.

[722] *Rose v. Commissioner*, 868 F.2d at 853 (citing *Sochin v. Commissioner*, 843 F.2d at 354).

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ed for tax purposes.[723] Nevertheless, courts that applied the unitary analysis often applied it similarly to the two-prong test[724] or as an alternative test.[725] As the Third Circuit indicated in *ACM P'ship v. Commissioner*:

> The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them … . However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.[726]

Nevertheless, both the Tax Court and the Third Circuit in *ACM P'ship v. Commissioner* examined each prong separately to reach the conclusion that the transaction had neither economic substance nor business purpose.[727] Similarly, in *Sochin v. Commissioner*,[728] the Ninth Circuit used almost the same words, holding that:

> [w]e did not intend our decision in *Bail Bonds* to outline a rigid two-step analysis. Instead, the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses.[729]

Thus, the Ninth Circuit effectively collapsed the two prongs into a single objective test.[730]

Before the addition to the Code of §7701(o) (adopting the conjunctive two-prong test), the flexible or unitary test had been adopted by the Second, Sixth, Eighth, Ninth, Tenth, and Eleventh Circuits and employed in several Tax Court cases.[731] As discussed herein, however, in some circuits, such as the Second and Eighth Circuits, it was not that clear that the unitary test was the prevailing doctrine.[732] Due to the flexible nature of the unitary standard, different versions of it emerged.[733] One notable version was the "generic tax shelter" that is discussed below.[734]

Comment: A court applying the pre-§7701(o) unitary analysis would generally discuss both prongs and make a decision based on its findings as to these prongs; however, the decision would be made based on the transaction's overall effect (in particular, does it have any practical effect other than tax effect), and not on the precise findings for each prong.[735]

The pre-§7701(o) unitary analysis allowed the court to be more flexible with respect to the weight given to each prong, and, in fact, it also allowed the court to completely ignore one prong, if the court deemed it unnecessary to apply such prong.[736] As set forth above, in some cases, courts presented the two alternative tests, the disjunctive and unitary, and concluded, generally, that under either test they would have reached the same conclusion (*Shriver v. Commissioner*,[737] *IES Indus., Inc. v. United States*,[738] *Compaq Computer Corp. v. Commis-*

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[723] *ACM P'ship v. Commissioner*, 157 F.3d at 247.

[724] *See Friedman v. Commissioner*, 869 F.2d at 792 (holding that although Tax Court did not apply the "exact test" of *Rice's Toyota World v. Commissioner*, there was nevertheless ample support for the court's finding of a sham transaction); *Hines v. Commissioner*, 912 F.2d 736 (4th Cir. 1990) ("While it is important to examine both the subjective motivations of the taxpayer and the objective reasonableness of the investment, in both instances our inquiry is directed to the same question: whether the transaction contained economic substance aside from tax consequences.").

[725] *Shriver v. Commissioner*, 899 F.2d at 726 ("Although we elect also to address the question of whether the two-part test applied in *Rice's Toyota World* is mandated by the Frank Lyon sham-transaction analysis, the following discussion only provides an alternative basis for our holding… Although we need not reach this issue, that is — whether there is a requirement for a two-part analysis — we do so to point out that such a requirement is far from settled law, notwithstanding [the taxpayer's] protestations.").

[726] *ACM P'ship v. Commissioner*, 157 F.3d at 247.

[727] *Id.*

[728] *Sochin v. Commissioner*, 843 F.2d at 354.

[729] *Id.* (citing *Neely v. United States*, 775 F.2d 1092, 1094 (9th Cir. 1985); *Thompson v. Commissioner*, 631 F.2d 642 (9th Cir. 1980), cert. denied, 452 U.S. 961 (1981)).

[730] *Id.*

[731] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), rev'g 64 T.C.M. 1003 (1992); *Gilman v. Commissioner*, 933 F.2d at 148; *Smith v. Commissioner*, 937 F.2d 1089, 1096 (6th Cir. 1991); *Bryant v. Commissioner*, 928 F.2d 745, 748 (6th Cir. 1991); *Karr v. Commissioner*, 924 F.2d 1018, 1022–23 (11th Cir. 1991), cert. denied, 112 S. Ct. 992 (1992); *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir 1990); *James v. Commissioner*, 899 F.2d 905, 908–09 (10th Cir. 1990); *Shriver v. Commissioner*, 899 F.2d 724, 726 (8th Cir. 1990); *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989); *Kirchman v. Commissioner*, 862 F.2d at 1492; *Collins v. Commissioner*, 857 F.2d 1383, 1385 (9th Cir. 1988); *Sochin v. Commissioner*, 843 F.2d at 354; *Zmuda v. Commissioner*, 731 F.2d at 1421; *Provizer v. Commissioner*, 996 F.2d 1216 (6th Cir. 1993), aff'g per curiam 63 T.C.M. 2531, 2548 (1992); *Rosenfeld v. Commissioner*, 706 F.2d 1277 (2d Cir. 1983); *Jackson v. Commissioner*, 966 F.2d 598, 601 (10th Cir. 1992); *Gardner v. Commissioner*, 954 F.2d 836, 839 (2d Cir. 1992), aff'g *Fox v. Commissioner*, 56 T.C.M. 863 (1988), cert. denied sub nom., *Falk v. Commissioner*, 112 S. Ct. 1940 (1992); *Lerman v. Commissioner*, 939 F.2d 44, 55 (3d Cir. 1991), aff'g *Fox v. Commissioner*, 56 T.C.M. 863 (1988), cert. denied, 112 S. Ct. 590 (1991); *Shriver v. Commissioner*, 899 F.2d at 726; *Forseth v. Commissioner*, 845 F.2d 746, 748 (7th Cir. 1988), aff'g 85 T.C. 127 (1985); *Mahoney v. Commissioner*, 808 F.2d 1219, 1220 (6th Cir. 1987), aff'g *Forseth v. Commissioner*, 85 T.C. 127 (1985).

[732] *Shriver v. Commissioner*, 899 F.2d at 726; *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *Gilman v. Commissioner*, 933 F.2d at 147.

[733] Examples of the different standards applied by different courts under the unitary test include *Zmuda v. Commissioner*, 731 F.2d at 1420 (no real difference between the business purpose and the economic substance tests; both allow the Commissioner to look past a transaction's form to its substance); *Lee v. Commissioner*, 155 F.3d at 586 (A transaction lacks economic substance if it "can not with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequences."); *Mahoney v. Commissioner*, 808 F.2d at 1220 (inquiry is whether transaction has any practical economic effects beyond the creation of tax benefits); *Boynton v. Commissioner*, 649 F.2d 1168, 1172 (5th Cir. 1981) ("Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized."); *Tolwinsky v. Commissioner*, 86 T.C. 1009, 1037 (1986) ("where transactions serve no 'purpose, substance, or utility apart from their anticipated tax consequences' they are disregarded for tax purposes"); *Cherin v. Commissioner*, 89 T.C. 986 (1987) (the Tax Court disavowed the existence of a two-prong test and determined that the taxpayer's investment in the cattle breeding program lacked a realistic potential for profit and should be disregarded as a sham.).

[734] *Rose v. Commissioner*, 88 T.C. 386 (1987).

[735] *Zmuda v. Commissioner*, 731 F.2d at 1421 (9th Cir. 1984); *Sochin v. Commissioner*, 843 F.2d at 354 (the test is "whether the transaction has any practical economic effects other than the creation of income tax losses."); *ACM P'ship*, 157 F.3d at 248.

[736] *ACM P'ship*, 157 F.3d at 248, n. 31.

[737] *Shriver v. Commissioner*, 899 F.2d at 726.

[738] 253 F.3d 350 (8th Cir. 2001).

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sioner[739] and *TIFD III-E Inc. v. United States*).[740] In addition, in those circuits the disjunctive test had been used at least once, and, naturally, taxpayers attempted to persuade the court to apply the disjunctive test, while the Government attempted to convince the court that the unitary test ought to apply.[741]

In *Long Term Capital Holdings v. United States*,[742] the taxpayer claimed that under the Second Circuit's test, a transaction is valid if it has *either* economic substance or business purposes.[743] The district court, however, dismissed this argument,[744] and indicated that "[t]he nature of the economic substance analysis is flexible, thereby giving rise to alternative formulations in the Second Circuit, including both subjective and objective inquiries."[745]

In contrast, in *TIFD III-E Inc. v. United States*, the court was not as clear as the court in *Long-Term Capital Holdings v. United States*[746] with respect to which standard prevails in the Second Circuit.[747] The taxpayer in *TIFD III-E Inc. v. United States* asked the court to apply the disjunctive test, while the government asked it to apply the unitary test.[748] The court applied a two prong analysis and held that the taxpayer had both business purpose and economic substance.[749] The court concluded that it did not have to decide which standard to apply.[750] On appeal, the Second Circuit did not clarify this issue, deciding the case on a different ground.

In *Sala v. United States*,[751] the Tenth Circuit reversed the district court and held that a "son-of-BOSS" transaction that had offsetting long and short options involving foreign currency lacked objective economic substance. In *Sala*, an investor entered into a program of trading foreign currency options maintained by an advisor. The program ("Deerhurst Program") consisted of two stages. In the first stage, beginning November 20, 2000, and ending December 31, 2000, Sala acquired 24 option trades at a net cost of $728,298 and contributed them to a newly formed corporation (Solid Currencies) together with approximately $8 million in cash. The corporation invested them in a partnership (Deerhurst GP), which liquidated at the end of the year, distributing cash and two foreign currency contracts, which the corporation then sold. In the second stage, Solid Currencies contributed the proceeds of the liquidation and sale to Deerhurst Trading LLC, managed by the same advisor, where they were invested in other foreign currency option trades through 2004. The taxpayer argued that because the liabilities created by the short options in the trades contributed to Deerhurst GP in the first stage were contingent, they did not reduce Solid Currencies's basis in Deerhurst GP. As a result, when Deerhurst GP was liquidated and the distributed contracts sold, the taxpayer claimed that Solid Currencies had realized a loss of approximately $60 million.

The IRS argued that the economic substance doctrine should be applied to the loss-generating first stage of the Deerhurst Program separately.[752] The taxpayer argued that the program as a whole could potentially be profitable over its five-year term. The district court agreed with the taxpayer and also held that Reg. §1.752-6, which was promulgated in order to disallow losses similar to that claimed in this case, could not be applied retroactively.

The appeals court reversed, disallowing the losses claimed on liquidation of the partnership. According to the appeals court, the expected tax benefit of nearly $24 million exceeded the potential profit of $500,000 over the course of one year. Citing *Rogers v. United States* [753] and *Keeler v. Commissioner*,[754] the court held that the existence of some potential profit is 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 appeals court specifically rejected the district court's finding that the taxpayer had a profit objective based on the five-year period as a whole. According to the appeals court, only the Deerhurst GP phase (the portion of the transaction that generated the claimed loss) is relevant to the economic substance analysis.

In reaching its decision, the Tenth Circuit did not address other grounds for the district court's decision, including the retroactivity of Reg. §1.752-6.

Comment: Under the pre-§7701(o) unitary analysis, instead of applying a rigid two-prong test (pursuant to which the court *must* find either lack of economic substance or lack of business purpose to invalidate the transaction), courts could apply a flexible analysis to simply determine whether the transaction had any benefit to the taxpayer other than the tax benefit. Practically, however, there is little difference between the unitary and the conjunctive standards, because a court applying the former test would examine both prongs to reach a conclusion, and would not validate a transaction if only one prong was satisfied.[755]

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[739] 113 T.C. 214 (1999).

[740] 342 F. Supp.2d 94 (D. Conn. 2004).

[741] *Id.*

[742] 330 F. Supp.2d 122 (D. Conn. 2004), aff'd, 150 Fed. Appx. 40 (2d Cir. 2005).

[743] *Id.* at n. 68.

[744] *Id.* (citing *Ferguson*, 29 F.3d at 102 ("Having concluded that the partnerships' … activities lacked economic substance, those activities must be disregarded for tax purposes and cannot form the basis of any deductions. It is unnecessary, therefore, for us to analyze the Tax Court's findings with respect to the partnerships' profit motive")).

[745] *Id.* (citing *Gilman v. Commissioner*, 933 F.2d at 148 and *Lee v. Commissioner*, 155 F.3d at 586).

[746] 330 F. Supp.2d 122 (D. Conn. 2004).

[747] 342 F. Supp.2d 94 (D. Conn. 2004).

[748] *Id.*

[749] *Id.*

[750] *Id.*

[751] 613 F.3d 1249 (10th Cir. 2010), rev'g 552 F. Supp.2d 1167 (D. Colo. 2008), reh'g en banc denied and opin. amended, 106 AFTR.2d 5488 (10th Cir. 2010) (adding footnote to opinion), *cert. denied*, 132 S. Ct. 91 (2011). *See also Fidelity Int'l Currency Advisor A Fund, LLC v. United States*, 747 F. Supp.2d 49 (D. Mass. 2010), aff'd 661 F.3d 667 (1st Cir. 2011) (foreign currency option transactions had no economic substance).

[752] *See* Notice 2000-44, 2000-36 I.R.B. 255; Chief Counsel Notice CC-2003-020.

[753] 281 F.3d 1108 (10th Cir. 2002).

[754] 243 F.3d 1212 (10th Cir. 2001).

[755] *IRS v. CM Holdings, Inc.*, 254 B.R. at 621 ("Although [the economic substance and business purpose] inquiries do not constitute two distinct prongs of analysis, the Court will address these component inquiries in turn."); *Sacks v. Commissioner*, 69 F.3d at 987 ("We stated that although the proper test to apply to a sham question is not a 'rigid two step analysis,' we typically focus on the subjective aspect of whether the taxpayer intended to do anything other than acquire tax deductions, and the objective aspect of whether the transaction had any economic substance other than creation of tax benefits.").

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H. Generic Tax Shelter Test (Before Enactment of §7701(o))

Before §7701(o), which adopts a conjunctive two-prong test, was added to the Code, a modified version of the pre-§7701(o) unitary standard emerged in the Tax Court in *Rose v. Commissioner* and was called the "generic tax shelter" test.[756] Under this test, transactions that were "generic tax shelters" were disregarded for tax purposes if devoid of economic substance.[757]

The Tax Court in *Rose v. Commissioner* defined a "generic tax shelter" as a transaction possessing some or all of the following characteristics: 1) promotion by materials that focus on tax benefits; 2) acceptance of price terms by investors without negotiation; 3) assets consisting of packages of purported rights that are difficult to value in the abstract and overvalued in relation to the tangible property included as part of the package; 4) tangible assets that were acquired or created at a relatively small cost shortly before the transaction in question; and 5) the deferring of the bulk of consideration by promissory notes, nonrecourse in form or substance.[758]

Whether a "generic tax shelter" was devoid of economic substance under this test was determined by evaluating the following factors: 1) the investment activities of the taxpayers; 2) the relationship between the asset's price and its fair market value; 3) the structure of the financing; and 4) the perceived Congressional intent.[759]

The Sixth Circuit affirmed the Tax Court's decision in *Rose v. Commissioner* but declined, however, to adopt the "generic tax shelter" test.[760] According to the Sixth Circuit:

> Whether characterized as a "generic tax shelter" test or a two-prong subjective/objective analysis, the essential inquiry is whether the transaction had any practicable economic effect other than the creation of economic tax losses.[761]

Thus, the Sixth Circuit found that the "generic tax shelter" test was similar to the unitary analysis discussed above.[762] As the Fourth Circuit also indicated in *Hunt v. Commissioner*, the generic tax shelter test was not adopted because there was no need to adopt another standard.[763]

Comment: The IRS attempted in subsequent cases to persuade the court to apply the generic tax shelter test. In *IRS v. CM Holdings, Inc.*[764] (one of the COLI cases), the IRS attempted to convince the court that the transaction constituted a "generic tax shelter" under the test articulated by the Tax Court in *Rose v. Commissioner*.[765] Stating that the generic tax shelter test had never been accepted in the Third Circuit, the court presented a long list of cases that had rejected the test and declined the IRS's attempt to apply the generic tax shelter standard to the case.[766]

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[756] *Rose v. Commissioner*, 88 T.C. 386 (1987).

[757] *Id. See also Hunt v. Commissioner*, 938 F.2d at 471.

[758] *Id.* at 415–422.

[759] *Id.*

[760] 868 F.2d at 854.

[761] *Rose v. Commissioner*, 868 F.2d at 854.

[762] *Id.*

[763] *Hunt v. Commissioner*, 938 F.2d at 471–72. *See also Collins v. Commissioner*, 857 F.2d at 1386 ("we need not adopt the generic tax shelter test. The casebooks are already glutted with tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify… Here, the court must look past the mining venture's form and uncover its substance… . Although the generic tax shelter test is not incorrect, it does not aid courts in that basic inquiry."); *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. 271, 276–77 (1993) ("We need not here decide whether we will follow the *Rose* approach in the future in view of its failure to gain acceptance by the Court of Appeals for the Sixth Circuit and others.").

[764] 254 B.R. 578, 644–45 (D. Del. 2000).

[765] *Id.* (citing 88 T.C. 386 (1987)).

[766] 254 B.R. at 644–45. The court cited the following cases for rejecting the generic tax shelter standard: *Nickeson v. Commissioner*, 962 F.2d 973, 976 (10th Cir. 1992) (while not explicitly adopting the generic test, finding no error in the Tax Court having done so because "the *Rose* test is simply an application of factors that courts typically use to determine whether investments in activities asserted to be profit motivated were actually entered into for tax benefits"); *Hunt v. Commissioner*, 938 F.2d at 471 n. 5 (finding "no need to adopt the 'generic tax shelter' test, since [the Fourth Circuit's] two-pronged [business purpose/economic substance] test accomplishes the same purpose"); *Smith v. Commissioner*, 937 F.2d at 1094 (noting that the Sixth Circuit did not adopt the "generic tax shelter test" in its affirmance of the Tax Court's decision in *Rose*); *Karr v. Commissioner*, 924 F.2d at 1023 (finding that the Tax Court did not err in applying the generic tax shelter test because it "correctly focused its analysis upon an examination of the substance of the transactions to determine whether those transactions had any practicable economic effect other than the creation of tax benefits."); *Rose v. Commissioner*, 868 F.2d at 853 (declining to adopt the "generic tax shelter" analysis "because it does not aid [the Court] in the basic inquiry as to whether the transaction has any practicable economic effects other than the creation of income tax losses," which is "the proper standard."); *Collins v. Commissioner*, 857 F.2d at 1386 ("Although the generic tax shelter analysis is not incorrect," the court declined to adopt it because "it does not aid courts in [the] basic inquiry"); *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. at 276–77 (where eight Tax Court judges advocated explicitly abandoning the generic tax shelter doctrine). *See id.* at 279–80 (Swift, J., concurring) (noting that no Court of Appeals has adopted the "unified" generic tax shelter analysis of *Rose* and stating "I would no longer follow *Rose*"); *id.* at 287 (Ruwe, J., concurring) ("Because the unified approach [of *Rose*] has been misunderstood, has been rejected by several Courts of Appeals, and is not particularly helpful, I would discontinue using it." (footnote and citations omitted)).

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V. The Pre-Codification Profit Requirement

A. Overview

Before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, courts deciding whether a transaction lacked economic substance frequently focused, when applicable, on whether the transaction had a reasonable possibility of profit regardless of its tax benefits.[767] Some courts defined the profit element as "crucial,"[768] while other courts held that finding the lack of profit potential may not be enough to render a transaction a sham.[769] Nevertheless, in many cases, the taxpayer's purported non-tax benefits could not be quantified in terms of "profits."[770] For example, in *Bass v. Commissioner*,[771] the court did not examine the taxpayers' potential profit, but rather looked to other business purposes. In *Bass*, the court accepted the taxpayer's position that the formation of the foreign target corporation had a business purpose, namely to hold oil and gas leases for development. In contrast, as set forth in greater detail below, in many cases, the profit potential test played a key role in the courts' decisions.[772]

In general, the three main uncertainties in relation to the profit requirement before codification of the economic substance doctrine concerned: (i) the role of the profit requirement under the two-prong test; (ii) whether the profit test was objective or subjective; and (iii) the amount of potential profit that a transaction had to have in order to have economic substance.[773] As set forth in greater detail below, the profit requirement played a key role in many landmark economic substance cases, from *Goldstein v. Commissioner*,[774] through *Rice's Toyota World Inc. v. Commissioner*,[775] *ACM P'ship v. Commissioner*,[776] *IES Indus., Inc. v. United States*,[777] *Compaq Computer Corp. v. Commissioner*,[778] and *Long Term Capital Holdings v. United States*.[779] With respect to whether the test was objective or subjective, courts were divided on how to apply the profit requirement, although the objective standard tended to be more commonly used.[780] Finally, the required amount of profit was the most controversial point; several standards pertaining to the amount of profit that is required to satisfy the economic substance standard emerged.[781] In transactions in which the taxpayer made a financial investment, courts generally looked for a non-de minimis, realistic potential for profit to determine whether there is economic substance.[782] Various courts, however, have indicated that *any* profit is sufficient.[783] On the other extreme end, some courts compared the profit potential to the tax benefits generated by the transaction.[784] A fourth alternative

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[767] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985) ("The economic substance inquiry … requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits."); *Sheldon v. Commissioner*, 94 T.C. 738, 759 (1990) ("where transactions are analyzed regarding their economic substance, the focus is upon profit objective or the potential for profit."); *IES Indus., Inc. v. United States*, 253 F.3d 350, 354 (8th Cir. 2001) (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit … apart from tax benefits."); *Friedman v. Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989) ("The first prong of this test, 'the business purpose' prong, concerns the subjective intent of the taxpayer, and is similar to the 'primarily for profit' standard of §§165 and 108."); *Bohrer v. Commissioner*, 945 F.2d 344 n. 5 (10th Cir. 1991) ("Since practical economic benefits are ordinarily construed as profits, a showing that objectively there is no possibility for profit in a transaction can show that the transaction was lacking in economic substance."); *Gefen v. Commissioner*, 87 T.C. 1471 (1986) ("A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits."); *Ockels v. Commissioner*, T.C. Memo 1987-507 ("If a transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits, the transaction has economic substance and will be recognized for tax purposes."); *Robertson v. Commissioner*, T.C. Memo 1994-424 ("A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for profit exclusive of tax benefits."); *Cherin v. Commissioner*, 89 T.C. at 993 (1987) ("A business transaction by its very nature must have economic substance, that is, a realistic potential for profit."); *Torres v. Commissioner*, 88 T.C. at 719 ("a finding of lack of economic substance is inappropriate if either a business purpose or a reasonable possibility of profit apart from expected tax benefits is found to have been present."); *Johnson v. United States*, 32 Fed. Cl. at 716–17 ("transaction lacks economic substance if no 'reasonable possibility of profit from the transaction existed apart from tax benefits' … . The determination of whether a transaction has economic substance is essentially a two part analysis: (1) whether the substance of the transaction is reflected in its form, and (2) whether the transaction had a reasonable objective possibility of providing a profit aside from tax benefits.") (citing *Rice's Toyota World*, 752 F.2d at 94).

[768] *Casebeer v. Commissioner*, 909 F.2d at 1364 (citing *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985)).

[769] *Jackson v. Commissioner*, 966 F.2d 598, 601 (10th Cir. 1992) ("we have never held that the mere presence of an individual's profit objective will require us to recognize for tax purposes a transaction which lacks economic substance." (quoting *Cherin v. Commissioner*, 89 T.C. at 993); *Cherin v. Commissioner*, 89 T.C. at 993 ("The phrase 'realistic potential for profit' does not mean that the transaction must make a profit or even that similar transactions generally are profitable."); *K2 Trading Ventures LLC v. United States*, 101 Fed. Cl. 365 (2011) (even assuming transactions had potential for profit, it does not outweigh other evidence demonstrating tax effects were entirely fictional and that partnership was formed not as legitimate investment vehicle, but as mechanism for generating inflated basis, resulting in paper losses when partners sold assets received in exchange for partnership interest).

[770] *UPS of Am. v. Commissioner*, T.C. Memo 1999-268, rev'd and rem'd, 254 F.3d 1014 (11th Cir. 2001).

[771] 50 T.C. 595 (1968).

[772] *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *Coltec Indus. Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), vacating 62 Fed. Cl. 716 (2004), cert. denied, 127 S. Ct. 1261 (2007).

[773] *See generally* Keinan (2003). *See also* McMahon, *Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters*, 2003 TNT 52-35 (March 17, 2003).

[774] 364 F.2d 734 (2d Cir. 1966).

[775] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[776] *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

[777] 253 F.3d 350 (8th Cir. 2001).

[778] 113 T.C. 214 (1999).

[779] 330 F. Supp.2d 122 (D. Conn. 2004) ("[A] transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.").

[780] *Id. Cf. ACM P'ship v. Commissioner*, T.C. Memo 1997-115 (applying the profit requirement test under the subjective prong).

[781] See the discussion in the Senate Report on the JOBS Act of 2004, S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637), presenting the competing views.

[782] *Rubin v. United States*, 304 F.2d 766 (7th Cir. 1962) (the court specifically addressed the issue of adequate profit motive, and decided that a profit made by the taxpayer, which amounted to $5,574, is "incidental" and should be disregarded for purposes of the "sham" transaction analysis).

[783] *Dow Chem. Co. v. United States*, 250 F. Supp.2d at 799 ("The question is whether the transaction has any economic purpose other than to generate tax deductions."). *See also* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005), specifically stating that even a nominal amount of profit could validate a transaction.

[784] *Sheldon v. Commissioner*, 94 T.C. at 767 (acknowledging that a few of the transactions had a small potential for gain, but dismissing the amounts as

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that was applied by only a few courts required at least a risk-free return.[785]

Comment: Echoing experiences with the two-prong standard, several variations of the profit requirement of the economic substance test emerged.[786] As stated in the Senate Report for the JOBS Act of 2004, "[t]here also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance."[787] The JCT Report (2005), however, used different terms, stating that "[t]here also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to satisfy economic substance."[788] As to the amount of profit required, the JCT suggested that "[i]n these cases [cases involving "reasonable possibility of profit" requirement], in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits."[789] Thus, under the JCT's view, *any* profit would have validated a transaction.[790]

B. The Role of the Profit Requirement

In most pre-codification[791] cases involving the economic substance doctrine, the profit requirement played a key role in the courts' determination.[792] In general, a profit test allowed the court to evaluate more objectively whether the disputed transaction had economic substance, because it involves quantitative analysis, where applicable.[793]

Rice's Toyota World, Inc. v. Commissioner illustrates the importance of the profit requirement in economic substance cases before codification of the economic substance doctrine.[794] In this case, the Tax Court and Fourth Circuit included the profit requirement test in *both prongs*.[795] Under the subjective business purpose prong, the Fourth Circuit observed that:

> [the taxpayer's] failure seriously to evaluate the likely residual value of the computer, its willingness to pay an inflated purchase price, and its use of nonrecourse debt that would facilitate abandonment of the transaction provide ample support for the tax court's finding that Rice did not have profit motivation apart from tax benefits.[796]

Concluding that the taxpayer did not have business purpose by virtue of not having profit motivation, the Fourth Circuit continued to the objective economic substance prong and stated that: "the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits."[797]

Some courts, however, viewed a reasonable expectation of profit (before the economic substance doctrine was codified) as not essential to determining whether a transaction lacked economic substance.[798] For example, some courts held that a reasonable expectation of profit is not a prerequisite for economic substance.[799] In *Bryant v. Commissioner*,[800] the Sixth Circuit stated:

> [I]n determining whether a transaction was a sham, the court should not address whether, in the light of hindsight, the taxpayer made a wise investment, as did the trial court there. Instead, the court must address whether the taxpayer made a bona fide investment at all or whether he merely purchased tax deductions. In this case, it is clear from the record that the Summit Gold Mine was a bona fide operating mine. Indeed, the Tax Court expressly found that by October of 1984, over 1.6 million dollars had been spent developing the mine, and hundreds of tons of ore were mined from Summit before it ceased operations in 1986, due in part to stricter federal regulation.[801]

Thus, under that approach, a taxpayer had to show a *real bona fide investment* in order to prevail.[802] As stated below, a real bona fide investment is generally demonstrated if a taxpayer is subject to risk of loss and opportunity for gain from the

"nominal" and "relatively insignificant."); *Saba P'ship v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2000); *Seykota v. Commissioner*, T.C. Memo 1991-234, at 99 n. 27 (citing *Walker v. Commissioner*, T.C. Memo 1990-609 ("The tax benefit of the straddle so far outweighs the economic profit that we cannot accept petitioner's contention that he was primarily motivated by the desire to earn a profit.")).

[785] *Hilton v. Commissioner*, 74 T.C. 305 (1980).

[786] For a summary of the different variations, see Keinan (2003).

[787] See the discussion in S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637), presenting the competing views.

[788] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005).

[789] *Id.*

[790] For an in-depth discussion on the profit requirement of the economic substance doctrine, see also Keinan (2003).

[791] *See* §7701(o), added to the Code by the Health Care and Education Reconciliation Act of 2010, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010.

[792] *Johnson v. United States*, 32 Fed. Cl. at 716–17 (stating that a transaction lacks economic substance if no "reasonable possibility of profit" existed); *ACM P'ship v. Commissioner*, T.C. Memo 1997-115, at 117–18 ("A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs."); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[793] *Gilman v. Commissioner*, T.C. Memo 1989-684 ("The presence of business purpose does not entitle a transaction to be recognized for Federal tax purposes where objective indicia of economic substance indicating a realistic potential for economic profit are not manifest."); *Gefen v. Commissioner*, 87 T.C. 1471, 1490 (1986) ("A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.").

[794] 752 F.2d 89 (4th Cir. 1985).

[795] *Id. See also Andantech, LLC v. Commissioner*, T.C. Memo 2002-97 (applying the profit potential test under both prongs).

[796] 752 F.2d at 94.

[797] *Id.*

[798] *Jackson v. Commissioner*, 966 F.2d at 601; *Cherin v. Commissioner*, 89 T.C. at 993.

[799] *Smith v. Commissioner*, 937 F.2d 1089 (6th Cir. 1991), rev'g 91 T.C. 733, 754 (1988).

[800] 928 F.2d 745 (6th Cir. 1991) aff'g in part and rev'g in part 58 TCM 235 (1989). *See also Jacobson v. Commissioner*, 915 F.2d 832 (2d Cir. 1990), rev'g 55 TCM 1437 (1988) (holding that relying on reasonable expectation for profit is "fundamentally flawed, and setting a dangerous precedent.").

[801] *Id.* at 749.

[802] *Id. See also Waren v. Commissioner*, 958 F.2d 370 (4th Cir.1992) ("since the fair market value of the timeshare units would never approach the year-end payoff amount and since this fact was obvious from the inception of the loan, we hold that petitioners have not made a bona fide investment in the property. Accordingly, the nonrecourse debt is without economic substance and will not be respected for Federal tax purposes. This has the effect of disallowing the interest deductions incurred on account of the debt.").

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transaction.[803] In *TIFD III-E Inc. v. United States*, the government argued that because the return earned by the Dutch banks was essentially guaranteed, they had no risk with respect to the transaction.[804] This meant, according to the government, that there was no economic effect to the transaction.[805] The court, however, disagreed and asserted that participating in upside potential, even with some guarantee against loss, is economically substantial and observed that the government's premise that a guarantee of a positive return indicates no risk, is simplistic. The court observed that whether an investment is "risky" to the investor depends on a number of factors, including the investor's cost of capital and opportunity costs. The court concluded that "[t]he economic reality of such a transaction is hard to dispute."[806]

The Second Circuit reversed the district court's decision, concluding that the district court erred in relying on the sham transaction doctrine rather than the totality-of-the-circumstances test set forth by the Supreme Court in *Commissioner v. Culbertson*.[807] Further, the Second Circuit elaborated that the district court erred in conducting the debt/equity analysis when it accepted "at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities."

Comment: As previously discussed, before the codification of the economic substance doctrine as §7701(o), some courts held that the economic substance doctrine required that the taxpayer change his or her economic position, a test broader than the profit requirement.[808]

Before the codification of the economic substance doctrine, many courts considered the profit requirement to be one of the two prongs in the determination whether to validate a transaction under the two-prong test.[809] In general, under this view, the profit motive test was one of the two prongs of the economic substance test.[810] Some courts applied the profit potential test under *both* prongs.[811] On the other hand, several courts discussed the profit requirement outside the two-prong test, or as an additional consideration.[812] As the Fourth Circuit indicated in *Thomas v. Commissioner*:[813]

> The Commissioner did not disallow the taxpayers' deductions on the ground that the program was a sham. Instead, the Commissioner asserted that the program lacked the primary objective of making a profit. These are different grounds for invalidating deductions… If a business has the primary objective of making a profit, deductions pertaining to a specific transaction may or may not be allowed depending on whether the transaction is a sham.[814]

In *Yosha v. Commissioner*, the Seventh Circuit held against the taxpayer under either the common law economic substance doctrine or the statutory profit requirement test:

> By either standard — "no non-tax motive or consequences," the test under the judge-made doctrine of substance over form, applicable to all deductions, or "no predominant non-tax motive," the statutory test applicable to the deduction of losses — this is an easy case.[815]

Under this view, a primary objective of making a profit was an independent test; if a taxpayer satisfied the primarily-for-profit requirement, the economic substance analysis was not required.[816] A court, however, could apply the profit potential test in addition to the sham transaction analysis.[817] As discussed below, this dual standard was normally applied when the court conducted a "primarily-for-profit" analysis under a statutory test such as §183.[818]

In several pre-§7701(o) cases involving economic substance analysis, courts also considered other quantitative factors, such as the reasonableness of the sales price and adherence to contractual terms.[819] The Tax Court summarized some of these factors in *Brown v. Commissioner*:

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[803] *Yosha v. Commissioner*, 861 F.2d at 500; *Fender v. United States*, 577 F.2d at 936; *Heltzer v. Commissioner*, 62 T.C.M. 518, 529 (1991).

[804] 342 F. Supp.2d 94 (D. Conn. 2004).

[805] *Id.*

[806] *Id.*

[807] 337 U.S. 733, 742 (1949) ("whether, considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.").

[808] *Knetsch v. United States*, 364 U.S. at 366; *ACM P'ship*, 157 F.3d at 248 n. 31. *See also* Senate Report on the JOBS Act of 2004, S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637) and Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005), proposing a similar standard. *Cf. Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (the court refused to apply the change-in-economic-position standard).

[809] *Johnson v. United States*, 32 Fed. Cl. at 716–17 (stating the profit requirement as one of the two prongs).

[810] *Collins v. Commissioner*, 857 F.2d at 1385; *Illes v. Commissioner*, 982 F.2d at 165; *Coltec Indus. Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), vacating 62 Fed. Cl. 716 (2004), cert. denied, 127 S. Ct. 1261 (2007); *Black & Decker v. United States*, 436 F.3d 431 (4th Cir. 2006), aff'g in part, rev'g in part and rem'g 340 F. Supp.2d 621 (D. Md. 2004).

[811] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, aff'd, 331 F.3d 972 (D.C. Cir. 2003).

[812] *Keane v. Commissioner*, 865 F.2d 1088, 1092 (9th Cir. 1989) (the profit motive test is not applied until the court determines that the transaction is itself a bona fide, not a sham (quoting *Sochin v. Commissioner*, 843 F.2d at 354 n. 6).

[813] 792 F.2d 1256, 1259 (4th Cir. 1986).

[814] *Id. See also Cook v. Commissioner*, 941 F.2d 734, 736–37 (9th Cir. 1991); *Pearlstein v. Commissioner*, 58 T.C.M. 699 (1989); *Persson v. Commissioner*, T.C. Memo 1989-567; *Nickeson v. Commissioner*, 962 F.2d 973 (10th Cir. 1992).

[815] 861 F.2d at 499.

[816] *Id.*

[817] *Thomas v. Commissioner*, 792 F.2d at 1259.

[818] *Id.*

[819] *Frank Lyon Co. v. United States*, 435 U.S. at 581–82 ("We recognize that the Government's position, and that taken by the Court of Appeals, is not without superficial appeal. One, indeed, may theorize that Frank Lyon's presence on the Worthen board of directors; Lyon's departure from its principal corporate activity into this unusual venture; the parallel between the payments under the building lease and the amounts due from Lyon on the New York Life mortgage; the provisions relating to condemnation or destruction of the property; the nature and presence of the several options available to Worthen; and the tax benefits, such as the use of double declining balance depreciation, that accrue to Lyon during the initial years of the arrangement, form the basis of an argument that Worthen should be regarded as the owner of the building and as the recipient of nothing more from Lyon than a $500,000 loan.").

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> In deciding whether a transaction has economic substance, great weight is placed on objective facts such as: The fair market value of the property involved, the presence or absence of arm's-length price negotiations, the relationship between sales price and fair market value, the financing structure, whether the benefits and burdens of ownership shifted, and whether the parties adhered to the terms of their contract.[820]

Comment: In general, this list of factors is consistent with the "generic tax shelter" test suggested by the Tax Court in *Rose v. Commissioner* (see IV.H., above), pursuant to which transactions with certain attributes were viewed as "generic tax shelters."[821] The Tax Court in *Andantech v. Commissioner* added another element, namely, whether other entities were inserted.[822] In particular, the Tax Court concluded that "[i]n determining a lack of economic substance, the fact the parties created and/or used intermediate entities for no valid business purpose is of significance."[823]

C. Profit Requirement — Subjective or Objective

1. Overview

Before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, many courts discussed the profit requirement under the *objective* prong of the economic substance doctrine by comparing the cost with the *reasonably expected* profit from the transaction.[824] Under this test, a *subjective belief* that the transaction would generate a profit may not have been sufficient to validate the transaction.[825] As the Fourth Circuit indicated in *Hines v. Commissioner:*

> [The taxpayer] claims that he subjectively believed, even if he was objectively wrong, that the investment would yield a profit aside from the tax benefits. The mere assertion of such a belief, particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham.[826]

By contrast, other courts evaluated the profit potential under the *subjective* prong (i.e., whether the taxpayer *intended* to make a profit).[827] In general, if the profit analysis was conducted under the subjective prong, it was frequently a "primarily-for-profit" analysis under one of the relevant statutory provisions, particularly §183.[828]

In *ACM P'ship v. Commissioner*, the Tax Court and the Third Circuit generally conducted the profit analysis under the subjective business purpose prong.[829] In *IRS v. CM Holdings, Inc.*, the taxpayer relied on *ACM P'ship v. Commissioner* for the view that "… the expectation of a pre-interest deduction profit is relevant only to analysis of subjective business motivation, to help inform the inquiry into why the taxpayer entered the transaction."[830] The district court, however, disagreed and held that "[a]lthough the existence of a reasonable expectation of pre-interest deduction profitability is relevant to the subjective prong of the analysis, it is also relevant to the objective analysis."[831] The district court also observed that in *ACM P'ship v. Commissioner*, the Third Circuit also held that the *objective prong* requires an examination "whether the transaction has any practical economic effects *other than* the creation of income tax [deductions]."[832] The district court concluded that it was implicit in the Third Court's decision that the profit requirement was also relevant for the objective prong.[833] Finally, the district court noted that the Third Circuit employed the unitary test, and not the rigid two-prong test, so that it really did not matter under which prong the profit requirement test was applied.[834]

2. Objective Determination of Profit Potential

a. General

Before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, the objective determination of profit potential was a cost v. reasonable possibility of profit analysis.[835] Under this approach, a court would compare the costs associated with the disputed transaction, with the profit

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[820] *Brown v. Commissioner*, T.C. Memo 1992-379 (citing *Cherin v. Commissioner*, 89 T.C. 986 (1987) and *Rose v. Commissioner*, 88 T.C. at 410). In lease cases, another element includes the reasonableness of the income and residual value projections. *See Rice's Toyota World*, 81 T.C. at 204–07; *Andantech, LLC v. Commissioner*, T.C. Memo 2002-97, at 131.

[821] *Rose v. Commissioner*, 88 T.C. 386 (1987). *See also Hunt v. Commissioner*, 938 F.2d at 471.

[822] T.C. Memo 2002-97 at 1512 (citing *Helba v. Commissioner*, 87 T.C. 983, 1011 (1986)).

[823] *Id.* at 144.

[824] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004). *See also Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (the court applied the same test, citing *Rice's Toyota World*); *IES Indus. v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit … apart from tax benefits."); *Johnson v. United States*, 32 Fed. Cl. at 716–17.

[825] *Carlson v. Commissioner*, T.C. Memo 1987-306.

[826] 912 F.2d at 740.

[827] *Collins v. Commissioner*, 857 F.2d at 1385 ("A taxpayer may deduct development costs only if the primary objective of the mining venture was to make a profit… However, the court does not inquire into a transaction's primary objective until it determines that the transaction is bona fide, that is, not a sham."); *Illes v. Commissioner*, 982 F.2d at 165 ("To be valid, an asserted deduction must satisfy both components of a two-part test. The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[828] *Friedman v. Commissioner*, 869 F.2d at 792 ("The first prong of [the economic substance] test, 'the business purpose' prong, concerns the subjective intent of the taxpayer, and is similar to the 'primarily for profit' standard of §§165 and 108.").

[829] 157 F.3d at 253–54; T.C. Memo 1997-115.

[830] *IRS v. CM Holdings, Inc.* (*In re CM Holdings*), 254 B.R. 578 (D. Del. 2000).

[831] *Id.*

[832] *Id.* (citing *ACM P'ship*, 157 F.3d at 247).

[833] *Id.*

[834] *Id.*

[835] *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004); *Johnson v. United States*, 32 Fed. Cl. at 716–17.

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that the taxpayer could reasonably expect from the transaction under the objective prong of the economic substance test.[836]

In *Gilman v. Commissioner*,[837] the Second Circuit affirmed the Tax Court's economic substance analysis, which was approached from "the standpoint of a prudent investor."[838] As the Tax Court indicated, under this standard, "a transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits."[839] The Tax Court elaborated that the disputed transaction lacked economic substance because, at the time the transaction was entered into, a prudent investor would have concluded that there was no chance to earn a non-tax based profit return in excess of the transaction's costs.[840]

The Second Circuit affirmed, clarifying that the most important element pertaining to economic substance in a sale-leaseback transaction was the critical objective measurement demonstrating that the taxpayer could not reasonably have expected to recoup his investment.[841]

Similarly, in *Goldstein v. Commissioner*,[842] the Second Circuit held that the taxpayer's alleged potential profits of $2,075 and $22,875 were offset by several expenses associated with the transaction, including attorney's fees.[843] The court also discounted the amount of $22,875 on the grounds that there was only "remote possibility" that such a gain would be realized.[844]

In *Cherin v. Commissioner*, the Tax Court elaborated on the meaning of "realistic potential for profit:"

> The phrase "realistic potential for profit" does not mean that the transaction must make a profit or even that similar transactions generally are profitable… Realistic potential for profit is found, however, when the transaction is carefully conceived and planned in accordance with standards applicable to the particular industry, so that judged by those standards the hypothetical reasonable businessman would make the investment.[845]

Before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, an important question in connection with the realistic potential for profit analysis was what constituted "costs" for purposes of comparing between the potential profit and costs.[846] While some types of costs, such as legal and investment banking fees, clearly were valid costs for this purpose, it was unclear whether other types of costs should be included in the equation.[847] In both *IES Indus., Inc. v. United States*[848] and *Compaq Computer Corp. v. Commissioner*,[849] the Eighth and Fifth Circuits concluded that foreign taxes *should not* be treated as a cost for purposes of determining the expected pre-tax profit.[850]

To illustrate, in *Compaq Computer Corp. v. Commissioner*,[851] the government argued that taking the Dutch tax into account, the taxpayer could not have reasonably expected to make a profit from the purchase and sale of the ADRs. In the government's view, the cash flows from the transaction were as follows:

Purchase price of the ADRs	$ 887,577,129
Less, sale price of the ADRs	($ 868,412,129)
Capital loss	$ 19,165,000
Dividend Income	$ 22,545,800
Less, Dutch withholding tax	($ 3,381,870)
Net dividend received	$ 19,163,930
Net Profit (Capital loss minus net dividend received):	($ 1,070)
Less, transaction cost	($ 1,485,685)
Net economic loss:	($ 1,486,755)

Thus, taking the Dutch tax into account, the transaction *could not have generated a profit.* The taxpayer's argument, however, which was accepted by the Fifth Circuit, was that foreign taxes should not be viewed as an additional cost in the cost

[836] *Rice's Toyota World v. Commissioner*, 752 F.2d at 91–92 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Indus. v. United States*, 253 F.3d at 353 ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test)."). *See also Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781.

[837] *Gilman v. Commissioner*, 933 F.2d at 148.

[838] *Id. See also Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 209 ("This requires that we first analyze the transaction as a prudent businessman would to ascertain whether it had any economic substance apart from its beneficial tax consequences. In other words, was there a 'realistic hope of profit'?"); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004), agreeing with *Gilman v. Commissioner*, 933 F.2d at 147 and following the profit potential analysis in *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966).

[839] *Gilman v. Commissioner*, T.C. Memo 1989-684.

[840] *Id. See also Larsen v. Commissioner*, 89 T.C. at 1254 ("The focus of our inquiry is to perform an objective analysis of the transactions to determine whether any realistic opportunity for economic profit existed exclusive of the anticipated tax benefits. We analyze the transaction as a prudent investor…").

[841] *Gilman v. Commissioner*, 933 F.2d at 147; *Casebeer v. Commissioner*, 909 F.2d at 1365–66.

[842] 364 F.2d 734 (2d Cir. 1966).

[843] *Id. See also Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[844] *Id. See also Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004) (district court followed cost v. benefits analysis conducted by *Second Circuit in Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), applied same cost-benefit analysis, and concluded taxpayer in *Long-Term Capital Holdings* "could not have had any realistic or reasonable expectation that it would make a non-tax based profit from the OTC transaction.").

[845] *Cherin v. Commissioner*, 89 T.C. at 993–994.

[846] *See Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999) (discussing the issue whether foreign taxes ought to be included in the cost-benefit equation).

[847] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[848] 253 F.3d 350 (8th Cir. 2001).

[849] 113 T.C. 214 (1999).

[850] *Cf.* §7701(o)(2)(B), applicable to transactions entered into after March 30, 2010 (fees and other transaction expenses, and foreign taxes in appropriate cases, shall be taken into account as expenses in determining pre-tax profit).

[851] 113 T.C. 214 (1999).

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v. expected profit calculation. Thus, under the taxpayer's calculation:

Capital loss	($ 19,165,000)
Dividend income	$ 22,545,800
Transaction costs	($ 1,485,685)
Net gain	$ 1,895,115

b. Cost-Benefit Analysis in Lease Cases

Before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, an objective cost v. profit analysis typically was conducted in lease cases.[852] The judicial treatment of a sale-leaseback transaction has usually been characterized as a search for economic substance by means of searching for potential profit.[853] Courts generally searched for the following two major aspects: the risk-benefit analysis and a non-tax profit motive examination.[854] In requiring a non-tax profit motive, the IRS has been more flexible with respect to sale-leaseback transactions and, generally, has required only a nominal profit objective.[855] Generally, the IRS has deemed an annual return of 2% on the taxpayer's equity investment to be sufficient.[856]

In lease cases, courts would generally assign significant weight to the non-tax profit motive perspective (from the buyer-lessor's point of view) and would evaluate whether the expected value of the property at the end of the lease would make abandonment imprudent.[857] As a result, courts have been looking for the expected value of the leased assets at the end of the lease contract for purposes of determining whether the taxpayer has reasonably expected non-tax profit expectations from the transaction and if the answer is positive, even a small profit expectation would suffice.[858]

In *Rice's Toyota World Inc. v. Commissioner*,[859] the taxpayer purchased a 70% interest in a six-year old IBM computer for $1,455,227. The taxpayer paid by giving Finalco, a financing company, a $250,000 recourse note, payable over three years, and two nonrecourse notes, totaling $1,205, 227, payable over eight years. The taxpayer leased the computer back to Finalco for eight years, with rents calculated so that the pre-tax cash flows to the taxpayer were $10,000 per year. In fact, the only amounts ever to change hands were the $10,000 annual payments, representing the excess of the taxpayer's income over its debt obligation.

The Tax Court observed that the taxpayer's initial investment amounted to $280,000, and that the two potential sources of return were the cash flows ($10,000 a year) and 70% of the computer's residual value.[860] Based on experts' testimonies, the court found that the computer's residual value would be $150,000, of which the taxpayer's share would be $105,000.[861] Accordingly, even after assuming a discount rate of zero, the Tax Court concluded that the taxpayer's potential return was $185,000, an amount lower than the invested amount.[862] Therefore, the Tax Court concluded that there was no "realistic hope of profit."[863]

The Fourth Circuit affirmed the objective profit potential analysis of the Tax Court and elaborated that:

> [T]he transaction carried no hope of earning Rice a profit unless the computer had residual value sufficient to recoup the $280,000 in principal and interest that Rice paid Finalco on the recourse note less the $10,000 net annual return to Rice under the lease agreement. Even assuming that Finalco paid Rice $10,000 annually for the full eight-year term, which is by no means assured, and ignoring the time value of Rice's money invested, Rice would have to realize $200,000 in residual value to earn a profit. If Finalco re-leased or sold the computer for Rice, the more likely development in view of Rice's lack of computer marketing experience, Rice would receive only 70 percent of the proceeds and would profit only if residual value exceeded approximately $286,000.[864]

The Fourth Circuit affirmed the Tax Court's determination that the projected residual value was sufficient to cover the expenses, and held that there was no reasonable possibility of making a profit from the transaction.[865]

In *Gefen v. Commissioner*,[866] another sale-leaseback case, the Tax Court employed a similar analysis. In this case, at the inception of the lease in 1977, the taxpayer assumed that the computer equipment would have a residual value in excess of 20% of the equipment's cost at the expiration of the computer lease in 1984. Furthermore, the taxpayer confirmed its assumption with an independent appraisal of the computer equipment, which indicated that it would be reasonable for the taxpayer to expect that the computer equipment would have a residual value in 1984 in excess of $745,000. The court found that such a belief was reasonable, although, actually, the equipment turned out to be valued at zero in 1984.[867] Because the taxpayers invest-

[852] For an excellent discussion on the application of the economic substance in lease cases, see 545 T.M., *Equipment Leasing: Tax Principles and Structuring*. *See also* Keinan, *The Profit Requirement* (2003).

[853] Hodge, *Sale-Leasebacks: A Search for Economic Substance*, 61 Ind. L. J. 721, 737–38 (1986).

[854] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[855] *See* Rev. Proc. 2001-28, 2001-19 I.R.B. 1156, *modifying and* superseding Rev. Proc. 75-21, 1975-1 C.B. 715.

[856] TAM 8332005.

[857] *Hilton v. Commissioner*, 74 T.C. 305 (1980).

[858] *James v. Commissioner*, 87 T.C. at 924. *See also* Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes at 991 (explaining that sale-leaseback transactions are subject to specific legislative preferential treatment and therefore, any non-tax profit motivation, even minimal, should suffice for determining the economic substance of a transaction).

[859] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[860] *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 205–06.

[861] *Id.*

[862] *Id.* at 206 ("Based upon our conclusion as to residual value and assuming a discount rate of zero, petitioner would not even recover his initial investment of $250,000, plus $30,000 interest, less the promised $10,000 yearly cash flow ($80,000), upon expiration of the 8-year lease.").

[863] *Id.* at 206 ("Our analysis of the facts in the instant case leads us to conclude that petitioner here, as in *Hilton*, would not be in a position to realize economic value remaining in the property.").

[864] 752 F.2d at 94.

[865] *Id.* at 94–5.

[866] 87 T.C. 1471 (1986).

[867] *Id.*

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ed $506,000 in the partnership, the reasonably expected profit for the partnership was as follows:

$ 3,589,694 (Price paid by the partnership for computer equipment) × 20% =	$ 717,939
Plus cash-flow projected in confidential memorandum	4,370
Less broker's fee of 50% of the amount in excess of 16% of the computer equipment's cost (50% of $143,588)	(71,794)
Less total amount invested by the partnership	(506,000)
Total partnership profit	144,515

Accordingly, the court held that: "This potential for profit constitutes the requisite economic substance."[868]

In *Long Term Capital Holdings v. United States*,[869] although the potential profit amounted to $1,959,633, Long Term had out of pocket costs of several million dollars, including approximately $1 million in legal fees, $3 million to the investment bank and other consultants, and several millions as partnership distributions. These costs, according to the district court, would wipe out the entire potential for profit. Thus, the district court applied the "prudent investor" standard and held that the taxpayer could not reasonably expect to make a profit from the disputed transaction.[870]

3. *Subjective Analysis of the Profit Requirement*

As set forth above, before §7701(o) was added to the Code, clarifying the application of the economic substance doctrine to transactions entered into after March 30, 2010, some courts applied a subjective analysis of the taxpayer's pursuit for profit.[871] This analysis was conducted either as a part of the two-prong test[872] or as a separate test.[873] For example, a subjective analysis was made when the disputed tax benefits were deductible under §162(a) (deduction for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"), §163 (interest deductions), or §174 (deduction for "research or experimental expenditures which are paid or incurred … in connection with [a] trade or business")[874] because an activity was not viewed as undertaken in a trade or business if it was not entered into with an intent to make a profit.[875]

Most notably, the profit requirement was frequently discussed in connection with the "entered-into-for-profit" requirement under §165(c),[876] §212,[877] and §183.[878] Nevertheless, even though the primarily-for-profit standard is subjective, in determining the subjective intent to make a profit, courts often used objective criteria.[879]

Pursuant to §183(a), where an "activity is not engaged in for profit, no deduction attributable to such activity shall be allowed … ." Section 183 generally does not apply to C corporations but rather to individuals and S corporations; however, a large number of economic substance cases have dealt with individuals, including *Gregory v. Helvering*,[880] *Knetsch v. United States*,[881] and *Goldstein v. Commissioner*.[882] Thus, a subjective analysis of a taxpayer's pursuit for profit under the general economic substance doctrine is consistent with the standard of §183.[883]

In *Smith v. Commissioner*,[884] the Tax Court explained the interplay between the common law economic substance standard and §183 as follows:

> Profit Objective and Economic Substance
>
> Determination of whether an activity is undertaken for profit is generally referred to as involving a "section 183 issue." Section 183 initially served to distin-

[868] *Id.*

[869] 330 F. Supp.2d 122 (D. Conn. 2004). For an in-depth discussion on the cost-benefit analysis in *Long Term Capital Holdings v. United States*, see Warren, *Understanding Long Term Capital*, 2005 TNT 25-48 (Jan. 26, 2005).

[870] *Long Term Capital Holdings*, 330 F. Supp.2d 122.

[871] *Friedman v. Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989).

[872] *Friedman*, 869 F.2d 785; *see also Seykota v. Commissioner*, T.C. Memo 1991-234 ("The business purpose, or profit motive, test forms a part of the accepted analysis of whether transactions are shams that must be disregarded for tax purposes.").

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

[874] *Smith v. Commissioner*, 937 F.2d 1089, 1103 (6th Cir. 1991).

[875] *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987) ("to be engaged in a trade or business . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."); *Agro Science Co. v. Commissioner*, 934 F.2d 573, 576 (5th Cir. 1991) ("Expenditures may only be deducted under sections 162, 174, and 202 if the facts and circumstances indicate that the taxpayer made them primarily in furtherance of a bona fide profit objective independent of tax consequences."). The profit requirement would presumably extend to the deduction for domestic research or experimental expenditures under §174A.

[876] Section 165(c) limits deductible losses under §165(a) "to (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business … ."

[877] Deduction by individuals of ordinary and necessary expenses paid or incurred for (1) the production or collection of income, (2) the management, conservation, or maintenance of property held for the production of income, or (3) in connection with the determination, collection, or refund of any tax. *See, e.g.*, *Kurdziel v. Commissioner*, T.C. Memo. 2019-20 (taxpayer unable to claim deductions for expenses of restoring military aircraft under non-exclusive nine-factor test of Reg. §1.183-2(b)).

[878] *Jacobson v. Commissioner*, 915 F.2d at 837 ("Determination of whether an activity is undertaken for profit is generally referred to as involving a 'section 183' issue. Section 183 initially served to distinguish between business objectives and personal objectives, but in recent years has been used frequently to compare business objectives with tax objectives."); *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. at 279; *Friedman v. Commissioner*, 869 F.2d at 792; *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991). *Cf. Bohrer v. Commissioner*, 945 F.2d at 345 n. 5 ("Since practical economic benefits are ordinarily construed as profits, a showing that objectively there is no possibility for profit in a transaction can show that the transaction was lacking in economic substance. Thus, the fact that possibilities for profit are discussed by the Tax Court is only reflecting the sham analysis, not an 'entered into for profit' analysis of IRC §165(c)(2) or §108 of the Tax Reform Act of 1984.").

[879] *Hunt v. Commissioner*, 938 F.2d at 472 ("It is proper to draw from objective facts inferences regarding a subjective intent to profit."); *Friedman v. Commissioner*, 869 F.2d at 792 (stating the same); *Faucloner v. Commissioner*, 748 F.2d at 894 ("the ultimate determination of whether an activity is engaged in for profit is to be made … by reference to objective standards, taking into account all of the facts and circumstances of each case. A taxpayer's mere statement of intent is given less weight than objective facts."); *Thomas v. Commissioner*, 792 F.2d at 1260 ("Indeed, whether profit was the primary objective of the venture must be determined on the basis of all the facts and circumstances."). *See also Killingsworth v. Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004).

[880] 293 U.S. 465 (1935).

[881] 364 U.S. 361 (1960).

[882] 364 F.2d 734 (2d Cir. 1966).

[883] *Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. at 279.

[884] 91 T.C. 733 (1988).

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> guish between business objectives and personal objectives, but in recent years has been used frequently to compare business objectives with tax objectives. See generally *Brannen v. Commissioner*, 78 T.C. 471, 506–507 (1982) aff'd, 722 F.2d 695 (11th Cir. 1984) *Jasionowski v. Commissioner*, 66 T.C. 312, 321 (1976). In *Rose v. Commissioner*, 88 T.C. 386, 414 (1987) aff'd, 868 F.2d 851 (6th Cir. 1989), we adopted a unified test of economic substance incorporating factors considered relevant in cases decided under §183.[885]

Similarly, in *Jacobson v. Commissioner*, the Second Circuit applied the same profit motive standard in analyzing a transaction for §183 and the economic substance purposes:

> Such cases [sham transactions] are also considered in terms of the §183(a) provision that where an "activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter" except to the limited extent specified in §183(b).[886]

In *Peat Oil & Gas Assocs. v. Commissioner*,[887] a decision reviewed by the full Tax Court, the Tax Court conducted a comprehensive research on the profit motive standard under §183, acknowledging that this standard should apply to the subjective prong of the economic substance standard as well.[888] As indicated by the Tax Court, over the years, the courts have been inconsistently describing the *quantity or level* of profit objective that must be established under §183.[889] The inconsistent profit-objective language employed by courts for purposes of §183 included, among other language, the following: "basic," "dominant," "primary," "predominant," "substantial," "reasonable," "bona fide," and "actual and honest."[890]

As the Tax Court observed, the legislative history of §183 states that the test should be whether the activity is *engaged in for profit* rather than whether it *is carried on with a reasonable expectation of profit*.[891] The legislative history to §183 indicates that:

> [I]n determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit. This will prevent the rule from being applicable to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates that the activity is actually engaged in for profit. For example, it might be argued that there was not a "reasonable" expectation of profit in the case of a bona fide inventor or a person who invests in a wildcat oil well … . The committee does not believe that this provision should apply to these situations … if the activity actually is engaged in for profit… In making the determination of whether an activity is not engaged in for profit, the committee intends that an objective rather than a subjective approach be employed. Thus, although a reasonable expectation of profit is not to be required, the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer entered the activity, or continued the activity, with the objective of making a profit. As previously indicated, a taxpayer who engaged in an activity in which there was a small chance for a large profit, such as a person who invested in a wildcat oil well or an inventor, could qualify under this test even though the expectation of profit might be considered unreasonable.[892]

In *Peat Oil & Gas Assocs. v. Commissioner*, the Tax Court explained that, to bring some uniformity to the analysis associated with the determination of profit objective for purposes of §183, the Tax Court had stated the test relating to profit objective to be whether the investors had an "actual and honest" profit objective.[893] The United States Circuit Courts of Appeals were less consistent. Nevertheless, nearly every United States Circuit Court of Appeals, in at least one opinion, had adopted the "actual and honest" profit objective test (or a synonymous non-quantitative test) without any reference to a "primary" or "dominant" profit-objective requirement.[894]

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[885] *Id.* at 753–54. *See also Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. at 279.

[886] 915 F.2d at 837.

[887] 100 T.C. 271 (1993).

[888] *Id.* at 279.

[889] *Id.*

[890] *Id.*

[891] *Id.* (citing H.R. Rep. No. 91-172 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645; S. Rep. No. 91-552 (1969)).

[892] S. Rep. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969 U.S.C.C.A.N. 2027, 2133–34.

[893] As indicated by the *Tax Court in Peat Oil & Gas Assocs. v. Commissioner*, 100 T.C. at 281–83, in a majority of Tax Court decisions in which profit objective was at issue, the courts have applied the "actual and honest" profit-objective test, or a synonymous test, in evaluating whether passive investors had the requisite profit objective. *See Krause v. Commissioner*, 99 T.C. 132 (1992); *Marine v. Commissioner*, 92 T.C. 958 (1989), aff'd without pub. opin., 921 F.2d 980 (9th Cir. 1991); *McCrary v. Commissioner*, 92 T.C. 827 (1989); *Levy v. Commissioner*, 91 T.C. 838 (1988); *Antonides v. Commissioner*, 91 T.C. 686 (1988), aff'd, 893 F.2d 656 (4th Cir. 1990); *Soriano v. Commissioner*, 90 T.C. 44 (1988); *Fielding v. Commissioner*, T.C. Memo 1992-553; *Universal Research v. Commissioner*, T.C. Memo 1991-437; *Schwartz v. Commissioner*, T.C. Memo 1991-380; *Berry v. Commissioner*, T.C. Memo 1991-145; *Charlton v. Commissioner*, T.C. Memo 1990-402; *Bukove v. Commissioner*, T.C. Memo 1989-588; *Golden v. Commissioner*, T.C. Memo 1989-514; *Keenan v. Commissioner*, T.C. Memo 1989-300; *Brown v. Commissioner*, T.C. Memo 1988-527.

[894] *Id.* The Tax Court has presented the conclusion of its survey as follows. 1st Circuit: *Estate of Power v. Commissioner*, 726 F.2d 826 (1st Cir. 1984), aff'g T.C. Memo 1983-552; 2d Circuit: *Schiley v. Commissioner*, 375 F.2d 747 (2d Cir. 1967), aff'g T.C. Memo 1965-111; 3d Circuit: *Weir v. Commissioner*, 109 F.2d 996 (3d Cir. 1940), aff'g in part and rev'g in part 39 B.T.A. 400 (1939); 4th Circuit: *Faucloner v. Commissioner*, 748 F.2d 890 (4th Cir. 1984), rev'g and rem'g T.C. Memo 1983-165; *Malmstedt v. Commissioner*, 578 F.2d 520, 527 (4th Cir. 1978), rev'g T.C. Memo 1976-46; 6th Circuit: *Smith v. Commissioner*, 937 F.2d 1089 (6th Cir. 1991), rev'g 91 T.C. 733 (1988); *Campell v. Commissioner*, 868 F.2d 833 (6th Cir. 1989), aff'g in part, rev'g in part and rem'g T.C. Memo 1986-569; 7th Circuit: *Burger v. Commissioner*, 809 F.2d 355 (7th Cir. 1987), aff'g T.C. Memo 1985-523; *Glimco v. Commissioner*, 397 F.2d 537 (7th Cir. 1968), aff'g T.C. Memo 1967-119; 8th Circuit: *Evans v. Commissioner*, 908 F.2d 369 (8th Cir. 1990), rev'g T.C. Memo 1988-468; 9th Circuit: *Hillndahl v. Commissioner*, 976 F.2d 737 (9th Cir. 1992), aff'g without pub. opin., *Noonan v. Commissioner*, T.C. Memo 1986-449; *Sochin v. Commissioner*, 843 F.2d 351 (9th Cir. 1988), aff'g *Brown v. Commissioner*, 85 T.C. 968 (1985); 10th Circuit: *Clark v. Commissioner*, 951 F.2d 1258 (10th Cir. 1991), aff'g without pub. opin. T.C. Memo 1989-598; D.C. Circuit: *Cornfeld v. Commissioner*, 797 F.2d 1049 (D.C. Cir. 1986), rev'g and rem'g T.C. Memo 1984-105; *Dreicer v. Commissioner*, 665 F.2d 1292 (D.C. Cir. 1981), rev'g and rem'g T.C. Memo 1979-395.

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Based on the legislative history of §183, the Sixth Circuit in *Bryant v. Commissioner* observed that:

> Therefore, on remand, the court should not engage in an independent inquiry of whether the Summit Gold Mine was *likely* to be profitable. Instead, the court should determine from the facts and circumstances surrounding the investment whether the taxpayer entered the activity with the objective of making a profit, keeping in mind that a small chance of making a large profit can support a profit motive.[895]

The "actual and honest" standard was adopted by the Tax Court as a valid standard for purposes of the subjective prong of the economic substance two-prong test.[896] As the Tax Court elaborated in *Rose v. Commissioner*:

> In any case where a taxpayer establishes a business purpose, i.e., an actual and honest profit objective, we may still recharacterize the terms of the transactions to accord with what we perceive to be the reality of the situation.[897]

Comment: The regulations under §183 define the standard as requiring the taxpayer to have an "objective of making a profit;" therefore, it appears that the focus is on subjective intent (i.e., did the taxpayer intend to make a profit) and not whether the taxpayer could have reasonably expected to make a profit.[898] On the other hand, under the legislative history of §183, in determining whether the taxpayer intended to engage in an activity for profit, an *objective rather than subjective* approach would be employed.[899] As to the *amount* of profit that is required to satisfy the test, for purposes of §183, the taxpayer satisfies the profit motive requirement regardless of the expected amount of profit and regardless of the expected amount of tax benefits; as long as the taxpayer *honestly expected* to make an actual profit, a deduction under §183 would be allowed.[900]

D. How Much Profit Is Enough?

1. Overview

The profit requirement applicable to transactions entered into after March 30, 2010, as codified, is discussed in V.A., above.

Discussing an earlier-proposed codification of the economic substance doctrine in general, and the role of the profit requirement in particular, the Senate Report on the JOBS Act of 2004 addressed the lack of uniformity among the courts regarding the profit requirement.[901] The report indicated that courts have applied different standards for evaluating the required amount of profit potential.[902] In 2000, Professor Joseph Bankman summarized the various standards that had been suggested by Congress, Treasury, and commentators as potential standards for the profit motive test.[903]

According to Professor Bankman, the most common alternatives suggested by Congress, Treasury, courts and commentators with respect to the appropriate amount of potential profit are:

- minimum expected rate of return
- comparison with similar taxpayers
- comparison of non-tax profit with tax benefits
- more than de minimis profit
- any profit
- the reasonable means approach[904]

2. Minimum Expected Rate of Return

Under this alternative, to satisfy the pre-§7701(o) profit requirement, the amount of expected[905] profit should exceed a risk-free rate of return.[906] According to the Joint Committee of Taxation in its 1999 report on tax shelters, a transaction will not be recognized for tax purposes if "[t]he reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected tax benefits."[907] Thus, the Joint Committee in 1999 supported an approach pursuant to which a comparison between tax and non-tax benefits must be conducted (see below). In addition, the Joint Committee introduced a numerical example to illustrate that when a transaction generates positive cash-flows, such flows should be discounted at a rate of 6%.[908] By using a discount rate of 6%, the Joint Committee implied that the taxpayer should reasonably expect a minimum return of 6% to satisfy the economic substance standard.[909]

In *Hilton v. Commissioner*,[910] the Tax Court focused its analysis on whether from the buyer's (lessor's) perspective, the

[895] *Bryant v. Commissioner*, 928 F.2d 745, 750 (6th Cir. 1991).

[896] *Coffey v. Commissioner*, T.C. Memo 1991-516, at 26 ("The 'business purpose' test involves the consideration whether a taxpayer had an 'actual and honest profit objective' in engaging in the transactions at issue.").

[897] 88 T.C. at 414.

[898] Reg. §1.183-2(a).

[899] S. Rep. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969 United States Code Cong. & Admin. News 2027, 2133–34.

[900] *Id.*

[901] S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637). Cf. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (suggesting that even a nominal profit amount will satisfy the economic substance test).

[902] *Id. See also* Keinan, *The Profit Requirement* (2003).

[903] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5 (2000).

[904] *Id. See also* Keinan, *The Profit Requirement* (2003).

[905] The meaning of the term "expected" also varies; while the Senate Report on the JOBS Act of 2004, S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637), discussed herein, wishes to set forth a high standard pursuant to which the taxpayer must "reasonably expect a pre-tax profit," courts generally support a more lenient standard pursuant to which the taxpayer must have a "reasonable possibility for profit." The Tax Court has confirmed the latter standard. *See Andantech, LLC v. Commissioner*, T.C. Memo 2002-97.

[906] Commentators generally disagreed with such a standard. *See, e.g., NYSBA Objects to Codification of Economic Substance Provisions*, 2003 TNT 102-19 (May 21, 2003) ("the economic substance doctrine is fundamentally an anti-abuse rule, and not all transactions that lack either a pre-tax return greater than a risk-free return or a substantial non-tax business purpose are abusive. It depends on the provision under consideration."); Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes 985 (1981) (stating that on the one hand that a "very small economic profit" is insufficient to validate a transaction, but on the other, that a requirement of a full market return is "incoherent.").

[907] JCT Report (1999), at 229.

[908] *Id.* at 230.

[909] *Id. See also* Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes 985 (1981) (suggesting that a discount rate that applies to the profit potential can be translated into a minimum rate of return equal to such a discount rate).

[910] 74 T.C. 305 (1980).

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transaction's pre-tax profit potential justified the original investment. Consistent with the majority of lease cases, the Tax Court identified four potential sources of return for the taxpayer: the proceeds resulting from selling the asset, refinancing of the mortgage or its condemnation, cash income generated by the lease and the residual value.[911] The Tax Court concluded that under the relevant circumstances, the only potential sources of profit were the income generated by the lease and the residual value.[912] The court first turned to examine the potential profit from the residual value and concluded that the asset, the cost of which was $3,137,000 in 1967, would not only have had to have kept its value for the entire 53-year term of the lease, it would also have to have appreciated in value, ignoring the effect of inflation, to $4,446,235, in order to generate positive value.[913] Later, the Tax Court examined the potential income streams from the lease. The Tax Court concluded that "[i]t goes without saying that the opportunity to earn $23,000 annually, commencing 30 years from the inception of the transaction, would not in and of itself appear to justify the $334,000 original investment by the petitioners. …"[914]

The Tax Court implied in a footnote that the present value of the future cash flows would exceed the taxpayer's costs only if the investment produced a pre-tax return of in excess of 6%.[915] Footnote 23 reads as follows:

> Even based upon petitioners' assumptions, the present value of the property determined on a conservative actuarial basis would not be indicative of economic substance. Such assumptions are:
>
> • The pre-tax net income will be $23,000 per annum, commencing at the end of 30 years and ending 23 years thereafter.
>
> • The property could always be sold for its original cost: $3,150,000 (rounded).
>
> • The property will be free and clear at the end of 53 years.
>
> Deriving factors from sec. 20.2031-10(f), table B, Estate Tax Regs., the computation is as follows:

(a) Determine present value of $23,000 per year for 53 years ($23,000 × 15.9070)	$365,861
(b) Subtract present value of $23,000 per year for 30 years ($23,000 × 13.7648)	316,590
Present value of net pre-tax rent	49,271
(c) Add present value of property to be received free and clear at end of 53 years ($3,150,000 × 0.0456)	143,640
Present value of the property	192,911
Cost of petitioners' interest	334,000
Deficit	(141,089)[916]

Comment: As Professor Warren indicated, the court's note could be read to require a pre-tax return of at least 6% to be given effect for tax purposes pursuant to an economic substance analysis.[917] The Ninth Circuit, however, in commenting on this footnote, clearly stated that:

> [W]e deem the six percent rate to be for illustrative purpose only. No suggestion of a minimum required rate of return is made. Taxpayers are allowed to make speculative investments without forfeiting the normal tax application of their actions.[918]

In *Estate of Thomas v. Commissioner*,[919] the sale-leaseback arrangement was almost similar to the arrangement in *Rice's Toyota World, Inc. v. Commissioner*.[920] As in *Rice's Toyota World*, the two potential profit sources were the income flows and the residual value. The Tax Court's analysis was consistent with the pre-tax profit potential analysis in *Rice's Toyota World, Inc. v. Commissioner*[921] and *Hilton v. Commissioner*.[922] As opposed to the results of these two cases, however, the Tax Court found in *Estate of Thomas* that the residual value could reasonably have been expected to be high enough to justify the initial investment.[923] The Tax Court reasoned: "[o]ur sole task here is to determine whether a profit was reasonably likely on these facts in order to find that tax avoidance was not the sole motivation for the transaction. Since the potential profit here was more than *de minimis*, we are satisfied that petitioners should prevail."[924] Thus, according to the Tax Court, the reasonableness of the lessor's profit expectation proved business purpose.

Comment: A significant aspect of the Tax Court's decision in *Estate of Thomas v. Commissioner* was the Tax Court's assumption of a *zero* discount rate.[925] By using a discount rate of zero, the court illustrated how a residual value of 14% would have yielded a slight profit. As one commentator illustrated, an assumed discount rate of 3% with a 14% residual value, or 6% with a 20% residual value, would have produced a negative expected cash flow.[926] The court's assumption of discount rate of zero in both *Rice's Toyota World, Inc. v. Commissioner*[927] and *Estate of Thomas v. Commissioner*[928] indicated the courts' willingness to recognize that *any amount of potential profit* would suffice with respect to sale-leaseback transactions.[929] This approach is consistent with the IRS's approach in Rev.

[911] *Id.*
[912] *Id.* at 357–58.
[913] *Id.* at 360.
[914] *Id.* at 356.
[915] *Id.* at 353 n. 23.
[916] *Id.*
[917] Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes at 985, 988 (1981).
[918] *Hilton v. Commissioner*, 671 F.2d 316, 317 (9th Cir. 1982), cert. denied, 459 U.S. 907 (1982).
[919] 84 T.C. 412 (1985).
[920] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).
[921] *Id.*
[922] *Hilton v. Commissioner*, 74 T.C. 305 (1980).
[923] 84 T.C. 412 (1985).
[924] *Id.* at n. 52.
[925] 84 T.C. 412 (1985).
[926] Hodge, *Sale-Leasebacks: A Search for Economic Substance*, 61 Ind. L. J. 721 at 751 (nn. 224–227).
[927] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).
[928] 84 T.C. 412 (1985).
[929] *See also* Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes, 985 (1981).

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Proc. 2001-28.[930] In that revenue procedure, the IRS set forth guidance pertaining to "leveraged leases."[931] Under that revenue procedure, the profit requirement is stated as follows:

> Profit Requirement
>
> The lessor must represent and demonstrate that it expects to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions, allowances, credits, and other tax attributes arising from such transaction. This requirement is met if:
>
> (1) *Overall Profit.* The aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment … exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor's Equity Investment in the property, including any direct costs to finance the Equity Investment; and
>
> (2) *Positive Cash Flow.* The aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.[932]

Comment: Thus, in the IRS's view, in a sale-leaseback case, there is no requirement to discount the amount of potential profit from the lease transaction.

3. Comparison with Similar Taxpayers

In cases decided before the codification of the economic substance doctrine as §7701(o) (applicable to transactions entered into after March 30, 2010), some courts held that the taxpayer must show an expected return that is similar to expected returns by similarly situated taxpayers for investments with similar risk characteristics.[933] As the Tax Court elaborated in *ACM P'ship*:

> Whether a transaction has economic substance is a factual determination… Key to this determination is that the transaction must be rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated *in accordance with commercial practices in the relevant industry*… A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs. (emphasis added).[934]

In *IRS v. CM Holdings, Inc.*,[935] the District Court and the Third Circuit observed that to satisfy the sham transaction standard, "[the taxpayer] must prove the purported transaction actually took place in a manner which did not deviate from relevant commercial norms."[936]

Comment: Professor Joseph Bankman suggested an equivalent approach: The legislature can specify a rate (which, presumably, would be based on the prevailing expected return in the relevant industry) as a safe harbor rate for transactions subject to challenge under the economic substance test.[937]

4. Comparison of Non-Tax Profit with Tax Benefits

As the Senate Report for the JOBS Act of 2004 indicates,[938] before the codification of the economic substance doctrine as §7701(o) (applicable to transactions entered into after March 30, 2010), some courts applied the profit requirement in a more rigid way and disallowed tax benefits even when the taxpayer was exposed to risk and the transaction had a profit potential, but the economic risks and profit potential were *insignificant* when compared to the tax benefits.[939] Thus, under this rigid standard, the profit potential must be more than de minimis, and also be significant in relation to the potential tax savings.[940] This standard was supported by the Treasury in 1999.[941] In general, Treasury suggested that:

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[930] 2001-19 I.R.B. 1156.

[931] *Id.*

[932] *Id.*

[933] *Cherin v. Commissioner*, 89 T.C. at 994 (1987) ("Realistic potential for profit is found … when the transaction is carefully conceived and planned in accordance with standards applicable to the particular industry, so that judged by those standards the hypothetical reasonable businessman would make the investment"); *Merryman v. Commissioner*, 873 F.2d at 881 ("Courts accordingly compare the transaction in question with transactions that might usually be expected to occur in bona fide business settings.").

[934] T.C. Memo 1997-115, at 117–18. *See also* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) ("It is intended that the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.").

[935] 301 F.3d 96 (3d Cir. 2002).

[936] *IRS v. CM Holdings, Inc.* (*In re CM Holdings, Inc.*), 254 B.R. 578 (D. Del. 2000).

[937] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5 (2000).

[938] S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637).

[939] Tucker v. Commissioner, 766 Fed. Appx. 132 (5th Cir. 2019), cert. den., No. 19-41, 2019 BL 392946, (U.S. Oct. 15, 2019) (applying pre-§7701(o) law to find transaction lacked objective economic reality where there was less than 41% chance of earning $487,707 profit and an expected $20 million tax benefit from $52 million in tax losses); *Goldstein v. Commissioner*, 364 F.2d 734, 739–40 (2d Cir. 1966 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. at 768 (stating that "potential for gain … is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions."). Note that in *Sheldon*, the taxpayer argued that *Goldstein* supports the proposition that any gain will suffice.

[940] *NYSBA Tax Section Concerned About Codifying Economic Substance Doctrine*, 2000 TNT 146-25 (July 25, 2000) (suggesting that "the 'reasonable possibility of significant profit' test be applied by comparing the discounted present value of the possible pre-tax profit in some reasonably likely scenario to the discounted present value of the net tax benefits … thus, it would be sufficient if the pre-tax profit in some realistic scenario, discounted to present value, is not insignificant in relation to the tax benefits.") *Cf.* Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, at n. 33 (disagreeing with such a standard).

[941] Treasury Report (1999). *See also IRS Chief Counsel Offers Historical Overview of Shelters*, 2005 TNT 29-61 (Feb. 11, 2005) ("The economic substance doctrine can apply even when a taxpayer exposes itself to risk of loss and where there is some profit potential (i.e., where the transactions are real) if the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits. [footnote omitted] In other words, the doctrine suggests a balancing of the risks and profit potential as compared to the tax benefits in order to determine whether the transactions had 'purpose, sub-

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> [a] tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction.[942]

A similar view was expressed by the Joint Committee on Taxation in 1999, suggesting that a tax avoidance transaction is a transaction in which "[t]he reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected tax benefits."[943]

In contrast, the JCT Report (2005) suggested that the business purpose prong would be satisfied if the taxpayer's non-tax purpose for entering into the transaction was "substantial," and the taxpayer's non-tax purpose for the transaction bore "a reasonable relationship to the taxpayer's normal business operations or investment activities."[944]

In *Sheldon v. Commissioner*, the taxpayer entered into a series of Treasury Bill sale-repurchase ("repo") transactions.[945] At the first stage, the taxpayer purchased Treasury Bills maturing two and a half months later, in the total principal amount of $60,000,000, with a discount of $756,000 (representing a yield of 10.21% on the investment). At the second stage, the taxpayer entered into a repo with the seller for a loan amount of $59,238,000 on the same Treasury Bills (representing a loan bearing interest of 10.5%). The expiration date of the repo was one month before the expiration date of the investment. At the maturity of the repo, the taxpayer entered into a second repo, which matured on the same expiration date of the investment. Accordingly, the taxpayer could, and in fact, had, some profit from the transaction, due to the mismatch in the maturity date between the initial repo and the investment's expiration dates.

The taxpayer relied on *Goldstein v. Commissioner*[946] in his argument that *any* profit, even minimal, should suffice for determining that the transaction did not lack economic substance.[947] The Tax Court, however, disagreed with the taxpayer and held that a de minimis expected gain will not suffice.[948] Further, the Tax Court held that insignificant potential profit should be compared with the expected tax benefits when determining the validity of the transaction under the economic substance doctrine.[949] Similar to the decision in *Goldstein v. Commissioner*,[950] the Tax Court in *Sheldon* found that the transactions were not "sham" (or fictitious) transactions, but lacked economic substance due to the potential minimal non-tax profit.[951]

In particular, the court held that even though the taxpayer made a profit of $18,300 in one of the deals, such profit is insignificant. The court, therefore, denied the claimed deductions stating that "[i]n instances where intermediate repos could have or did generate some gain from the [positive] carry, these amounts were nominal, either fixed or short-term and stable and, in any event, merely reduced the fixed losses by relatively insignificant amounts."[952] The Tax Court ultimately found that the nominal profit that existed in this case was absorbed by losses on related transactions.[953]

Comment: The court's finding of insignificant profit potential resulted in the court's conclusion that the transaction (i) lacked a non-tax business purpose, and (ii) lacked economic substance since no reasonable possibility of a pre-tax profit in excess of a de minimis amount existed.[954] The minority view, however, rejected the comparison approach:

> The majority applies an incorrect test for determining economic substance … . I have found no authority for comparing potential profit with expected tax benefits when evaluating a transaction for economic substance … . To date, the only instances I can find in which we have compared potential profit with expected tax benefits are those in which we have evaluated a transaction for profit objective. I believe the majority improperly evaluates the transactions in issue for economic substance by applying a test that heretofore has been used only in determining whether a taxpayer had an actual and honest profit objective for Section 183 purposes.[955]

In *Wexler v. Commissioner*,[956] the facts were almost similar to these in *Sheldon v. Commissioner*[957] with a very important exception: The maturity date of the investment and the repo were identical.[958] The district court and the Third Circuit recognized the impossibility of more than a de minimis profit under the relevant circumstances (i.e., the lack of mismatch between the expiration dates of the repo and the investment), and treated the transaction as a "sham" transaction.[959]

Similarly, the Tax Court in *Saba P'ship v. Commissioner* expressed the following view:

> Relatively modest profits are insufficient, standing alone, to clothe the disputed CINS transactions with economic substance. In particular, even assuming for the sake of argument that the partnerships reasonably could have expected profits of up to $10,800,000 on a 5-year investment in the LIBOR notes, such profits would be inconsequential when compared with the

stance or utility apart from their anticipated tax consequences.'") (citing *Goldstein v. Commissioner* and *Sheldon v. Commissioner* for this view).

[942] Treasury Report (1999).

[943] JCT Report (1999), at 229.

[944] *See* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005), at 21.

[945] *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[946] 364 F.2d 734 (2d Cir. 1966).

[947] The taxpayer argued that the use of the word "solely" in *Goldstein* indicated that if there is any potential for profit the transaction has substance. 94 T.C. at 767. The Tax Court dismissed the arguments on the grounds that the court in *Goldstein* determined that the transaction lacked substance in general. *Id.*

[948] *Id.*

[949] 94 T.C. at 768.

[950] 364 F.2d 734 (2d Cir. 1966).

[951] 94 T.C. at 768.

[952] *Id.*

[953] *Id.* at 768–69. *See also Estate of Baron v. Commissioner*, 83 T.C. at 542.

[954] *Id.*

[955] *Id.* at 771–72.

[956] *United States v. Wexler*, 31 F.3d 117 (3d Cir. 1994).

[957] *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[958] *Wexler*, 31 F.3d at 125 (3d Cir. 1994).

[959] *Id.*

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capital losses of approximately $170,000,000 that the CINS transactions were designed to generate.[960]

Comment: Many courts rejected this approach. For example, in *Estate of Baron v. Commissioner*,[961] the Second Circuit concluded that "[w]here a *bona fide* expectation of economic gain exists, the possibility of significant tax benefits will not *per se* preclude the taxpayer from taking deductions for depreciation on the investment." (emphasis in original). Similarly, the comparison approach was criticized by many commentators.[962] As discussed below, the Senate version of the JOBS Act of 2004 included a comparison approach. That version, however was not adopted by the House and was not included in the bill signed by the President on October 22, 2004.

5. More than De Minimis Profit

Before the codification of the economic substance doctrine as §7701(o) (applicable to transactions entered into after March 30, 2010), many courts applying the profit requirement under the objective prong viewed the standard as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the claimed tax benefits.[963] As the Senate Report for the JOBS Act of 2004 indicates,[964] many courts denied tax benefits on the grounds that the subject transactions lacked profit potential that was more than de minimis.[965]

Goldstein v. Commissioner[966] is one of the landmark cases in which the court applied an objective profit motive analysis.[967] As set forth also in I., above, in this case, the taxpayer sought to shelter $140,000 that she won in the Irish sweepstakes by borrowing $945,000 from two banks at 4% interest, and investing the proceeds in United States Treasury securities maturing in three or four years, with a face amount of $1,000,000, which paid interest of 1.5%. Similar to *Knetsch v. United States*,[968] the taxpayer had locked in an economic loss from the inception of the transaction. The taxpayer sought to exploit the different tax treatment for borrowing transactions involving prepaid interest and lending transactions that do not involve prepaid interest. By borrowing to purchase the Treasury securities and prepaying much of the interest on the borrowing, the taxpayer sought to secure a large interest deduction in the year of the borrowing. This deduction effectively would be reversed in later years by interest and gain on the Treasury securities. Aside from the purported tax benefits, the simultaneous lending and borrowing transactions produced little net economic consequence for the taxpayer.

The taxpayer argued that she realistically anticipated an economic gain on the loan transactions due to anticipated appreciation in the value of the Treasury obligations, and that this gain would more than offset the loss that was bound to result because of the unfavorable interest rate differential. Despite the difference between the yield on the notes and the interest on the loan, and the $6,500 fees that were paid by the taxpayer, if the market for the underlying notes would have returned to its previous high rate within two years, and if the taxpayer would have sold the notes at the right time, the court found that the taxpayer could have made a profit of $22,000 from the transaction.[969] The Second Circuit disallowed the interest deduction claimed under §163 citing a lack of economic substance as well as a lack of a non-tax business purpose as the reason for disallowance. In particular, the Second Circuit observed that taking into account all the costs associated with the transaction, there was only a "remote possibility" that the transaction would generate a gain.[970]

Comment: As a commentator indicated, a potential gain from transactions similar to that in *Goldstein v. Commissioner* could arise if the investment would mature later than the loan, and if the investment's value increases due to a decline in the market's interest rates.[971] In *Goldstein v. Commissioner*, the mismatch created only a minimal potential profit, but potentially, changes in the interest rate could have created a more significant profit.[972]

Several courts required the taxpayer's profit potential to be more than "nominal" or "incidental."[973] In *Hines v. Commissioner*,[974] the taxpayer invested $127,324 in computer equipment leased for eight years and under the most favorable view, could expect a profit of $17,000 on the investment of almost $130,000. The court stated that this potential profit is "minimal," and concluded that "a reasonable person would have expected to suffer a substantial loss."[975] Accordingly, the transaction was held to be a sham transaction.

In *Seykota v. Commissioner*, the taxpayers entered into options straddles by selling and buying puts and calls having the same strike price and exercise date.[976] Subsequently, if a change in market prices caused one leg of the straddle to decline in value, the taxpayer would close out the loss position to realize a loss, while the gain leg would be closed out in the following year.[977]

The Tax Court held that the transactions were shams on the ground that:

---

[960] 78 T.C.M. at 721.

[961] 798 F.2d 65, 72 (2d Cir. 1986).

[962] *See generally* Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. at n. 33 (stating that: "the court [in *Saba*] favored an approach that compared tax benefits to pre-tax profits — an approach consistent with the Treasury Department's shelter proposals but inconsistent with most case law on point.").

[963] *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[964] S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637).

[965] Citing Knetsch, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); and *Ginsburg v. Commissioner*, 35 T.C.M. 860 (1976) (leveraged cattle-breeding program lacked economic substance).

[966] 364 F.2d 734 (2d Cir. 1966).

[967] *See also Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[968] 364 U.S. 361 (1960).

[969] 364 F.2d at 740. *See also* Hariton, *Sorting out the Tangle of the Economic Substance*, 52 Tax Law. 235, 247 (1999).

[970] 364 F.2d at 740.

[971] *See* Surdell, *A New Test for Corporate Tax Shelters*, 97 TNT 110-102.

[972] *Id.*

[973] *Rubin v. United States*, 304 F.2d 766, 770 (7th Cir. 1962) ("Due to the fluctuations in the market it was likely that taxpayer would either make or lose money on the transaction; but this was incidental to the chimerical character of the transaction."); *Lewis v. Commissioner*, 328 F.2d 634, 640 (7th Cir. 1964) (Citing *Rubin v. United States*). *Cf.* Jt. Comm. on Tax'n, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (suggesting that only a "nominal" amount of profit would be enough).

[974] 912 F.2d at 740.

[975] *Id.*

[976] T.C. Memo 1991-234.

[977] *Id.*

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> [P]etitioners have failed to prove from an objective standpoint that the transactions were likely to produce economic benefits aside from tax deductions. The transactions were marketed for their tax consequences. The investors' downside risks were limited to their initial margin payments. The offsetting positions and fees incurred in the gold carry transactions and straddles served to eliminate any "upside potential."[978]

Although the taxpayer argued that the transaction generated profits representing annual returns of 0.8%, 2.37% and 3.4%, the court held that the tax motivations "were pre-eminent" and "dwarfed the incidental economics" of the transactions.[979] In Rev. Rul. 99-14,[980] the IRS ruled that a LILO transaction lacked economic substance even though under the facts set forth in the ruling, the taxpayer could have expected to realize a small pre-tax profit. The IRS ruled that "[t]he presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes."

In *AWG Leasing Trust v. United States*, the Court compared the potential rate of return for the transaction at issue (3.4%) with the potential rate of return for similar transactions (2.5-3.5%). Because the potential rate of return was within the average range, the Court found a sufficient profit motive. However, the transaction was still invalid because it failed the substance-over-form test.[981]

For a further discussion of *AWG Leasing* and the substance-over-form test, see 545 T.M., *Equipment Leasing: Tax Principles and Structuring*.

Comment: Professor Joseph Bankman suggested another alternative — where a taxpayer has a consistent pattern of similar transactions, those transactions may offer a rate of return against which to measure the economic return from the underlying transaction.[982] Another commentator suggested to apply an economic profit test using financial economics analysis: The expected value of the future pre-tax cash flows from a financial transaction should equal the transaction's purchase price, proceeds, or other initial cash flow.[983] A transaction would meet the expected value test if either (i) the after-tax present value of the transaction's after-tax cash flows is zero or negative, or (ii) should the after-tax present value be positive, the pre-tax present value of the transaction's pre-tax cash flows is also positive and commensurate with the after-tax present value.[984]

6. Any Profit

Before the codification of the economic substance doctrine as §7701(o) (applicable to transactions entered into after March 30, 2010), several courts determined that a transaction would have economic substance if any profit, even a de minimis one, can be shown.[985] In *Bridges v. Commissioner*,[986] the Fourth Circuit held that:

> We do not construe the Court to mean, nor do we intend to hold, that the transaction is a sham simply because it proves to be unprofitable and even though it results in a loss and a reduction of income tax liability. If there is, under the realities of the terms of the transaction, some reasonable hope of the transaction appreciably affecting the taxpayer's beneficial interest other than by tax reduction, the transaction would not be a sham for tax purposes.[987]

The Court further observed that:

> if there is, under the realities of the terms of the transaction, some real risk of loss to the taxpayer, other than whatever loss might be actually "built-in" (as it was in the instant case), the transaction would not be a sham for tax purposes.[988]

In a 2005 Coordinated Issue Paper, the IRS indicated that "[t]he doctrine of economic substance should be raised in cases where the facts show that the transaction at issue was primarily designed to generate the tax losses, with little if any possibility for profit … ."[989]

In the Senate Report on the JOBS Act of 2004, the Senate cited *Rice's Toyota World, Inc. v. Commissioner*,[990] *IES Indus., Inc. v. United States*[991] and *Compaq Computer Corp. v. Commissioner*[992] for the view that "[i]n these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits."[993] In other words, this standard requires that the expected profit from the transaction exceeds the transaction's costs, and the profit would not be discounted.[994] In addition, as discussed above, in the case of a subjective determination of profit potential (most commonly under §183), *any* potential for profit would satisfy the profit require-

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[978] *Id.*

[979] *Id.* at 103.

[980] 1999-1 C.B. 835, *superseded by* Rev. Rul. 2002-69, 2002-44 I.R.B. 760.

[981] 592 F. Supp.2d 953 (N.D. Ohio 2008).

[982] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5 (2000).

[983] Gunther, *Economics and Compaq v. Commissioner*, 2002 TNT 209-28 (Oct. 25, 2002).

[984] *Id.*

[985] *Dow Chem. Co. v. United States*, 250 F. Supp.2d at 799 ("The question is whether the transaction has *any* economic purpose other than to generate tax deductions.").

[986] 325 F.2d 180, 18485 (4th Cir. 1963).

[987] *Id.* (citing *Hanover Bank v. Commissioner*, 369 U.S. 672 (1962); *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962); *Maysteel Prods., Inc. v. Commissioner*, 287 F.2d 429 (7th Cir. 1961); *Luden's, Inc. v. United States*, 196 F. Supp.2d 526 (E.D. Pa. 1961); *Stanton v. Commissioner*, 34 T.C. 1 (1960)).

[988] *Id.* Citing *Humphreys v. Commissioner*, 301 F.2d 33 (6th Cir. 1962); *Fabreeka Prods. Co. v. Commissioner*, 294 F.2d 876 (1st Cir. 1961); *Maysteel Prods., Inc. v. Commissioner*, 287 F.2d 429 (7th Cir. 1961).

[989] *Coordinated Issue Paper Addressing Offsetting Options Transactions*, 2005 TNT 144-19. Effective Jan. 21, 2014, all current Coordinated Issue Papers are decoordinated, and any guidance or tools relevant to addressing an issue or transaction that were provided in a Coordinated Issue Paper will be made available through LB&I directives or other guidance. The decoordination of any coordinated issue has no effect on whether the issue will continue to be pursued by LB&I in a taxpayer examination or on the IRS's views regarding any transaction, including listed transactions. LB&I-04-0114-002 (Jan. 21, 2014).

[990] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[991] 253 F.3d 350 (8th Cir. 2001).

[992] 113 T.C. 214 (1999).

[993] S. Rpt. No. 192, 108th Cong., 1st Sess. (2003) (to accompany S. 1637). *See also* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (stating the same).

[994] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

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ment test. More importantly, the regulations under §183 provide that even a small chance of making a large profit may be sufficient, even if the expectation of a profit may be considered unreasonable.[995]

Comment: Under this standard, taxpayers would be able to rely on the profit potential test if they, "could show that some taxpayers, somewhere, would have found the pre-tax return it had received to be attractive."[996]

7. The Reasonable Means Approach

Before the codification of the economic substance doctrine as §7701(o) (applicable to transactions entered into after March 30, 2010), some courts stated that the taxpayer not only must reasonably expect more than de minimis amount of profit from the transaction, but also that the disputed transaction was a "reasonable means" of achieving such a profit.[997] In other words, if a taxpayer could have made a certain return by entering into a simple, straightforward investment but instead, chose to make the same return on a much more complicated transaction, the latter may be viewed as lacking economic substance.[998]

In *Andantech v. Commissioner*, the D.C. Circuit observed that "Although it is possible that the computer leasing business could have been profitable and beneficial to any one of the parties involved, there was no evidence of a non-tax need to form the partnership in order to take advantage of the potential profits of the business."[999]

In *Glass v. Commissioner*, the Tax Court held that options straddle transactions were sham transactions, although the taxpayer could have made small "difference gains."[1000] The Tax Court stated that:

> [g]iven the complexity of trading in commodity options and futures and the relatively high cost of commissions, profiting from difference gains in amounts sizable enough to make the enterprise worthwhile is a difficult and hazardous undertaking at best.[1001]

Comment: Thus, the court in *Glass* implied that a complex transaction that still could have generated a profit may have been disregarded if the taxpayer could have expected to make a similar profit by entering into a much more simple transaction.

In *Long-Term Capital Holdings v. United States*,[1002] the district court elaborated that:

> The absence of reasonableness sheds light on Long Term's subjective motivation, particularly given the high level of sophistication possessed by Long Term's principals in matters economic… Moreover, the construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees itself points to Long Term's true motivation, tax avoidance. Taking fee-generating investments was Long Term's core business and was regularly executed without either the complex machinations related to OTC's contributions or the attendant millions in transaction costs. See Boca Investerings P'ship, 341 F.3d at 631–632. For these and the following reasons, the Court finds that fees, strategic value added by B&B, and increasing Long Term's principals' Portfolio investments did not motivate the OTC transaction; rather Long Term possessed no business purpose other than tax avoidance.

Nevertheless, in *Lerman v. Commissioner*, the Tax Court observed that:

> [The Commissioner's] suggestion that [the taxpayer] could have made money more safely by depositing the purchase price in a bank than he could have by investing in a CCR herd is irrelevant. As stated in sec. 1.183-2(b)(9), Income Tax Reg., 'the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit.'[1003]

Comment: Pursuant to §183, the IRS may not use the reasonable means approach.[1004] As set forth below, a "reasonable means" approach was included in the Senate version of the JOBS Act of 2004. Under that proposal, the business purpose prong would have been satisfied if "the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose."[1005] The JCT Report (2005) abandoned the "reasonable means" approach and suggested a different one; a transaction will satisfy the business purpose prong if it is "substantial" and "bear a reasonable relationship to the taxpayer's normal business operations or investment activities."[1006]

[995] The determination of whether a taxpayer has an objective of making a profit is based on all facts and circumstances. Pursuant to Reg. §1.183-2(b), relevant factors include: (i) the manner in which the taxpayer carries on the activity; (ii) the expertise of the taxpayer or his advisors; (iii) the time and effort expended by the taxpayer in carrying on the activity; (iv) the expectation that the asset used in the activity may appreciate in value; (v) the success of the taxpayer in carrying on other similar or dissimilar activities; (vi) the taxpayer's history of income or losses with respect to the activity; (vii) the amount of occasional profits, if any, which are earned; (viii) the financial status of the taxpayer; and (ix) whether there are elements of personal pleasure or recreation in carrying on the activity.

[996] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5 (2000).

[997] *Boca Investerings P'ship*, 341 F.3d at 631–632. *See also ASA Investerings*, 201 F.3d at 513 (indicating that the business purpose doctrine reduces the incentive to engage in "wasteful activity.").

[998] *Id. See also Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[999] 331 F.3d 972, 980 (D.C. Cir. 2003).

[1000] 87 T.C. at 1177; *Bohrer v. Commissioner*, 945 F.2d 344 (10th Cir. 1991); *Lee v. Commissioner*, 897 F.2d 915 (8th Cir. 1989); *Kielmar v. Commissioner*, 884 F.2d 959 (7th Cir. 1989); *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Friedman v. Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Keane v. Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Ratliff v. Commissioner*, 865 F.2d 97 (6th Cir. 1989); *Killingsworth v. Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); and *Herrington v. Commissioner*, 854 F.2d 755 (5th Cir. 1988).

[1001] *Id.*

[1002] 330 F. Supp.2d 122 (D. Conn. 2004).

[1003] *Lerman v. Commissioner*, 77 T.C. at 1346 n. 29. *Cf. ACM P'ship v. Commissioner*, T.C. Memo 1997-115 (the Tax Court examined several other investment alternatives, including the deposit of the funds in a bank account).

[1004] Reg. §1.183-2(b)(9).

[1005] Proposed Code §7701(n)(1)(B)(i)(I) and (II), S. 1637. *See also* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005).

[1006] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005).

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Under §7701(o), which was added to the Code on March 30, 2010 and applies to transactions entered into after that date, the business purpose prong of the two-prong test will be satisfied if the taxpayer has a substantial purpose (apart from federal income tax effects and state and local income tax effects that are related to federal income tax effects) for entering into the transaction.[1007]

E. Economic Risk

Before the standard was codified as §7701(o) (applicable to transactions entered into after March 30, 2010), an important element that was used by the courts in applying the economic substance standard, particularly when an investment was involved, was whether the taxpayer (as investor) was exposed to any economic risk from the transaction.[1008] The Second Circuit determined in *Bridges v. Commissioner* that "if there is, under the realities of the terms of the transaction, some real risk of loss to the taxpayer, other than whatever loss might be actually 'built-in' (as it was in the instant case), the transaction would not be a sham for tax purposes."[1009]

The economic risk inherent in a transaction is a concept closely related to the transaction's profit potential.[1010] In *Knetsch v. United States*, the U.S. Court observed that a transaction will be disregarded if it did "not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax."[1011]

In *Yosha v. Commissioner*, the Seventh Circuit concluded that entering into a commodities straddle transaction, where there was no opportunity for market-based gain or loss, had no economic substance.[1012] The Seventh Circuit held that in order to satisfy the economic substance standard, the taxpayer must be exposed to risk of loss; a transaction that does not expose the taxpayer to any economic risk (i.e., a transaction that has a "zero prospect of gain or loss")[1013] is considered as having no economic substance.[1014]

In *ACM P'ship v. Commissioner*, the Third Circuit elaborated that disposing of property at a loss, which had no net economic effect on the taxpayer's economic position, either because the taxpayer retained the opportunity to reacquire the property at the same price, or because the taxpayer had offset the economic effect of the disposition by acquiring assets virtually identical to those relinquished, had no economic substance.[1015] The Third Circuit concluded that:

> Just as the taxpayer in *Gregory* engaged in offsetting transactions by creating a new corporation, transferring stock to the corporation, transferring the stock back out of the corporation and then liquidating the corporation, just as the taxpayers in *Knetsch* and *Weller* engaged in offsetting transactions by acquiring annuity policies and borrowing back virtually their entire value, and just as the taxpayers in *Lerman* and the other property disposition cases engaged in inconsequential transactions by disposing of property while retaining the opportunity to reacquire the same or virtually identical property at the same price, so ACM engaged in mutually offsetting transactions by acquiring the Citicorp notes only to relinquish them a short time later under circumstances which assured that their principal value would remain unchanged and their interest yield would be virtually identical to the interest yield on the cash deposits which ACM used to acquire the Citicorp notes (footnote omitted).[1016]

In *Fender v. United States*, the Fifth Circuit disallowed deductions for a loss that the taxpayers incurred on a bond sale.[1017] The unrated bonds were sold at a substantial loss to a bank that was approximately 41% owned by the taxpayers. Although increased interest rates had caused the bonds' market value to decrease since the taxpayers had purchased them, the issuer was financially sound and capable of fulfilling its obligations relating to the bonds. A little more than a month after the sale, and in a new tax year, the taxpayers repurchased the bonds for roughly the same price for which they had sold the bonds.[1018]

In examining the transaction, the court considered "whether the taxpayers were exposed to a real risk of not being able to repurchase the bonds in a short period of time and thus of not being able to recover the apparent loss from the … sale to the bank."[1019] The court determined that the taxpayers had sufficient control over the bank to ensure that the bonds would be resold to them. Furthermore, the unrated nature of the bonds greatly limited their marketability and would have made it dif-

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[1007] §7701(o)(1)(B), §7701(o)(3).

[1008] *Yosha v. Commissioner*, 861 F.2d at 500 (stating that transactions that do not involve market risk are not economically substantial transactions); *Fender v. United States*, 577 F.2d at 936 (stating that whether the taxpayers were entitled to a loss deduction depended on whether they faced "a real risk of not being able to … recover the apparent loss" arising from the transaction); *Heltzer v. Commissioner*, 62 T.C.M. 518, 529 (1991) ("Commodity trading lacks economic substance where it is virtually risk-free … .").

[1009] *Bridges v. Commissioner*, 325 F.2d at 185. *See also Maysteel Products, Inc. v. Commissioner*, 287 F.2d at 431 ("While the end result here was a gift — not a business transaction — the bond purchase, loan, note and pledge of collateral, sale of the bonds, and satisfaction of the loan were in every respect genuine financial and commercial transactions. They were real in every sense. And the taxpayer was exposed to all of the usual risks involved in such transactions. It incurred genuine obligations; risks and obligations beyond its control. The transaction here had economic substance, was not a sham nor rigged device without real substance or risk, and inducement or motive is without significance. Taxpayer incurred the risk of loss in event of decline in the market; was entitled to benefit from any advance; it was not bound to make the gift it ultimately did but could have retained the benefits of the transaction. Substantive and economic reality were present.").

[1010] *See* Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) ("some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.") (citing *Goldstein v. Commissioner*, 364 F.2d at 739–40 and *Sheldon v. Commissioner*, 94 T.C. at 768).

[1011] 364 U.S. at 366.

[1012] *Yosha v. Commissioner*, 861 F.2d at 501.

[1013] 861 F.2d at 501.

[1014] *Id.* At 500 ("Straddles that involve no market risks are not economically substantial straddles and hedges; they are artifices created by accomplices in tax evasion, the brokers.").

[1015] *ACM P'ship v. Commissioner*, 157 F.3d at 249 (citing *Yosha v. Commissioner*, 861 F.2d at 501; *Lerman v. Commissioner*, 939 F.2d at 48; *Merryman v. Commissioner*, 873 F.2d 879 (5th Cir. 1989); *Kirchman v. Commissioner*, 862 F.2d at 1492–93)).

[1016] *Id.* at 250.

[1017] *Fender v. United States*, 577 F.2d 934 (5th Cir. 1978).

[1018] *Id.*

[1019] *Id.* at 936.

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ficult for the bank to sell them to anyone but the taxpayers. While the initial sale created a genuine loss, the loss was effectively canceled by the subsequent repurchase. The net non-tax cash effect of the transactions was zero dollars.[1020]

By contrast, in *IES Indus., Inc. v. United States*[1021] and *Compaq Computer Corp. v. Commissioner*,[1022] both the Eighth and the Fifth Circuits concluded that the *avoidance* of risk, rather than its acceptance, satisfied the business purpose test.[1023] In both cases, the purchases and sales of the ADRs were made within a very short period, so that the taxpayers will be exposed to very minimal risk.[1024] In *IES Indus., Inc. v. United States*, the Eighth Circuit observed that the taxpayer's "disinclination to accept any more risk than necessary … strikes us as an exercise of good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions."[1025]

The issue of exposure to economic risk is frequently raised in the context of the validity of a partnership.[1026] In particular (before the economic substance doctrine was codified as §7701(o), applicable to transactions entered into after March 30, 2010), when a court examined whether a partnership ought to be respected for tax purposes under the economic substance doctrine, a determination that a partner was *not* exposed to any risk of loss could have resulted in treating the partner as a creditor of the entity rather than a partner; if the purported partnership has only two partners and one partner is treated as a creditor, the partnership will be disregarded as such for tax purposes.[1027]

In *ASA Investerings P'ship v. Commissioner*, the D.C. Circuit affirmed the Tax Court's analysis of the foreign partner's (ABN) opportunity for gain/risk of loss.[1028] The D.C. Circuit applied the test set forth by the United States Supreme Court in *Commissioner v. Culbertson*, pursuant to which the existence of a partnership for tax purposes depends on whether, "considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[1029]

On the *gain* side, the D.C. Circuit first observed that:

> we find no clear error in the court's findings that the direct payments made to ABN were to compensate it merely for its funding costs. Petitioner says that there was no explicit agreement that ABN would receive a return of LIBOR plus 75 basis points, pointing to the fact that the payments actually made by AlliedSignal to ABN did not produce such a return… But petitioner makes no argument that these payments were related to the success of the partnership's investments (*i.e.*, the PPNs and LIBOR notes), and under the circumstances it is reasonable to infer that they were made pursuant to a pre-arranged agreement to compensate ABN for its funding costs (plus some amount above LIBOR, even if not 75 basis points).[1030]

On the *risk of loss* side, the D.C. Circuit continued and held that:

> There was no clear error in the Tax Court's determination that at no point during the transaction did ABN assume greater than de minimis risk. The PPNs were essentially risk free: not only were they issued by banks with the highest credit ratings but they were held for a mere three weeks. Moreover, because of the side agreement under which any loss on the PPNs would be embedded in the value of the LIBOR notes, AlliedSignal would bear any shortfall over the brief period in which PPNs were held. Petitioner argues that ABN was subject to the risk that AlliedSignal would ultimately decide not to acquire the LIBOR notes. This seems unlikely to the point of triviality, however, for two reasons: first, this step was integral to AlliedSignal's tax objective, and to the entire transaction; and second, at the point when the LIBOR notes would be distributed, Dominguito still owned over 40% of ASA, and according to the partnership agreement, any act of the partnership committee would require the consent of partners whose interest equaled or exceeded 95%. Nor was there any real hazard that AlliedSignal might agree to distribute the LIBOR notes but refuse to make the adjustment for any loss on the PPNs: as den Baas had stated in a memorandum to ABN officials, the SPCs could counter by refusing consent for the distribution of the notes altogether.

The court observed that the LIBOR notes had greater inherent risk than the short-term PPNs; ABN, however, entered into hedge transactions outside the partnership to reduce the risk to a de minimis amount.[1031]

Accordingly, the D.C. Circuit concluded that the foreign partner was a creditor rather than a partner and, therefore, the parties did not intend to create a partnership.[1032]

By contrast, in *TIFD III-E Inc. v. United States*, two Dutch banks and TIFD III-E formed Castle Harbour, a partnership.[1033] The government argued that, because the return earned by the Dutch banks was essentially guaranteed, it had no risk with respect to the transaction, and this means, according to the government, that there was no economic effect to the partner-

[1020] *Id.* at 937–38.
[1021] 253 F.3d 350.
[1022] 277 F.3d 778 (5th Cir. 2001).
[1023] Shaviro & Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 2002 TNT 19-31 (2002) ("What the courts in *Compaq* and *IES* had to say about economic risk was no less misguided than their discussion of pre-tax profit. On the topic of risk, the decisions have two main themes. First, they turn prior antiabuse doctrine on its head, by treating the avoidance of risk, rather than the acceptance of risk, as the harbinger of non-tax business purpose and consequent legitimacy … . Second, the courts claimed that the taxpayers actually did bear risks that 'were not by any means insignificant.' Supposedly, market prices could have changed in mid-transaction; 'any of the individual trades could have been broken up or, for that matter, could have been executed incorrectly; and the dividend might not have been paid' or might have differed from the pre-announced amount.").
[1024] *Id.*
[1025] 253 F.3d at 355.
[1026] *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004), distinguishing *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000).
[1027] *Id.*
[1028] 201 F.3d 505 (D.C. Cir 2000).
[1029] 337 U.S. at 742.
[1030] *Id.* at 514.
[1031] *Id.* at 514–15.
[1032] *Id.*
[1033] 342 F. Supp.2d 94 (D. Conn. 2004).

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ship.[1034] The court dismissed this argument and observed that in return for a significant portion of Castle Harbour's operating income, the Dutch banks contributed approximately $117 million.[1035] The court elaborated that even with an 8.5% guaranteed return, the Dutch banks still participated in the economically real upside of the leasing business.[1036]

Although the investment accounts provided the Dutch banks with some guarantee of return, the court held that the *lack of risk* was not enough to make a transaction economically meaningless.[1037] The District Court explained that: "[i]t is hard to see how an assurance about the manner in which returns would be paid could undercut the economic reality of an initial investment."[1038] Therefore, the District Court asserted that participating in upside potential, even with some guarantee against loss, is economically substantial.[1039] Finally, the court observed that the government's premise that a guarantee of a positive return indicates no risk, was simplistic; whether an investment is "risky" to the investor depends on a number of factors, including the investor's cost of capital and opportunity costs.[1040] The court concluded that "[t]he economic reality of such a transaction is hard to dispute."[1041]

Comment: The district court distinguished this case from the situations in *ASA Investerings P'ship v. Commissioner*,[1042] mainly on the grounds that in *ASA Investerings*, the foreign partners were entirely indifferent to the partnership's activities (because their return was 100% guaranteed), as opposed to *TIFD III-E Inc. v. United States*, where the Dutch banks could have suffered some downside (albeit limited) and could have earned more profit than the guaranteed return. In *TIFD III-E Inc. v. United States*, the Dutch banks had a very real stake in the transaction because their return was tied directly to the performance of the aircraft leasing business.[1043]

The Second Circuit reversed the district court's decision, primarily on the ground that the Dutch banks were not bona fide equity participants, but rather secured lenders.[1044] The Second Circuit concluded that:

> … the Dutch banks' interest was overwhelmingly in the nature of a secured lender's interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits. The banks had no meaningful stake in the success or failure of Castle Harbour. While their interest was not totally devoid of indicia of an equity participation in a partnership, those indicia were either illusory or insignificant in the overall context of the banks' investment. The IRS appropriately rejected the equity characterization.

For a full discussion of *TIFD III-E*, including the procedural history, see VIII.E., below.

[1034] *Id.*
[1035] *Id.*
[1036] *Id.*
[1037] *Id.*
[1038] *Id.*
[1039] *Id.*
[1040] *Id.*
[1041] *Id.*

[1042] 201 F.3d 505 (D.C. Cir 2000).
[1043] 342 F. Supp.2d 94 (D. Conn. 2004).
[1044] For a discussion on debt/equity distinction in the partnership context, see Dantzler, *Debt vs. Equity in the Partnership Context*, 2006 TNT 20-37 (Jan 11, 2006).

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VI. Economic Substance and Entity Recognition

A. Overview

The Internal Revenue Code generally recognizes a corporation's separate existence for tax purposes so long as it carries on a bona fide business and does not serve solely tax avoidance purposes.[1045] Thus, it is generally recognized that the corporate form will be disregarded only where such form serves no business purpose has no economic substance.[1046] In *N. Ind. Pub. Servs. Co. v. Commissioner*, the Seventh Circuit held that, "the form that the taxpayer chooses for conducting business that results in tax-avoidance must be a viable business entity, that is, it must have been formed for a substantial business purpose or actually engage in substantive business activity."[1047] Thus, the Third Circuit indicated that the *Moline Properties* principle is derived from the general substance-over-form doctrine.[1048]

Courts have consistently applied this standard in determining whether a given entity qualifies as a valid separate entity.[1049] The *Moline Properties* doctrine has been applied by courts not only with respect to corporations but also to other entities such as partnerships and trusts.[1050]

In *Zmuda v. Commissioner*, the taxpayers argued that "a showing of business purpose, substantiated by business records and meeting minutes, would have validated the entities as business trusts."[1051] The Ninth Circuit first asserted that "[t]he business purpose rule has been used to determine the validity of the formation of an entity."[1052] Citing *Moline Props., Inc. v. Commissioner*, the Ninth Circuit continued and determined that "[i]f the purpose of incorporation is a business activity, such as investment or profit, or if incorporation is followed by the conduct of business, then the corporation is a separate taxable entity."[1053]

With respect to partnerships, the Ninth Circuit cited *Commissioner v. Tower*[1054] and concluded that "[t]he existence of a partnership also is determined by its business purpose."[1055] When the validity of a partnership is examined, "a finding that no real change in the economic relation between the parties occurred establishes that no partnership exists for business purposes."[1056] Finally, the Ninth Circuit in *Zmuda* observed that "the economic substance formula may be used to determine whether a family trust is valid, *Markosian v. Commissioner*, 73 T.C. 1235 (1980) and whether a trust is a grantor trust for tax purposes, *Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983)."[1057] In addition, the Ninth Circuit, in *Sparkman v. Commissioner*[1058] affirmed the use of the *Markosian* factors to determine that a private trust organization lacked economic substance.

B. Corporations: Piercing the Corporate Veil for Tax Purposes

In *Moline Props., Inc. v. Commissioner*, the United States Supreme Court set forth the standard for recognizing an entity for federal income tax purposes.[1059] The taxpayer, the sole shareholder of a corporation, attempted to characterize gain from the sale of real property, title to which was held by the corporation, as gain to the sole shareholder on the grounds that the existence of the corporation was "merely fictitious" for federal income tax purposes.[1060] The Supreme Court held that the taxpayer could not disregard the corporate form of his business organization unless such form was a "sham or unreal."[1061]

The Supreme Court explained the bedrock principle of the separate existence of the corporate entity:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[1062]

Courts have interpreted *Moline Properties* as setting forth a two-prong disjunctive test in determining whether a separate corporate entity should be recognized, a standard that is equivalent to the economic substance standard.[1063] The first prong applies a subjective standard requiring the taxpayer to demonstrate a legitimate, non-tax business purpose that is served by the selection of the corporate form as a separate and independent vehicle for owning and conducting the activity in question.[1064] The second prong applies an objective standard requiring that the entity has engaged in sufficient business activity.[1065]

[1045] *Moline Props.*, 319 U.S. at 438 ("The doctrine of corporate entity fills a useful purpose in business life."); *Paymer v. Commissioner*, 150 F.2d 334, 336 (2d Cir. 1945) ("As a general rule a corporation is a taxpayer separate and distinct from its stockholders.").

[1046] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[1047] *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 512 (quoting *Bass v. Commissioner*, 50 T.C. at 600).

[1048] *Id. See also Norton v. Commissioner*, T.C. Memo 2002-137 ("Where an entity is created that has no real economic effect and which affects no cognizable economic relationships, the substance of a transaction involving this entity will control over the form.") (citing *Zmuda v. Commissioner*, 731 F.2d at 1420).

[1049] *Bollinger v. Commissioner*, 485 U.S. 340 (1988); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945); *Nutt v. Commissioner*, 39 T.C. 231 (1962), rem'd on another issue, 351 F.2d 452 (9th Cir. 1965), cert. denied, 384 U.S. 918 (1966), acq., 1964-2 C.B. 5; *Siegel v. Commissioner*, 45 T.C. 566 (1966), acq., 1966-2 C.B. 7; *Bass v. Commissioner*, 50 T.C. 595 (1968).

[1050] The application of the doctrine to other entities was affirmed by *the Ninth Circuit in Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984).

[1051] *Id.* at 1420.

[1052] *Id.* at 1420.

[1053] *Id.* (citing *Moline Props. v. Commissioner*, 319 U.S. at 438–39).

[1054] 327 U.S. at 291.

[1055] *Id.* at 1421.

[1056] *Id.* (citing *Commissioner v. Tower*, 327 U.S. at 291).

[1057] *Id.*

[1058] 509 F.3d 1149 (9th Cir. 2007).

[1059] 319 U.S. 436 (1943).

[1060] *Id.* at 436.

[1061] *Id.* at 438–39.

[1062] *Id.* at 438–39.

[1063] *Rogers v. Commissioner*, 34 T.C.M. 1254, 1256 (1975) ("*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity … . Business purpose or business activity are alternative requirements."); *Bertoli v. Commissioner*, 103 T.C. 501, 511–12 (1994).

[1064] *Moline Props., Inc. v. Commissioner*, 319 U.S. 436 (1943). *See also* discussion above regarding the two-prong test.

[1065] *Id.*

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If either prong is satisfied, the entity will be recognized as a separate entity.[1066]

The *amount* of business activity necessary to satisfy the objective standard is minimal.[1067] For example, in *Taylor v. Commissioner*, the First Circuit recognized the separate existence of a corporation, the activities of which consisted solely of holding title to real estate, collecting revenues, opening a checking account, borrowing money, and executing legal documents.[1068]

In *ASA Investerings P'ship v. Commissioner*,[1069] the taxpayer argued that the partnership "[E]ngaged in more than sufficient business activity to be respected as a genuine entity" under *Moline Props., Inc. v. United States*.[1070] The D.C. Circuit, however held that the "term 'corporation' will be interpreted to mean a corporation which does 'business' in the ordinary meaning; and that escaping taxation is not business in the ordinary meaning."[1071]

In *Rogers v. Commissioner*, the Tax Court found that the corporation had real business activity despite the absence of an office, employees, books and records.[1072] In particular, the court held that the entity's negotiation of loans, use of bank accounts, payment of state taxes, and filing of certain reports and statements constituted sufficient activity to satisfy the active business test.[1073]

In *Aiken Indus. v. Commissioner*, the IRS challenged the formation of a foreign corporation on substance-over-form and conduit theories.[1074] In this case, a domestic corporation borrowed $2,250,000 at an interest rate of 4% from a Bahamian corporation. The Bahamian corporation owned 99.997% of the domestic corporation's parent company (a domestic corporation). The Bahamian corporation's wholly owned Ecuadorian subsidiary incorporated a company in the Republic of Honduras. The Bahamian corporation assigned the domestic corporation's note to the Honduran corporation in exchange for nine promissory notes ($250,000 each), which totaled $2,250,000 and bore interest of 4%. Because of this assignment, the domestic corporation made its 4% interest payments to the Honduran corporation, which, in turn, made its 4% interest payments to the Bahamian corporation.[1075]

The taxpayer argued that legal and operational considerations supported the validity of the transaction; in particular, pertaining to the separate existence of the Honduran corporation, the taxpayer argued that the corporation was formed pursuant to Honduran law and therefore was entitled to the tax benefits from the United States-Honduras Treaty.[1076]

The Tax Court found that the formation of the Honduran entity had no business purpose other than tax savings.[1077] The Tax Court also held that the Honduran entity was "merely a conduit" to pass on the interest to the Bahamian holder and found that the domestic issuer did not have a bona-fide debtor-creditor relationship with the Honduran entity.[1078] Therefore, the Tax Court concluded that there was no economic substance for structuring the transaction with the Honduran entity.[1079]

The IRS attempted to apply the decision in *Aiken Indus.* on similar facts. In *N. Ind. Pub. Serv. Co. v. Commissioner ("NIPSCO")*, the taxpayer created a Netherlands Antilles subsidiary for the purpose of obtaining funds.[1080] The subsidiary issued notes in the Eurobond market with a call option that were guaranteed by NIPSCO, and remitted the proceeds to NIPSCO in exchange for a $70 million note. The subsidiary earned income on the spread between the interest it received from NIPSCO and the interest it paid to the holders of the notes. When NIPSCO paid off the note, the subsidiary redeemed the notes for a premium in addition to principal and interest paid to the holders of the notes. Subsequently, the subsidiary was liquidated.

Similar to *Aiken Indus. v. Commissioner*,[1081] the taxpayer's goal was to obtain exemption under the treaty between the United States and the Netherlands Antilles, while in the absence of the subsidiary, NIPSCO would have been required to withhold tax on the interest payments. The IRS argued that the subsidiary was merely a conduit and should be disregarded on the grounds that the subsidiary was not adequately capitalized.[1082]

The Tax Court in *NIPSCO* rejected the IRS's argument on the grounds that an entity should not be viewed as a conduit and disregarded for tax purposes merely because its debt/equity ratio might be inadequate.[1083] The Tax Court distinguished *Aiken* from *NIPSCO* on the following grounds: (i) in *Aiken*, the transaction was between related parties while in *NIPSCO*, the Euronotes purchasers were unrelated to NIPSCO; and (ii) in *Aiken*, the transaction had no business purpose, while in *NIPSCO*, the subsidiary had legitimate business purpose, that is, to borrow money in Europe at a favorable rate and to lend it to NIPSCO, and to derive a profit from the spread in the interest rates.[1084]

The Tax Court relied on *Moline Properties* for the decision that so long as a foreign entity conducts substantive business

[1066] *Id.*

[1067] *Siegel v. Commissioner*, 45 T.C. at 577 ("Nor may it be said that Ainsley's minimal activity did not constitute the conduct of business. The point is that Ainsley was formed for only a limited purpose, namely, to invest in the joint venture, and it in fact carried out that purpose. This was a sufficient amount of business in these circumstances to justify recognition of the corporation if in fact such business was done by Ainsley rather than by petitioner.").

[1068] 445 F.2d 455, 457 (1st Cir. 1971).

[1069] 201 F.3d 505 (D.C. Cir. 2000).

[1070] 319 U.S. 436 (1943).

[1071] *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 513 (citing *National Investors Corp. v. Hoey*, 144 F.2d 466, 468 (2d Cir. 1944)).

[1072] 34 T.C.M. at 1257.

[1073] *Id.*

[1074] *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971), *acq.*, 1972-2 C.B. 1.

[1075] *Id.*

[1076] *Id.*

[1077] *Id.* at 934 ("In these circumstances, where the transfer of MPI's note from ECL to Industrias in exchange for the notes of Industrias left Industrias with the same inflow and outflow of funds and where MPI, ECL, and Industrias were all members of the same corporate family, we cannot find that this transaction had any valid economic or business purpose. Its only purpose was to obtain the benefits of the exemption established by the treaty for interest paid by a United States corporation to a Honduran corporation.").

[1078] *Id.*

[1079] *Id.*

[1080] 115 F.3d 506 (7th Cir 1997).

[1081] *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971).

[1082] 115 F.3d 506 (7th Cir. 1997).

[1083] 105 T.C. at 349.

[1084] *Id.* at 353–55.

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activity, even minimal activity, the entity will not be disregarded for federal tax purposes, notwithstanding the fact that the subsidiary was created with a view to reducing taxes.[1085]

The Seventh Circuit affirmed the Tax Court's reliance on the *Moline Properties* line of cases for "the principle that so long as a foreign subsidiary conducts substantive business activity — even minimal activity — the subsidiary will not be disregarded for federal tax purposes, notwithstanding the fact that the subsidiary was created with a view to reducing taxes."[1086] The Seventh Circuit observed that

> [the *Moline Properties* line of] cases engender the principle that a corporation and the form of its transactions are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions … . [I]t is, unnecessary, and we think inappropriate, for us to sever a corporation from its transactions in analyzing a case … where the corporation was formed with the intent of structuring its economic transactions to take advantage of laws that afford tax savings.[1087]

The Seventh Circuit further elaborated that:

> From *Gregory* and *Aiken Industries*, we glean the following: Transactions involving a foreign corporation are to be disregarded for lack of meaningful economic activity if the corporation is merely transitory, engaging in absolutely no business activity for profit — in other words, it is a "mere skeleton." See Bass, 50 T.C. at 602 n.3. Transactions will also be disregarded if the foreign corporation lacks dominion and control over the interest payments it collects.[1088]

In *Bass v. Commissioner*, the IRS argued that the taxpayers' wholly owned foreign corporation ought to be disregarded under substance over form theory.[1089] The taxpayer argued that the formation of the foreign corporation was done for business purposes — to hold oil and gas leases for development.[1090] The Tax Court found that the foreign corporation carried on substantive business activity and held that the foreign company should be respected as a separate entity.[1091]

In *Bolger v. Commissioner*, 10 corporations acquired properties and entered into net lease arrangements with an entity that was interested in using the particular property.[1092] The corporations sold the notes for an amount equal to the purchase price of the property, secured by a first mortgage and an assignment of the lease. The mortgage payments were made over a period equal to the term of the lease. After the lease and mortgage arrangements were made, the corporations conveyed the property to the shareholders for "one dollar and other consideration."[1093] The shareholders executed an assumption agreement in favor of the corporation, promising to assume all of the corporation's obligations under the lease and the mortgage, on a nonrecourse basis. Bolger participated in this transaction as a shareholder. On his income tax returns for a four-year period, Bolger took his share of the income and deductions as a coowner of the properties.[1094] The IRS disallowed the depreciation deductions. The Tax Court determined that the corporations were all viable entities, both before and after the transfer of the properties and hence had to be treated as separate entities, and that the corporations had transferred what ownership interests they had to their shareholders.[1095]

In *Black & Decker Corp. v. United States*, the district court applied a combination of the *Moline Properties* doctrine and objective economic substance analysis to conclude that a corporation *and its transactions* are objectively valid, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically based business transactions.[1096] However, the Fourth Circuit in *Black & Decker* reversed the district court stating that the economic substance test does not focus on the general business activities of a corporation, but on the specific transaction in which the tax consequences are disputed.[1097]

Where taxpayers created, and soon after dissolved, an S corporation the stated purpose of which was to facilitate day trading, the Tax Court determined that formation of the S corporation lacked economic substance, and disallowed the loss claimed on dissolution.[1098] Taxpayers transferred personal assets of cash and marketable securities to a wholly-owned S corporation, which in turn immediately transferred those assets to a family limited partnership. A few weeks later, petitioners dissolved the S corporation and received the partnership interest as a liquidating distribution. During the existence of the S corporation, only 11 day trades were executed, and despite the time, effort, and cost of establishing the company, within 17

[1085] *Id.* at 347–48 (citing also *Hosp. Corp. of Am. v. Commissioner*, 81 T.C. 520, 579 (1983) ("Generally, the corporate entity will be respected except in 'exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights.'")); *Ross Glove Co. v. Commissioner*, 60 T.C. 569. 588 (1973) ("If [the corporation] was organized for and engaged in substantial business activity, it will be recognized for tax purposes."); *Nat Harrison Assocs., Inc. v. Commissioner*, 42 T.C. 601, 618 (1964) ("It is clear from the evidence that Overseas was a valid legal entity, separate from the domestic partnership and corporation, and that it was operated for a valid business purpose. Respondent tacitly admits this by not attempting to allocate the income from other contracts performed by Overseas to the domestic entities and by determining that the three stockholders of Overseas received dividends from it during the years here involved. Harrison testified that he and the other owners of the Harrison businesses decided that Overseas would conduct the business activities outside the United States and that the domestic corporation would conduct the business activities within the United States. This was a natural division of the business. The evidence also shows that Overseas has continued in business from the date it became active up to the date of the trial. Whether the primary reason for its existence and conduct of business was to avoid U.S. taxes or to permit more economical performance of contracts through use of native labor, or a combination of these and other reasons, makes no difference in this regard. Any one of these reasons would constitute a valid business purpose for its existence and conduct of business as long as it actually conducted business.").

[1086] 115 F.3d 506 (7th Cir 1997).

[1087] *Id.* at 512.

[1088] *Id.* at 513.

[1089] 50 T.C. 595 (1968).

[1090] *Id.*

[1091] *Id.*

[1092] *Bolger v. Commissioner*, 59 T.C. 760 (1973).

[1093] *Id.*

[1094] *Id.*

[1095] *Id.*

[1096] *Black & Decker Corp v. United States*, 340 F. Supp.2d 621 (D. Md. 2004) (citing *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 512; *Moline Props. Inc. v. Commissioner*, 319 U.S. at 438–39; *Frank Lyon Co. v. United States*, 435 U.S. at 583–84).

[1097] *Black & Decker Corp v. United States*, 436 F.3d 431 (4th Cir. 2006), aff'g in part, rev'g in part and rem'g, 340 F. Supp.2d 621 (D. Md. 2004).

[1098] *Daichman v. Commissioner*, T.C. Memo 2020-126.

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days of organization taxpayers had begun taking steps to dissolve the corporation, before any actual significant trading had even occurred. Taxpayers claimed a nonpassive loss on dissolution, which they used to offset wage income and nonpassive partnership income. The IRS denied the claimed loss, arguing that the dissolved S corporation was not engaged in a trade or business, that the transactions generating the loss lacked economic substance, and that the taxpayers understated the value of certain assets. The Tax Court found that an advisor offered taxpayers a prepackaged tax strategy designed to create an artificial loss through a circular flow of assets, the application of substantial discounts, and the misreporting of the resulting loss as an ordinary loss, rather than a short-term capital loss. The Tax Court held that the transactions at issue did not have economic substance and that the taxpayers were not entitled to the claimed loss deduction.[1099]

C. The Validity of a Partnership

In *Commissioner v. Tower*, the taxpayer managed and controlled a manufacturing business (operated as a corporation).[1100] The taxpayer was the president, owning 445 of the corporation's 500 shares, the taxpayer's wife was the vice president, owning five shares, and a third person (Amidon) was the secretary, owning 25 shares. The taxpayer transferred 190 shares to his wife and, three days later, the corporation was dissolved and a partnership was organized, consisting of the taxpayer and Amidon as general partners, and the taxpayer's wife as a limited partner with no authority to participate in the conduct of the business. Each partner contributed the value of his or her stock and no new capital was contributed. The taxpayer continued to manage and control the business, which was conducted as before except that the taxpayer and Amidon ceased to draw salaries. The wife contributed no services to the business.

The United States Supreme Court established the following principle:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. [footnote omitted] When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.[1101]

The taxpayer argued that under *Gregory v. Helvering* "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[1102] The United States Supreme Court, however, observed that:

> We do not reject [the *Gregory v. Helvering*] principle. It would clearly apply, for example, in a situation where a member of a partnership, in order to keep from paying future taxes on partnership profits and in order to get into a lower income tax bracket, sells his interest to a stranger, relinquishing all control of the business. But the situation is different where the taxpayer draws a paper purporting to sell his partnership interest even to a stranger, though actually he continues to control the business to the extent he had before the "sale" and channels the income to his wife. Then a showing that the arrangement was made for the express purpose of reducing taxes simply lends further support to the inference that the husband still controls the income from his partnership interest, that no partnership really exists and that earnings are really his and are therefore taxable to him and not to his wife. The arrangement we are here considering was of the type where proof of a motive to reduce income taxes simply lent further strength to the inference drawn by the Tax Court that the wife was not really a partner. See Paul, Selected Studies in Federal Taxation, 2d series, pp. 293–300. To rule otherwise would mean ordering the Tax Court to shut its eyes to the realities of tax avoidance schemes.[1103]

Three years later, in *Commissioner v. Culbertson*,[1104] (a case involving a partnership between a father and four children), the United States Supreme Court relied on the principle set forth in *Commissioner v. Tower* and held that the existence of a valid partnership depends on whether:

> considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise (footnote omitted).[1105]

In *Luna v. Commissioner*, the Tax Court set forth the following nonexclusive list of factors that various courts have concluded to be relevant in considering whether a partnership was created. These factors include:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party had made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books

[1099] *Daichman v. Commissioner*, T.C. Memo 2020-126.
[1100] 327 U.S. 280 (1946).
[1101] *Id.* at 286–87.
[1102] *Id.* at 288.
[1103] *Id.* at 288–89.
[1104] 337 U.S. 733 (1949).
[1105] *Id.* at 742.

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> of account were maintained for the venture; and whether the parties exercised mutual control over the assumed mutual responsibilities for the enterprise.[1106]

In *Cross Refined Coal, LLC v. Commissioner*,[1107] the Tax Court concluded that in some circumstances, partners may join together in order to share after-tax profits. Acknowledging that the partners in a refined coal venture would not share in pre-tax profits because the sale of refined coal would generate nothing but losses, the court found that the partners joined together to share the after-tax profit coming from tax credits for the sale of refined coal. Citing *Sacks v. Commissioner*,[1108] the court explained that when Congress creates a tax credit to incent an otherwise uneconomical activity, the economic substance of that activity should be evaluated by including the tax incentive. To do otherwise, the court explained, would remove the incentive to undertake an otherwise uneconomical activity that Congress wishes to encourage.

The Tax Court applied the *Luna* factors to decide in *WB Acquisition, Inc. v. Commissioner* that a joint venture between a partnership and its wholly-owned subsidiary, both of which were controlled and managed by the same two individuals, was not a valid partnership.[1109] The general theme of the court's analysis was that the joint venture was not conducted as it would have been had the venturers been unrelated. In essence, the court concluded that the joint venture was not operated according to the joint venture agreement, one of the venturers contributed nothing of value to the venture, the joint venturers did not exercise control over the income and capital of the joint venture in a manner commensurate with their joint venture interests, and the joint venturers did not share in the risk of loss. A few items were of particular significance in the court's evaluation of the *Luna* factors. First, the joint venture agreement called for a 30%/70% allocation of profits, but when the venture proved more profitable than expected, the parties adjusted the allocation (but did not amend the agreement) to a 49.6%/50.4% division. The court found no legitimate reason for one party to forfeit 19.6% of the profits. Second, the joint venture failed to file an income tax return, which was a material failure to comply with the joint venture agreement provision requiring such a return be filed. Third, the partnership contributed only the services of the controlling individuals and its financial guarantee to the joint venture, which would have been contributed regardless of the existence of the joint venture. The court noted that the joint venture obtained a performance bond based on the guarantees of the joint venturers, the controlling individuals, and other companies controlled by those individuals. If the partnership's guarantee was valuable enough to merit a 70% profit interest in the joint venture, the court reasoned, then the guarantees of the other parties also should have had value; yet none of those other entities were party to the joint venture so as to enjoy a share of the expected profits. In addition, the court reasoned that the guarantees would have been provided even without the joint venture, because the venture was between the partnership and its subsidiary. Fourth, instead of the joint venturers exerting control commensurate with their joint venture interests, the individuals that controlled the joint venturers exerted control over the enterprise and did not cause the joint venturers to deal with each other at arm's length. Fifth, the joint venture agreement included an indemnity clause requiring one of the venturers to be reimbursed for all of its costs related to the joint venture, so that the joint venturers did not share in the risk of loss associated with the joint venture's business.

WB Acquisition, Inc. v. Commissioner was appealed to the Court of Appeals for the Ninth Circuit, which held that the Tax Court did not clearly err in finding the joint venture was not operated with the intention of being a bona fide partnership.[1110] The only portion of the Tax Court's *Luna* analysis challenged on appeal was the holding that the partnership's contribution of its financial guarantee to the joint venture was worthless, because without the partnership's guarantee, the subsidiary could not have obtained the performance bond that was a prerequisite to winning a construction contract. The Ninth Circuit focused on the fact that the partnership's business included that of its wholly-owned subsidiary, so that the partnership was obligated to provide the guarantees regardless of the existence of the joint venture. Likewise, the partnership was obligated to offer the personal guarantees of the controlling individuals, not because of the joint venture, but because the individuals had already promised to support the business of the partnership.

In *Merryman v. Commissioner*, the IRS disallowed the taxpayers' deductions and investment tax credits attributable to their interests in a partnership on the grounds that the partnership had neither business purpose nor economic substance other than to obtain the tax benefits.[1111] The Fifth Circuit affirmed the trial court's judgment and restated the general principle that transactions with neither business purpose nor economic substance other than creation of tax benefits would be disregarded for tax purposes.[1112] The court concluded that the partnership had no economic substance on the grounds that the partnership: (i) had no offices or employees; (ii) paid no salaries; (iii) carried on no business dealings other than execution of a sales contract and a management agreement; (iv) owned no property; (v) maintained no books or records; and (vi) did not hold itself out as being engaged in business.[1113]

The Fifth Circuit also considered whether a partnership should be respected in *Southgate Master Fund, LLC v. United States*.[1114] Nonperforming loans were contributed to a partnership, resulting in the partnership's inside basis in the loans being equal to their face amount. The partnership interest of the partner that contributed the loans was then purchased by another party, and the built-in losses on the loans were then recognized. While the Fifth Circuit found that the acquisition of the loans had economic substance because there was a reasonable profit potential, it concluded that the partnership was a sham

[1106] 42 T.C. 1067 (1964).
[1107] 19502-17 (T.C. Aug. 29, 2019).
[1108] 69 F.3d 982 (9th Cir. 1995).
[1109] T.C. Memo 2011-36.
[1110] *DJB Holding Corp. v. Commissioner*, No. 12-70574 (9th Cir. Oct. 7, 2015), aff'g sub. nom. *WB Acquisition, Inc. v. Commissioner*, T.C. Memo 2011-36.
[1111] 873 F.2d 879 (5th Cir. 1989).
[1112] *Id.*
[1113] *Id. See also Packard v. Commissioner*, 85 T.C. 397, 419 (1985) (S corporation disregarded for tax purposes even though the underlying investment was held not to be a sham).
[1114] 659 F.3d 466 (5th Cir. 2011).

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because there was a lack of a business purpose in joining together to form the partnership.

In *ASA Investerings P'ship v. Commissioner*,[1115] the taxpayer argued that the partnership "[E]ngaged in more than sufficient business activity to be respected as a genuine entity" under *Moline Properties*.[1116] The facts were similar to the facts in all the other CINS transactions discussed herein. Both the Tax Court and the D.C. Circuit followed the decision in *ACM P'ship v. Commissioner*, holding that ABN and AlliedSignal did not intend to join together for the purpose of carrying on a partnership and sharing in profits and losses.[1117] The Tax Court indicated, and the D.C. Circuit affirmed, that while AlliedSignal entered into the agreement solely to generate a capital loss (focusing only on the potential tax benefits), ABN entered into the agreement solely to receive its pre-determined return, which was not dependent upon the performance of the partnership.[1118]

The Tax Court also reviewed whether the parties' relationships were those of a debtor-creditor.[1119] The Tax Court cited *Dixie Dairies Corp. v. Commissioner*[1120] for the view that in analyzing whether an investment should be characterized as debt or equity:

> [t]he ultimate question [is] whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a loan for which repayment was expected regardless of the success of the venture.[1121]

The Tax Court concluded that the parties had a debtor-creditor rather than a partner-partnership relationship.[1122] The D.C. Circuit affirmed the Tax Court's decision and held that:

> [I]f engaging in business activity were sufficient to validate a partnership ASA would qualify. It was infused with a substantial amount of capital … and invested it … over a period of two years. In fact, however, courts have understood the "business activity" reference in *Moline* to exclude activity whose sole purpose is tax avoidance. This reading treats "sham entity" cases the same way the law treats "sham transaction" cases, in which the existence of formal business activity is a given but the inquiry turns on the existence of a non-tax business motive. Thus, what the [taxpayer] alleges to be a two-pronged inquiry is in fact a unitary test — whether the "sham" be the entity or the transaction — under which the absence of a non-tax business purpose is fatal.[1123]

Accordingly, the D.C. Circuit concluded that the parties had no intention of entering into a partnership.[1124] The D.C. Circuit concluded that the partnership had no business activity on the grounds that: (i) the purchase and sale of the PPNs did not constitute business activities,[1125] and (ii) the taxpayer structured the transaction so that it could yield no profit or loss on the purchase and sale of the PPNs.[1126]

In contrast, in *Salina P'ship v. Commissioner*, the Tax Court held that the taxpayer's investment in a partnership had economic substance and business purposes.[1127] The partnership was formed with the principal business purpose of investing in long and short positions in fixed-income securities, using hedging and leveraging strategies.[1128] The Tax Court examined the taxpayer's business purpose by reviewing *all* of the partnership's activities (around 2,000 trades over a two-year period) and rejected the IRS's argument that the business purpose should be evaluated based on two particular trades which triggered the favorable tax consequences.[1129] The bifurcation/integration issue is discussed in greater detail below.

In *Andantech, LLC v. Commissioner*, the Tax Court discussed the business purpose/economic substance of a partnership with a foreign entity.[1130] Relying on *Commissioner v. Tower* and *ASA Investerings*, the Tax Court concluded that:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses (citation omitted). When the existence of an alleged partnership is challenged, the question arises whether the partners truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.[1131]

The Tax Court observed that for this purpose, "'[b]usiness activity' excludes activity whose sole purpose is tax avoidance."[1132] Accordingly, the Tax Court held that "[t]he record reveals that Andantech-Foreign was not created for the purpose

[1115] 201 F.3d 505 (D.C. Cir. 2000).

[1116] *Id.* at 512 (citing *Moline Props.*, 319 U.S. at 438–39).

[1117] *Id.*

[1118] *Id.* at 513–14.

[1119] *ASA Investerings P'ship v. Commissioner*, T.C. Memo 1998-305. *See also TIFD III Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004).

[1120] 74 T.C. 476 (1980).

[1121] 74 T.C. at 494.

[1122] *Cf. TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004).

[1123] *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512.

[1124] *Id.* at 513–514.

[1125] *Id.* at 513 ("Although [ASA's] investment in LIBOR Notes might have had a business purpose, the prior three-week investment in and subsequent sale of PPNs was … a business activity merely conducted for tax purposes."). *See also Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003) ("We then approved the Tax Court's approach to the Supreme Court's test set out in Culbertson which determined that the existence of a partnership would depend on whether, 'considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.' … . We stated that 'the Tax Court was, we think, sound in its basic inquiry, trying to decide whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance.' … . Finally, we affirmed the Tax Court's conclusion that AlliedSignal and ABN did not have 'the requisite intent to join together for the purpose of carrying on a partnership.'").

[1126] *Id.* at n. 5 ("The PPNs cost $850 million. When an expert was later engaged by [the taxpayer] to evaluate the partnership's gains and losses, [the taxpayer] asked that he assign to the LIBOR Notes a value which, together with the cash, would bring the total value of the PPNs to $850 million. [The taxpayer] evidently did not believe that the initial investment in PPNs increased the return from the transactions in the aggregate.").

[1127] T.C. Memo 2000-352.

[1128] *Id.*

[1129] *Id.*

[1130] T.C. Memo 2002-97.

[1131] *Id.* at 91 (citing *Commissioner v. Tower*, 327 U.S. at 286 and *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000)).

[1132] *Id.* at 91 (citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512).

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of carrying on a trade or business but rather to strip the income from the transaction and avoid United States taxation. Consequently, we will not recognize Andantech-Foreign as a partnership for Federal income tax purposes."[1133]

In *TIFD III-E Inc. v. United States*, the Government relied on *ASA Investerings* and argued that even if the transaction *as a whole* had economic substance, for tax purposes the Dutch banks were not partners in a partnership but rather creditors.[1134] The court focused on "whether there was any economic reality to the choice of the partnership form," and concluded that:

> the transaction that created Castle Harbour was not a sham. In other words, I concluded there was valid business purpose and economic reality in the arrangement by which the GECC entities and the Dutch Banks came together to form Castle Harbour, *i.e.*, there was economic substance in not only the actions, but also the formation, of the partnership.[1135]

In conclusion, the decision to form a partnership, noted the court, may be economically insubstantial, even though the partnership undertakes a legitimate business. The court found that there was economic substance in not only the actions, but also the formation, of the partnership.[1136]

The Second Circuit reversed the district court's decision, and concluded that the district court erred in relying on the sham transaction doctrine rather than the totality-of-the-circumstances test set forth by the Supreme Court in *Commissioner v. Culbertson*.[1137] Further, the Second Circuit elaborated that the district court erred in conducting the debt/equity analysis when it accepted "at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities."

For a full discussion of *TIFD III-E*, including the procedural history, see VIII.E., below.

In *Markell Co. v. Commissioner*,[1138] the court found that scrupulous adherence to the formal requirements to make the entity look like a partnership was insufficient to overcome the absence of any objective indication of mutual combination for the present conduct of an ongoing enterprise other than tax avoidance. The court's analysis focused on the *Luna* factors discussed above, and also cited to *TIFD III-E*. The partnership engaged in only one transaction, which the court found fell short of the "course of activities" required for a business. For a full discussion of *Markell Co.*, see VIII.L. below.

In some cases, the partnership itself is recognized as a valid entity but a particular party's status as partner is invalidated. For example, a contribution of assets with built-in losses to a partnership in exchange for a partnership interest was recast as a disguised sale where the contributor immediately sold its partnership interest and the court found the contributor never viewed the transaction as anything other than a sale of depreciated assets. The court found that the partnership should be recognized as an entity because it was organized with the legitimate business purpose of earning a return on devalued Russian debt. However, the court found that the alleged partner's participation in the partnership was motivated purely by a desire to get cash as soon as possible and that there was no other reason to contribute assets to the partnership. In fact, the court noted, all of the testimony suggested that the alleged partner viewed the transaction as nothing more than a sale. Therefore, the court concluded, the party that contributed the depreciated assets to the partnership was never a bona fide partner. The economic substance of what it did, if the interim step of becoming a partner is ignored, was to sell its securities to the party that bought its partnership interest.[1139]

D. Trusts

"Whether a trust lacks economic substance for tax purposes is a factual question to be decided on the basis of the facts before the Court."[1140] In *Markosian v. Commissioner*,[1141] the Tax Court held that:

> [A] taxpayer has the legal right to minimize his taxes or avoid them totally by any means which the law permits. (citation omitted) However, this right does not bestow upon the taxpayer the right to structure a paper entity to avoid tax when that entity does not stand on the solid foundation of economic reality. When the form of the transaction has not, in fact, altered any cognizable economic relationships, we will look through that form and apply the tax law according to the substance of the transaction.[1142]

In *Furman v. Commissioner*,[1143] the Tax Court observed that for purposes of recognizing the validity of a trust for tax purposes, "[a] finding of validity under State law, however, does not mean that the trust will necessarily be recognized for tax purposes."[1144]

In *Gouveia v. Commissioner*, the Tax Court summarized the factors that courts have considered in determining whether a trust is a valid entity for tax purposes:[1145]

> (1) Whether the taxpayer's relationship, as grantor, to property purportedly transferred into trust differed materially before and after the trust's formation; (2) Whether the trust had a bona fide independent

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[1133] *Id.* at 95 (citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512).

[1134] 342 F. Supp.2d 94 (D. Conn. 2004).

[1135] *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004).

[1136] *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004).

[1137] 337 U.S. 733, 742 (1949) ("whether, considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.").

[1138] T.C. Memo 2014-86.

[1139] *Russian Recovery Fund Ltd. v. United States*, 122 Fed. Cl. 600 (2015), aff'd, No. 16-01718 (Fed. Cir. Mar. 14, 2017).

[1140] *Norton v. Commissioner*, T.C. Memo 2002-137.

[1141] 73 T.C. 1235 (1981).

[1142] 73 T.C. 1235, 1241 (1981). The Ninth Circuit affirmed the application of the *Markosian* factors in *Sparkman v. Commissioner*, 509 F.3d 1149 (9th Cir. 2007), to determine whether a private trust organization is a legitimate business enterprise.

[1143] 45 T.C. 360, 364 (1966), aff'd per curiam, 381 F.2d 22 (5th Cir. 1967).

[1144] 45 T.C. at 364. *See also Zmuda v. Commissioner*, 79 T.C. 714, 720 (1982) ("[the substance-over-form] rule applies regardless of whether the entity has a separate existence recognized under State law (citation omitted) and whether, in form, it is a trust, a common law business trust, or some other form of jural entity."); *Gouveia v. Commissioner*, T.C. Memo 2004-256, at 44.

[1145] T.C. Memo 2004-256.

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trustee; (3) Whether an economic interest in the trust passed to trust beneficiaries other than the grantor; and (4) Whether the taxpayer honored restrictions imposed by the trust or by the law of trusts.[1146]

E. The Importance of Control

Many taxpayers have sought to obtain advantageous tax consequences through the formation of controlled entities.[1147] In such cases, courts have observed that a taxpayer's substantive control over the entity would generally result in a determination that the entity has no real substance.[1148] In *Derr v. Commissioner*,[1149] the Tax Court discussed the existence of control as an indication for non-economic substance and observed that "Although 'mere control alone' will not allow the form of a transaction to be disregarded, it indicates that the transaction was not made at arm's length."[1150] In general control over an entity may indicate that the taxpayer is actually dealing with himself rather than with a real entity.[1151] The Tax Court relied on an earlier case, *Decon Corp. v. Commissioner*,[1152] where it previously held that:

> [the taxpayer] exercised a great deal of control over the operations of Decon by virtue of his ability to select two of the three directors of the corporation and direct the trustee how to vote the common stock … Mere control alone, however, will not render the transaction a sham … But such control may indicate the transfer was not made at arm's length. [The taxpayer] was effectively dealing with himself in transferring the escrow position to Decon, and this lack of arm's-length dealing gives us cause to scrutinize the transaction in applying the substance versus form test.[1153]

[1146] *Id. See also Markosian v. Commissioner*, 73 T.C. at 1241; *Vlach v. Commissioner*, T.C. Memo 2013-116; *Norton v. Commissioner*, T.C. Memo 2002-137; *Castro v. Commissioner*, T.C. Memo 2001-115; *Buckmaster v. Commissioner*, T.C. Memo 1997-236; *Hanson v. Commissioner*, T.C. Memo 1981-675, aff'd per curiam, 696 F.2d 1232 (9th Cir. 1983). All cases setting forth the same list of requirements.

[1147] *Higgins v. Smith*, 308 U.S. at 476–77.

[1148] *Palmer v. Commissioner*, 44 T.C. 92 (1965). *Cf. Sun Props., Inc. v. United States*, 220 F.2d 171, 175 (5th Cir. 1955) ("As for the circumstance … that taxpayer is a 'thin corporation,' we do not think this is any ground to infer that this transaction was a contribution to capital.").

[1149] 77 T.C. 708 (1981).

[1150] *Id.* at 723.

[1151] *Id.*

[1152] *Decon Corp. v. Commissioner*, 65 T.C. 829 (1976).

[1153] *Id.* at 839.

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VII. Integration or Bifurcation of a Series of Transactions

A. Introduction

According to a standard description of the economic substance doctrine, the issue before the court is "whether the *transaction* that generated the claimed deductions … had economic substance."[1154] What constitutes a "transaction" for this purpose has been controversial, and courts have differed on whether, in demonstrating the presence or absence of business purpose and/or economic substance, the IRS or the taxpayer can (1) "bifurcate" or "disaggregate" what might be regarded as a single "transaction" from a commercial or legal standpoint into separate "steps"; or (2) "integrate" or "aggregate" a series of two or more commercially or legally distinct "transactions."

In some cases, the courts have followed the "integration" approach, considering the substance of all of the activities related to a tax benefit in determining whether to allow the benefit.[1155] In other cases, courts have adopted a "bifurcation" approach, disassembling a single transaction into separate parts or "steps" in order to focus on the portion of the transaction that results in the tax benefits at issue.[1156] For example, courts have bifurcated transactions to disallow tax benefits where the taxpayer combined in a purported single transaction (1) activities with non-tax objectives with (2) unrelated activities with only tax-avoidance motives.[1157] Integration and bifurcation are obviously not one-way streets; either approach may work for or against the taxpayer, depending on the facts.

Unlike the distinction between the "conjunctive" and "conjunctive" tests for applying the economic substance doctrine, where it can be said with some justification that a particular circuit has favored one test over another, the likelihood that the "aggregation" or "disaggregation" approach will apply in a particular case is more closely tied to the nature of the transaction than to the jurisdiction. For example, bifurcation has worked in the government's favor in some "foreign tax generator" cases,[1158] but in some other cases involving partnership redemptions to "step up" the basis of subsequently transferred assets, the courts have declined to permit the "slicing and dicing" of an integrated transaction by the IRS in order to "challenge only an isolated component of the overall transaction."[1159]

The IRS position concerning the "integration" approach, as set forth in Notice 98-5,[1160] is that if a taxpayer enters into a series of transactions, some of which could generate a non-tax profit, the question whether these transactions should be integrated with transactions that generate a tax-reducing non-tax loss in order to validate the entire transaction must be answered on a case-by-case basis:

> If necessary to effectuate the purposes of the regulations, a series of related transactions or investments may be treated as a single arrangement, or portions of a single transaction or investment may be treated as separate arrangements. The proper grouping of transactions and investments into arrangements will depend on all relevant facts and circumstances.[1161]

Concerning the "bifurcation" approach, the IRS indicated in a 2005 Coordinated Issue Paper (without citing any authority) that a transaction can be bifurcated under the step transaction doctrine.[1162]

Section 7701(o)(5)(D), which defines "transaction" to include "a series of transactions," attempts but likely does not succeed in resolving most such issues. On its face, this definition seems to empower the IRS or the taxpayer to integrate otherwise distinct transactions to determine whether, taking them together, they demonstrate the presence or absence of a substantial nontax purpose and/or a meaningful change in the taxpayer's economic position. Section 7701(o)(5)(D) seemingly has nothing to say about whether a single transaction may be bifurcated, but the legislative history indicates otherwise, explaining that §7701(o)(5)(D):

> 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.[1163]

On October 9, 2014, in Notice 2014-58,[1164] the IRS issued guidance on the meaning of "transaction" for purposes of applying §7701(o). The Notice states that "[f]acts and circumstances determine whether a plan's steps are aggregated or dis-

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[1154] *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282, 284 (2d Cir. 2003).

[1155] *See Salina P'ship v. Commissioner*, T.C. Memo 2000-352.

[1156] *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990) ("The only transactions at issue in this case are the purported sales by the Communications Group to the joint venture. These sales cannot be legitimized merely because they were on the periphery of some legitimate transactions"); *Karr v. Commissioner*, 924 F.2d 1018 (11th Cir. 1991) ("The activities of the other entities involved in exploiting the Koppelman process, however, cannot necessarily be attributed to POGA [the taxpayer].").

[1157] *ACM P'ship v. Commissioner*, 157 F.3d 231, 256 n. 48 (3d Cir. 1998) ("While ACM purported to combine the tax avoidance objectives of Merrill Lynch's initial May 1989 proposal with the non-tax debt acquisition objectives incorporated into subsequent proposals, … the non-tax motivations behind ACM's debt purchase do not alter the fact that the contingent installment sale was motivated only by tax avoidance purposes."), cited by both the Senate Report (2004) and Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) for this view. *See also Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004); *CNT Investors, LLC v. Commissioner*, 144 T.C. No. 11 (2015).

[1158] *See, e.g., Bank of N.Y. Mellon v. Commissioner*, 140 T.C. 15 (2013).

[1159] *Shell Petroleum Inc. v. United States*, 102 AFTR.2d 2008-5085 (S.D. Tex. 2008). *See also Countryside LP v. Commissioner*, T.C. Memo 2008-3.

[1160] 1998-1 C.B. 334.

[1161] *Id.*

[1162] *See Coordinated Issue Paper Addresses Partnership Straddle Tax Shelters*, 2005 TNT 91-27 (May 9, 2005) ("[E]ven if the step transaction doctrine does not apply to an entire transaction, it may allow the Government to collapse a portion of a transaction, which may be sufficient to prevent the intended tax avoidance result."). Effective Jan. 21, 2014, all current Coordinated Issue Papers are decoordinated, and any guidance or tools relevant to addressing an issue or transaction that were provided in a Coordinated Issue Paper will be made available through LB&I directives or other guidance. The decoordination of any coordinated issue has no effect on whether the issue will continue to be pursued by LB&I in a taxpayer examination or on the IRS's views regarding any transaction, including listed transactions. LB&I-04-0114-002 (Jan. 21, 2014).

[1163] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, JCX-18-10 (Mar. 21, 2010) at 153 (JCT Report (2010)).

[1164] 2014-44 I.R.B. 746.

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aggregated when defining a transaction." For example, the IRS will apply an "aggregation approach" to "a series of interconnected steps with a common objective," but will apply a "disaggregation approach" to a "tax-motivated step" that is "not necessary to achieve a non-tax objective" of a series of steps. The Notice gives the following example of when the disaggregation approach would apply:

> For example, if transfers of multiple assets and liabilities occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may take many forms, including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective.

The significance of Notice 2014-58 for the integration/bifurcation issue is unclear. Given the silence of §7701(o)(5)(D) on disaggregation and the legislative history's endorsement of the "present-day ability of the courts" to disaggregate, the courts may in many cases decline to isolate a "tax-motivated step" simply because it was not "necessary to achieve a nontax objective."

B. Identifying the Transaction that Gave Rise to the Benefits

1. Integration

In *Sheldon v. Commissioner*,[1165] the majority adopted an integration approach and accordingly examined the taxpayer's potential profit from all of the preliminary and intermediate repossessions as a single transaction. Judge Wells, in a minority opinion, however, disagreed with the majority's integration approach, and argued that the court should examine each separate repo for economic substance.[1166] Pursuant to Judge Wells's approach, some repos, which generated more than a minimal profit, should have been respected as having economic substance.[1167] Thus, under the majority's view, a series of transactions should be integrated for purposes of the profit motive examination, while the minority view is that each transaction should be tested separately, and, consequently, some transactions could satisfy the economic substance standard while others could not.[1168]

Similarly, in *Lerman v. Commissioner*, the court acknowledged that:

> [i]f a transaction is devoid of economic substance — as the transactions involved here undeniably were — it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot be the basis for a deductible 'loss.'[1169]

In *Seykota v. Commissioner*,[1170] the taxpayer entered into four different types of transactions: (i) "Arbitrage and Carry"; (ii) T-Bond option markets; (iii) T-Bill option markets; and (iv) Stock forward markets.[1171] The Tax Court held that the latter three programs were fictitious trades (i.e., factual shams) while only the first one actually took place. The Tax Court further held that each of the four programs lacked economic substance.[1172] In conducting the subjective business purpose/profit motive analysis, the Tax Court stated that:

> We must also consider whether petitioners entered into the gold carry and Merit market transactions with a primary profit motive. Since, in the FTI program, petitioners' participation involved both gold carry and Merit transactions, and because these transactions were interdependent, it is not possible to decide whether petitioners had a profit motive for the gold carry transactions separate from their motives for the Merit market transactions. Thus, we apply the business purpose prong of the "sham in substance" analysis to the FTI and Merit transactions in combination, recognizing the interrelated nature of these programs as components of an overall scheme to generate tax benefits.[1173]

However, integration may work to the taxpayer's benefit. In *Salina P'ship LP v. Commissioner*,[1174] the Tax Court held that the taxpayer's investment in a partnership had economic substance and business purposes. The Salina partnership was formed as a limited partnership on December 16, 1992, by two limited liability companies, for the purpose of employing an investment strategy titled "STAMPS." On December 17, 1992, Salina purchased $140 million in Treasury notes and entered into a short sale of $350 million in Treasury bills. On December 28, 1992, Florida Power and Light (FPL) purchased a 98% interest in Salina for $76.5 million. Two days later, Salina liquidated its investment by closing its short position and selling its long position. Salina reported a capital gain of $344 million during its short tax year from December 28–31, 1992, of which $337 million was allocated to FPL. From January 1993 through November 1994, the partnership entered into approximately 2,000 actual trades on which it earned a significant profit of approximately 10% (during 1993). The partnership was liquidated in November 1994.[1175]

The IRS asked the Tax Court to segregate the economic substance analysis of the investment in the partnership into two parts: (1) the investment during the period of December 28 through 31, 1992 (i.e., the four days during which the two transactions that generated the tax benefits were entered into), and (2) the investment during the period of January 1, 1993 through November 1994.[1176] The IRS conceded that the taxpayer had a valid business purpose during the latter period, but argued that the transaction as a whole was structured solely to provide the

[1165] *Sheldon v. Commissioner*, 94 T.C. 738 (1990).
[1166] *Id.* at 774.
[1167] *Id.*
[1168] *Id.*
[1169] 939 F.2d at 45.
[1170] *Id.*
[1171] T.C. Memo 1991-234.
[1172] *Id.*
[1173] *Id.* at 115–16.
[1174] T.C. Memo 2000-352.
[1175] *Id.*
[1176] *Id.*

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taxpayer with a tax benefit. Accordingly, the IRS asked the Tax Court to hold that, for the period from December 28 through 31, 1992, the partnership should be disregarded for tax purposes as a sham in substance, and the tax benefits from these two transactions should be denied.[1177]

The Tax Court disagreed with the IRS and stated that "the economic substance of a transaction turns on a review of the *entire* transaction."[1178] Accordingly, the Tax Court judged the taxpayer's motives by looking at the entirety of the partnership's activities, which comprised 2,000 actual trades over a two-year period, and rejected the IRS's argument that such motives should be evaluated based on two particular trades, which triggered favorable tax consequences.[1179]

2. Bifurcation

In *ACM P'ship v. Commissioner*, the Third Circuit was inconsistent with respect to which approach, integration or bifurcation, should be applied.[1180] The Third Circuit initially observed that all of the steps of a transaction should be considered in determining whether a transaction has economic substance.[1181] As the Third Circuit Court observed, the transaction should be viewed "as a whole, and each step, from the commencement … to the consummation … is relevant."[1182] In analyzing the taxpayer's potential for profit, however, the Tax Court and the Third Circuit focused on the purchase and sale of the Citicorp Notes, i.e., the events that directly lead to the tax benefits at issue.[1183] The court refused to take into account the profits resulting from the investment of the $140 million of cash received as part of the consideration for the Citicorp Notes.[1184] In addition, the court refused (and the Third circuit affirmed) to take into account the profit that the taxpayer earned from the portion of the notes that were sold later in 1991 and not exchanged for the LIBOR notes.[1185]

Comment: Citing *ACM P'ship v. Commissioner*, the JCT Report (2005) observed that "[i]n making [the business purpose] determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction."[1186] Thus, the JCT implied that bifurcation applies only to the business purpose prong and not to the entire economic substance determination.

In *Long Term Capital Holdings v. United States*, the district court elaborated that:

> Long Term cannot avoid the requirements of economic substance simply by coupling a routine economic transaction generating substantial profits and with no inherent tax benefits to a unique transaction that otherwise has no hope of turning a profit.[1187]

In *Coltec Indus. v. United States*,[1188] the Federal Circuit considered a transaction in which a new corporation (Garrison) was formed with the purported business purpose of acting as a litigation management company. In connection with the formation of Garrison, liabilities were assumed by Garrison. The court stated that the taxpayer's purported business purpose "focuses on the wrong transaction — the creation of Garrison as a separate subsidiary to manage asbestos liabilities. … [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale."[1189] As a result, the court focused on whether there was a business purpose for Garrison's assumption of liabilities, and found there to be none.

C. Allowing the Benefits for a Particular Portion

A related question is whether with respect to an entire transaction, a court can allow certain tax benefits while disallowing others.[1190] This issue frequently arises with respect to claimed deductions under §163 (i.e., interest paid on a debt instrument).[1191] In particular, taxpayers have attempted to argue that if an enforceable debt instrument exists between the parties, even if the debt is a part of a larger transaction, and the larger transaction is determined to be lacking economic substance, the interest on the debt should be deductible.[1192] Under this approach, "in some circumstances, a sham transaction may

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[1177] *Id.*

[1178] *Id.* at 36 (citing *Kirchman v. Commissioner*, 862 F.2d at 1493–94 ("Petitioners are correct in asserting that the tax court was obligated to analyze the entire transaction.")); *Winn Dixie v. Commissioner*, 113 T.C. at 280 ("We will begin with an examination of the economic substance of petitioner's 1993 COLI plan. In doing so, we focus on the COLI transaction in its entirety rather than any single step.").

[1179] *Id.*

[1180] 157 F.3d 231 (3d Cir. 1998).

[1181] *Id.*

[1182] 157 F.3d at 247 (citing *Weller v. Commissioner*, 270 F.2d at 297).

[1183] 157 F.3d at 260.

[1184] This approach was affirmed by the Third Circuit. *See* 157 F.3d at 260 ("Tax Court properly analyzed the profitability of the transactions whose economic substance is at issue, namely the contingent installment exchange of Citicorp notes for LIBOR notes which gave rise to the disputed tax consequences. Any profits arising from ACM's investment of $140 million in cash into Colgate debt issues did not result from the contingent installment exchange whose economic substance is in issue.").

[1185] 157 F.3d at 260 n. 57 ("For similar reasons, we reject ACM's contention … that the Tax Court erroneously excluded from its profitability analysis the gains derived from the portion of the Citicorp notes which ACM held until October 1991 instead of exchanging them for LIBOR notes. These notes, like the $140 million cash proceeds of the Citicorp note disposition, were not involved in the exchange for contingent-payment notes. Thus, any profits generated thereby may not be considered to be profits arising from the contingent installment sale.").

[1186] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (Jan. 27, 2005) (citing *ACM P'ship v. Commissioner*, 157 F.3d at 256 n. 48).

[1187] 330 F. Supp.2d 122 (D. Conn. 2004). *See also Bank of N.Y. Mellon Corp. v. Commissioner*, 140 T.C. 15 (2013) (finding loan not "commercially linked" to trust structure used in transaction and ignoring profit potential of loan, citing *Long-Term Capital Holdings*).

[1188] 454 F.3d 1340 (Fed. Cir. 2006).

[1189] *Id.* at 1358.

[1190] *ACM P'ship v. Commissioner*, 157 F.3d 231, 260–63 (3d Cir. 1998).

[1191] *Lee v. Commissioner*, 155 F.3d at 586–87 (the taxpayers entered into a transactions held by the court to be sham transactions. The taxpayers argued that interest arising from sham transactions may still be deducted so long as the debt itself has economic substance. The Second Circuit declined to accept the taxpayers' argument and held that in order for an interest deduction to be valid under §163, the underlying transaction must have economic substance); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 92; *Rose v. Commissioner*, 88 T.C. at 423, *aff'd*, 868 F.2d 851 (6th Cir. 1989) (In both cases the taxpayers issued recourse notes to the promoters of the plans. The courts held that the transactions lacked economic substance. Nevertheless, both courts allowed the deduction of interest actually paid on the recourse notes.) *See also Seykota v. Commissioner*, T.C. Memo 1991-234, *on reh'g*, 1991-541.

[1192] *Id. See also United States v. Wexler*, 31 F.3d at 125.

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have separable, economically substantive, elements that give rise to deductible interest obligations."[1193]

By contrast, in *Winn Dixie Stores, Inc. v. Commissioner,* the Tax Court has indicated that:

> The fact that an enforceable debt exists between the borrower and the lender is not dispositive of whether interest arising from that debt is deductible under §163. Rather the overall transaction, of which the debt is a part, must have economic substance before interest can be deducted.[1194]

Similarly, in *UPS of Am. v. Commissioner*, in accordance with the determination that the restructuring was a sham transaction, the Tax Court held that UPS was not entitled to deduct the amounts retained by NUF as ordinary and necessary expenses under §162 because "expenses incurred in furtherance of a sham transaction are not deductible."[1195]

Most courts rely on *Rice's Toyota World Inc. v. Commissioner* for the view that some tax benefits ought to be allowed even if others are disallowed under the economic substance doctrine.[1196] In *Rice's Toyota World*, the Tax Court disregarded the transaction in its entirety, effectively determining that the recourse debt was a sham because the underlying sale-leaseback transaction was a sham.[1197]

On appeal, the Fourth Circuit examined whether *any part* of the overall transaction was economically substantive.[1198] Reversing the determination by the Tax Court that the interest on the recourse debt undertaken to finance the sale-leaseback arrangement (which was held to be a sham transaction) was not deductible, the Fourth Circuit separated between the capital depreciation and the interest on the nonrecourse notes and the interest paid on the recourse note.[1199]

The Fourth Circuit explained that the Internal Revenue Code does not limit deductibility of interest depending upon the item purchased by the taxpayer.[1200] The determination that the sale-leaseback transaction was a sham did not support, in the Fourth Circuit's view, the Tax Court's conclusion that the recourse loan was not genuine debt; rather, the Fourth Circuit observed that the recourse loan had created a genuine legal obligation on the part of the taxpayer, and possessed sufficient economic substance to justify the taxpayer's interest deductions.[1201]

Put broadly, the Fourth Circuit asserted that the taxpayer "purchas[ed] … something of economic value," and characterized "the 'cash payment' on the recourse note as a 'fee' for purchase of expected tax benefits."[1202] The Fourth Circuit concluded that "a sham transaction *may* contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded."[1203]

In *Seykota v. Commissioner*, the Tax Court initially held that the transactions entered into by the taxpayer lacked economic substance; however, the Tax Court allowed deductions for interest payments paid by the taxpayer on a loan taken to enter into the transactions.[1204] The Tax Court observed that:

> There is no requirement that the interest be incurred in a trade or business, or in an activity engaged in primarily for profit. Thus, a deduction for interest paid will be allowed when it is paid on a valid, existing indebtedness even when the transaction of which the debt is a component lacks economic substance.[1205]

The IRS, however, submitted a motion for reconsideration, and asked the Tax Court to reconsider the allowance of the interest deduction.[1206] The Tax Court accepted the IRS position and disallowed the interest deductions, explaining that:

> The function of the interest payments in this case distinguishes it from [*Rice's Toyota* and *Rose*]. In those cases the investors paid interest and they deducted it. The lenders retained that interest and that was the end of the matter. The fact that the loan proceeds were used to invest in transactions that lacked economic substance did not affect the deductibility of the interest under section 163. Here, however, the Arbitrage and Carry investors paid interest and deducted it, but that was not the end of the matter. Unlike the taxpayers in [*Rice's Toyota* and *Rose*] the investors here recovered their interest in the form of gains upon their subsequent sale of the gold they purchased. According to design, their interest payments merely functioned as the first part of a scheme for the mismatching of deductions and income. Here, because the Arbitrage and Carry program lacked economic substance, the investors' gains — that is, their income from the program — are disregarded for tax purposes, as are their losses. In such a situation, it would be incorrect to permit the investors to claim deductions for interest they paid as part of their costs of carrying the gold, while failing to tax them on the offsetting income they received on the later sale of the gold.[1207]

Thus, under the Tax Court's reasoning in the rehearing, if the debt is incurred solely for purposes of funding the sham transaction, and the interest payments are not used for any other purpose, interest may be disallowed under §163.[1208]

[1193] 31 F.3d at 125.

[1194] *Winn Dixie Stores, Inc. v. Commissioner*, 113 T.C. at 279–80. *See also Lee v. Commissioner*, 155 F.3d at 587 (interpreting *Jacobson* as follows: "*Jacobson* stands for the proposition that, in order for a deduction to be accepted, not only must the underlying transaction have economic substance, but the debt must be real as well."); *Sheldon v. Commissioner*, 94 T.C. at 762; *Brown v. Commissioner*, 85 T.C. 968 (1985), aff'd sub nom. *Sochin v. Commissioner*, 843 F.2d 351 (9th Cir. 1988).

[1195] T.C. Memo 1999-268 at 139.

[1196] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). *See also Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d at 1548–49; *James v. Commissioner*, 899 F.2d at 910; *Rose v. Commissioner*, 88 T.C. at 408–409.

[1197] 81 T.C. 184 (1983).

[1198] *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[1199] *Id.*

[1200] *Id.*

[1201] *Id.*

[1202] *Id.*

[1203] *Id.* The court held that the installment payments on the recourse notes were "genuine obligations" and that the "interest due upon their payment was equally an obligation of economic substance."

[1204] T.C. Memo 1991-234, at 131 (citing *Rose v. Commissioner*, 88 T.C. at 423).

[1205] *Id.*

[1206] T.C. Memo 1991-541.

[1207] *Id.* at 8–10.

[1208] *Id.*

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In *ACM P'ship v. Commissioner*, the Third Circuit clarified the circumstances under which certain benefits would be allowed even though the entire transaction lacks economic substance.[1209] In this case, the taxpayer relied on *Rice's Toyota* for the view that it was entitled to deduct the portion of its loss that is attributed to the holding on the LIBOR notes and not attributable to the installment sale (which was held to be lacking economic substance).[1210]

The Third Circuit in *ACM P'ship* compared *Rice's Toyota* with *Wexler*.[1211] In *Rice's Toyota*, according to the Third Circuit, the recourse note "had sufficient economic substance to give rise to an interest deduction." In *Wexler*, on the other hand, as the Third Circuit indicated, "the claimed deductions … did not constitute such a 'separable, economically substantive'" item that was distinct from the sham aspects of the transaction, but rather constituted "the principal tax benefits of the transaction."[1212]

Accordingly, the Third Circuit in *ACM P'ship* concluded that:

> The actual economic losses associated with ACM's ownership of the LIBOR notes are both economically substantive and separable from the sham aspects of the underlying transaction. Far from being the "centerpiece" or "principal tax benefit" of the underlying transaction, the approximately $6 million in economic losses which ACM seeks to deduct were separate and distinct from the $87 million tax loss that did not correspond to any actual economic loss but rather was an artifact of the ratable basis recovery rule which inflated the tax basis of the LIBOR notes well above their actual cost basis. In contrast to its economically inconsequential acquisition and disposition of the Citicorp notes, ACM's ownership of the BOT LIBOR notes, which extended over two years under circumstances that posed an actual risk to the principal value of that investment, had an economically substantive impact on ACM's net financial position. In these circumstances, recognition of both the income and the loss aspects of ACM's investment in those notes will result in consistent tax treatment which accurately reflects the economic reality of ACM's transactions and will allow deduction only of a "separable, economically substantive" item that is not the "centerpiece" of the transactions, consistently with our holding in Wexler.[1213]

Comment: The key element is, therefore, the separateness of the sham transaction and the "real" transaction portions. This analysis has particularly been applied in cases where indebtedness was involved as a part of a larger transaction.

In *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, the Ninth Circuit also relied on *Rice's Toyota*, applied the same analysis and held that:

> *Rice's Toyota* is relevant to the case at issue because the court below basically relied on the sham nature of the underlying Farila transaction in concluding that the Anglo Dutch loans were shams. We read *Rice's Toyota* to hold that, as a factual matter, indebtedness undertaken to fund a sham transaction is not *necessarily* a sham. [footnote omitted] Consequently, a transaction involving use of loans to fund a tax avoidance scheme cannot be disregarded in its entirety unless the loans themselves have been separately examined and found to be shams.[1214]

In *James v. Commissioner*, the IRS actually followed the bifurcation approach, disallowed several tax benefits associated with a sham transaction, but allowed certain tax benefits on the grounds that they were separable.[1215] The Tax Court upheld the IRS's bifurcation approach.[1216] The taxpayer argued that "the Tax Court's opinion was improperly based on a legally unprecedented, novel, and unique 'bifurcated sham transaction theory.'"[1217]

The reasons for the taxpayer's assertion that the bifurcation approach is inappropriate was that: "[i]f the Commissioner treats a transaction as a sham … he cannot allow certain deductions or credits related thereto and disallow others — a transaction either is a sham or it is not."[1218] Thus, the taxpayer argued that if the IRS recognizes the validity of some elements of the larger transaction, it should validate the entire transaction. Thus, the taxpayer asked the court to conclude that "by allowing the joint ventures to deduct these expenses, the Commissioner has effectively conceded that the subject transactions have economic substance and business purpose."[1219]

The Ninth Circuit disagreed with the taxpayer's interpretation and affirmed the Tax Court's decision.[1220] Specifically, relying on *Rice's Toyota* and *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, the Ninth Circuit observed that:

> The "bifurcated transaction" approach does have a basis in established law, however. As the Fourth Circuit held in *Rice's Toyota*, "a sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded." 752 F.2d at 96 (allowing interest deductions on recourse debt even though underlying transaction was a sham); *see also Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 & n. 6 (9th Cir. 1987). We agree that within the framework of a sham transaction a taxpayer may incur bona fide obligations which should be recognized for tax purposes.[1221]

[1209] 157 F.3d at 261, citing *Wexler*, 31 F.3d at 125.
[1210] *Id.*
[1211] *Id.*
[1212] 157 F.3d at 261, citing *Wexler*, 31 F.3d at 125. The Third Circuit in *Wexler* concluded that "allowance of the deduction would have permitted the taxpayer to reap the entire benefit of its sham transaction" by allowing him the deduction "that was the centerpiece of the whole scheme."
[1213] *Id.*
[1214] 820 F.2d at 1548–49.
[1215] 899 F.2d at 910.
[1216] 87 T.C. 905 (1986).
[1217] 899 F.2d at 910.
[1218] *Id.*
[1219] *Id.*
[1220] 899 F.2d at 910.
[1221] *Id.*

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The Tax Court has followed the same principle and indicated in *Friendship Dairies, Inc. v. Commissioner* that:

> Because petitioner's transaction lacked economic substance, petitioner's deductions for depreciation and interest on its long-term note, as well as its claimed investment tax credit, must be disallowed. *Rice's Toyota World, Inc. v. Commissioner, supra.* Although petitioner is entitled to deduct the interest on its short-term notes.[1222]

In one case, the court applied the bifurcation approach in the opposite direction (i.e., determined that the transaction as a whole had substance, but disallowed the interest on the related debt). In *Lee v. Commissioner*, the court, in discussing *Jacobson v. Commissioner*,[1223] held that:

> Having found that there was economic substance in the overall deal, and hence that the taxpayer's interest deductions were presumptively valid, the court went on to consider whether one of several debts the taxpayer had incurred was itself real or sham. For, obviously, even a finding that an underlying transaction has economic substance cannot be sufficient to sustain deductions for interest expenses if the debt itself is nothing but a sham.[1224]

Thus, the court concluded that even if the whole transaction has economic substance, it can still disregard a loan that was taken in connection with the transaction, if such a loan does not have substance.[1225]

[1222] 90 T.C. at 1067–68 (citing *Rice's Toyota World* and *Rose v. Commissioner*, 88 T.C. at 423).

[1223] 915 F.2d at 839.

[1224] 155 F.3d at 587.

[1225] *Id.*

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VIII. Pre-Codification Economic Substance Cases by Topic

Most of the cases discussed in this Chapter VIII are also discussed elsewhere in the Portfolio. The cases are detailed here for the benefit of the reader seeking greater detail. The cases are grouped by major topic. For the evolution and historical perspective on the common law doctrines in general and the economic substance doctrine in particular, as reflected in these and other cases, readers should also consult Chapter II, above.

A. Transactions Involving Transitory Holding of American Depository Receipts

1. Overview

IES Indus., Inc. v. United States[1226] and *Compaq Computer Corp. v. Commissioner*[1227] involved the purchase of American Depository Receipts (ADRs) "cum dividend" and their virtually immediate sale "ex dividend" (a purchase or sale of an ADR share with the purchaser entitled to a declared dividend (settlement taking place on or before the record date of the dividend).[1228] The Tax Court in *Compaq Computer Corp.* and the U.S. district court of the Northern District of Iowa in *IES Indus., Inc.* disallowed the losses and tax credits claimed on the grounds that the disputed ADR transactions lacked both economic substance and business purpose. The Eighth Circuit reversed *IES Indus.* in July 2001 and the Fifth Circuit reversed *Compaq Computers, Inc.* in December 2001. Both appellate courts reversed on the grounds that the ADR transactions had both economic substance and business purpose.[1229]

Editor's Note: Both the *Compaq Computer Corp.* and *IES Indus.* decisions were decided in favor of the taxpayer in part based on the conclusion that foreign taxes should not be treated as expenses in applying the economic substance doctrine. Note that in codifying the economic substance doctrine, Congress instructed the IRS to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. *See* §7701(o)(2)(B).

2. Compaq Computer Corp. v. Commissioner

a. Facts

In *Compaq Computer Corp. v. Commissioner*,[1230] Compaq had a long-term capital gain from a previous sale and was in an excess foreign tax credit limitation position. Twenty-First Securities, an investment bank, suggested to Compaq to enter into an ADR transaction that involved the purchase of ADRs representing a stock interest in Royal Dutch Shell, immediately before the record date for a dividend, followed by the immediate resale of the same ADRs ex-dividend. On September 16, 1992, during about one hour, a total of 23 transactions involving the purchase and immediate resale of the ADRs, with predetermined prices, were consummated. Each purchase trade and its related resale were completed before the next trade day commenced (i.e., outside of European market trading hours) to minimize the risk of price changes. The counterparty in all of the transactions was another client of Twenty-First.

The same counterparty sold the ADRs to Compaq and bought them back. Due to the different settlement dates on the sales and purchases, the taxpayer was the shareholder of record of 10 million ADRs on the dividend record date and was therefore entitled to a dividend of $22,545,800, which was subject to 15% Dutch withholding tax. The transaction resulted in a related foreign tax credit of over $3.4 million.

b. The Parties' Arguments

The IRS argued that the taxpayer was not entitled to a foreign tax credit because the transactions had no objective economic consequences or business purpose other than reduction of taxes. The IRS elaborated that the taxpayer had no reasonable possibility of profit from the transactions and therefore it had no business purpose for the purchase and sale of the ADRs apart from obtaining a tax benefit. In particular, the IRS argued that the taxpayer's profit calculation ignored the fact that it did not receive $22,545,800 in dividend, but only the net dividend of $19,163,930, because of the Dutch tax liability. Furthermore, the IRS asserted that every aspect of the taxpayer's ADR transaction was deliberately predetermined and designed to yield a specific result and eliminate all economic risk and influences from outside market forces on the purchases and sales of the ADRs.

Comment: The IRS's argument in *Compaq* was consistent with Notice 98-5.[1231] This Notice addressed transactions that were designed to acquire or generate foreign tax credits that could be used to shelter low-tax foreign-source income from residual U.S. taxes. Such transactions, according to the Notice, were generally structured to yield little or no economic profit relative to their expected yield in U.S. tax benefits and typically involve either: (i) acquisition of an asset that generates an income stream subject to foreign withholding tax or (ii) effective duplication of tax benefits through the use of certain structures designed to exploit inconsistencies between United States and foreign tax laws. Thus, Notice 98-5 expressed the IRS's concern that United States taxpayers might enter into such transactions and effectively transform the U.S. worldwide system of taxation into a system exempting foreign-source income from residual U.S. taxes. The Notice set forth an objective test for determining whether a transaction should be upheld or not; a transaction would be upheld if it generates economic profit, treating foreign taxes as an expense.

The IRS's calculations of the profit potential from the transaction in *Compaq* were as follows:

[1226] 253 F.3d 350 (8th Cir. 2001).

[1227] 277 F.3d 778 (5th Cir. 2001).

[1228] As the Tax Court explained in *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214, 215 (1999): "An ADR (American Depository Receipt) is a trading unit issued by a trust, which represents ownership of stock in a foreign corporation that is deposited with the trust. ADRs are the customary form of trading foreign stocks on U.S. stock exchanges, including the New York Stock Exchange (NYSE)."

[1229] Today, §901(k) denies tax credit for dividends if a taxpayer holds the shares for less than 15 days, but this provision did not apply to the *Compaq* case.

[1230] 113 T.C. 214 (1999).

[1231] 1998-3 I.R.B. 49.

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The loss from the purchase and resale:	
Purchase price of the ADRs:	($887,577,129)
Minus, sale price of the ADRs:	$868,412,129
Net capital loss:	($19,165,000)
The dividend income:	
Dividend income:	$22,545,800
Less, Dutch withholding tax:	($3,381,870)
Net dividend income received:	$19,163,930
Overall gross income:	
Capital loss minus net dividend received:	($1,070)
Less, transaction cost:	($1,485,685)
Net economic loss:	($1,486,755)[1232]

The taxpayer argued that it was entitled to the foreign tax credit because (i) it complied with the applicable statutes and regulations, (ii) the transaction had economic substance because it had potential profit, and (iii) the doctrine of economic substance should not be applied in its case to deny a foreign tax credit. In particular, the taxpayer argued that the foreign tax should not be treated as a cost in the profit potential calculation. The taxpayer's resulting calculation of the profit potential from the transactions was:

Capital loss	($19,165,000)
Dividend income	$22,545,800
Transaction costs	($1,485,685)
Net Gain	$1,895,115[1233]

c. The Tax Court's Holding

The court disallowed the foreign tax credit on the grounds that the transaction had only a tax purpose and satisfied neither the economic substance standard nor the business purpose test. For purposes of applying the objective economic substance test, the Tax Court looked at objective profit potential. The Tax Court held that the transaction was consummated to "capture" a foreign tax credit by timed acquisition and sale of ADRs.[1234] The Tax Court held that transactions that involve no market risk are not economically substantial transactions, but merely tax artifices.

In particular, the Tax Court summarized:

> Every aspect of petitioner's ADR transaction was deliberately predetermined and designed by petitioner and Twenty-First to yield a specific result and to eliminate all economic risks and influences from outside market forces on the purchases and sales in the ADR transaction. Petitioner had no reasonable possibility of a profit from the ADR transaction without the anticipated Federal income tax consequences. Petitioner had no business purpose for the purchase and sale of Royal Dutch ADR's apart from obtaining a Federal income tax benefit in the form of a foreign tax credit while offsetting the previously recognized capital gain.[1235]

Thus, the Tax Court applied a conjunctive two-prong test. The Tax Court first dismissed the taxpayer's argument that the transaction could have been profitable. The key point in the Tax Court's decision was the treatment of the foreign tax as a cost; the $3,381,870 foreign tax appeared on the IRS's cost side of the equation but not on the taxpayer's. The Tax Court accepted the IRS's side and concluded that the taxpayer, rather than expecting a pre-tax profit of $1,895,115, as it had argued, could only expect a loss of $1,486,755. Thus, the Tax Court concluded that ex-ante, the taxpayer could not have reasonably expected to make a profit by engaging in the transaction. Finally, still in the context of the objective prong, the Tax Court observed that "there was virtually no risk of price fluctuation [from the transaction]."[1236] As a result, the Tax Court concluded that the transaction had no economic substance: "we have found that this transaction was deliberately predetermined and designed by petitioner and Twenty-First to yield a specific result and to eliminate all market risks."[1237]

Turning into the business purpose prong, the Tax Court cited *ACM P'ship* for the proposition that to satisfy the business prong, "the transaction must be rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and economic situation."[1238] The Tax Court also observed that "[the business purpose] inquiry takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction."[1239]

The Tax Court found that the transaction had no business purpose, mainly on the grounds that:

> The ADR transaction was marketed to petitioner by Twenty-First for the purpose of partially shielding a capital gain previously realized… As a whole, the record indicates and we conclude that petitioner was motivated by the expected tax benefits of the ADR transaction, and no other business purpose existed.[1240]

d. Reversal by the Fifth Circuit

The Fifth Circuit reversed the Tax Court's decision and held that the IRS must treat foreign taxes and domestic taxes similarly, so that in computing pre-tax profit, both will be disregarded. As a result, the Fifth Circuit followed the Eighth Circuit (in *IES Indus.*) and held for the taxpayer.

The Fifth Circuit first discussed the application of the two-prong test:

[1232] 113 T.C. at 223.
[1233] *Id.* at 221.
[1234] *Id.* at 223.
[1235] *Id.* at 219–20.
[1236] *Id.* at 222–24.
[1237] *Id.* at 224.
[1238] *Id.* at 224 (citing *ACM P'ship*, T.C. Memo 1997-115).
[1239] *Id.* at 224 (citing *UPS of Am.*, T.C. Memo 1999-268).
[1240] *Id.* at 224–25.

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> In *Rice's Toyota World*, the court held that after *Frank Lyon Co.*, it is appropriate for a court to engage in a two-part inquiry to determine whether a transaction has economic substance or is a sham that should not be recognized for income tax purposes … . Other courts have said that business purpose and reasonable possibility of profit are merely factors to be considered in determining whether a transaction is a sham … . Because we conclude that the ADR transaction in this case had both economic substance and a business purpose, we do not need to decide today which of these views to adopt.[1241]

Turning first to the profit test, the Fifth Circuit reversed the Tax Court's decision to include the Dutch tax as a cost in the profit analysis. By disregarding the foreign tax as a cost, the Fifth Circuit "transformed" the transaction from a losing transaction into a profitable one, concluding that the taxpayer made a net gain of $1,895,115 from the transaction.[1242] The Fifth Circuit primarily relied on the Eighth Circuit's decision in *IES Indus.*, which was issued several months prior to the Fifth Circuit's decision in *Compaq*, for this analysis.[1243]

With respect to the business purpose test, the Fifth Circuit observed that "the evidence shows that Compaq actually and legitimately also sought the (pre-tax) $1.9 million profit it would get from the Royal Dutch dividend of approximately $22.5 million less the $20.7 million or so in capital losses that Compaq would incur from the sale of the ADRs ex dividend."[1244]

Comment: The Fifth Circuit effectively collapsed the economic substance and business purpose prong into a single profit potential test; because the taxpayer could have reasonably expected a profit from the transaction, it is evident that the taxpayer also had a business purpose.

Finally, the Fifth Circuit disagreed with the Tax Court on the question whether elimination of risk indicates lack of economic substance. The Fifth Circuit first observed that there was risk in the transaction, indicating that:

> The transaction occurred on a public market, not in an environment controlled by Compaq or its agents. The market prices of the ADRs could have changed during the course of the transaction … any of the individual trades could have been broken up or, for that matter, could have been executed incorrectly; and the dividend might not have been paid or might have been paid in an amount different from that anticipated by Compaq.[1245]

The Fifth Circuit, however, concluded that even if all the risk would have been eliminated, the *avoidance* of risk, rather than its acceptance, would be a factor in favor of the taxpayer.[1246] The Fifth Circuit concluded that "Because the Royal Dutch ADR transaction had both economic substance and a non-tax business purpose, it should have been recognized as valid for United States income tax purposes."[1247]

3. IES Indus. Inc. v. United States

a. Facts

The Eighth Circuit reversed a district court's decision in a case with facts almost similar to the facts in *Compaq*. In *IES Indus.*,[1248] the taxpayer, in a series of transactions, also purchased ADRs cum-dividend, and sold them a couple of days later after receiving the dividends. The total value of the ADRs purchased and sold by IES during the years 1991 and 1992 exceeded $9.2 billion. Similar to the decision in *Compaq Computer Corp. v. Commissioner*, the parties had different views with respect to the cash flows associated with the transaction. The taxpayer had a capital loss of $82,700,000 from the resale of the ADRs and had gross dividend income of $90,800,000 and a related foreign tax credit of over $13.5 million. In addition, the taxpayer incurred transaction costs of $3,100,000. Accordingly, the IRS argued that the taxpayer did not, and could not reasonably expect, any potential gain from the transaction, since the taxpayer's foreign tax liability of $13,500,000 should have been considered as an additional cost.

b. District Court

The district court held for the government, in a decision consistent with the Tax Court's decision in *Compaq Computer Corp. v. Commissioner*.

c. Eighth Circuit

The Eighth Circuit reversed the district court's decision on grounds generally similar to the reversal of the Tax Court's decision in *Compaq Computer Corp. v. Commissioner*. Similar to *Compaq Computer Corp. v. Commissioner*, the Court of Appeals first discussed the application of the two-prong test:

> [i]n determining whether a transaction is a sham for tax purposes, the Eighth Circuit has applied a two-part test set forth in *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91–92 (4th Cir. 1985), which the Fourth Circuit ostensibly found in the Supreme Court's opinion in *Frank Lyon Co.* … Applying that test, a transaction will be characterized as a sham if "it is not motivated by any economic purpose outside of tax considerations" (the business purpose test), and if it "is without economic substance because no real potential for profit exists" (the economic substance test) … we do not decide whether the *Rice's Toyota World* test requires a two-part analysis because we conclude that the ADR trades here had both economic substance and business purpose.[1249]

Discussing first the objective economic substance prong, the Eighth Circuit applied an objective profit potential test. The Eighth Circuit agreed with the taxpayer's view of profit and

[1241] *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781.

[1242] 277 F.3d at 782–83.

[1243] 277 F.3d at 782–86.

[1244] 277 F.3d at 787.

[1245] 277 F.3d at 787 (citing *IES Indus.*, 253 F.3d at 355).

[1246] *Id.* (citing *IES Indus.*, 253 F.3d at 355). *See generally* Shaviro & Weisbach, *The Fifth Circuit Gets it Wrong in Compaq v. Commissioner*, 2002 TNT 19-31 (Jan. 28, 2002).

[1247] 277 F.3d at 787.

[1248] 253 F.3d 350 (8th Cir. 2001).

[1249] *Id.* at 353–54. *See also Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781.

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held that the economic benefit to the taxpayer was the amount of the gross dividend, *before* the foreign taxes were paid.[1250] Therefore, the non-tax profit of approximately $5,000,000 was enough, according to the Eighth Circuit's decision, to satisfy the economic substance standard.

As to the business purpose prong, the Eighth Circuit observed that "the business purpose test is a subjective economic substance test."[1251] The Eight Circuit's decision was issued prior to the Fifth Circuit's reversal in *Compaq Computer Corp. v. Commissioner*. Thus, the Eighth Circuit had to distinguish the case from the Tax Court's decision in *Compaq Computer Corp. v. Commissioner* (decision for the government). The Eighth Circuit distinguished the facts in the present case from the facts in *Compaq Computer Corp. v. Commissioner* on the grounds that in *Compaq Computer Corp. v. Commissioner*, the taxpayer was not at risk at all throughout the transaction. The Eighth Circuit held that IES, as the entity legally entitled to receive the dividend, bore the risk that a dividend would not be paid. The court noted that IES reduced the risk of fluctuations in the market price of the ADRs by trading them when the United States markets were closed, but instead of determining that such actions reflect an isolation of risk, the court held that this was a valid business judgment made by IES. The court blessed the transaction on the grounds that IES exercised good business judgment consistent with a subjective intent to treat the ADR trades as profit-making transactions.[1252]

Finally, in support for the finding of a business purpose, the Eighth Circuit further explained that:

> It also is important to note that these were not transactions conducted by alter-egos of IES or straw entities created by IES simply for the purpose of conducting ADR trades… All of the parties involved — the foreign corporations, the trusts issuing the ADRs, the tax-exempt ADR owners, Twenty-First, other brokers involved, the counterparties — were entities separate and apart from IES, doing legitimate business before IES started trading ADRs and (as far as we know) continuing such legitimate business after that time.[1253]

Comment: Subsequent to the dates of the above transactions but before the decisions, §901(k) was enacted, pursuant to which a taxpayer must hold an ADR for at least 16 days within a 30-day period in order for the foreign taxes to qualify for the foreign tax credit. Accordingly, if this Code section were applicable to the two transactions, the foreign tax credit would have been disallowed in both *IES Indus. Inc. v. United States* and *Compaq Computer Corp. v. Commissioner*.

B. The CINS Transactions

1. Background

The CINS transactions used a perceived loophole in temporary regulations under §453 governing the timing of recognition of gain from an installment sale, pursuant to which a taxpayer who sold property in exchange for payments to be received over a period of time, was required, in general, to allocate the basis of the property disposed of pro-rata among the taxable years in which payments were expected to be received.[1254] The regulations under §453(b) required accelerated recognition of gain on contingent installment sales through a ratable basis recovery rule. The regulations also granted the Commissioner the right to require another method of basis recovery in cases where the allocation "substantially and inappropriately accelerated recovery of basis."[1255] It also offered taxpayers the right to "petition" the Commissioner for an alternative method of basis recovery in cases where the pro-rata method of allocation "substantially and inappropriately deferred recovery of basis."[1256]

In a typical CINS transaction, a United States and foreign entity formed a partnership, which acquired non-readily-marketable property and sold it in exchange for a large fixed payment plus small contingent payments. The resulting gain for the year of the sale (arising from allocation to the first year of only a pro-rata share of the basis of the property disposed of) would be allocated to the foreign partner, who would be indifferent, while the later years' corresponding losses would be allocated to the United States partner, who could use them to offset otherwise taxable gains from the sale of other property. The transaction was specifically designed to accelerate gain for the foreign partner and provide, through the partnership agreement, a distributive share of most of the losses to the domestic partners in later tax years.

ACM P'ship v. Commissioner[1257] was the first CINS transaction reviewed by the Tax Court. The Tax Court held that the transaction lacked economic substance and business purpose.[1258] The Third Circuit affirmed the Tax Court's decision.[1259] Subsequently, the D.C. Circuit has followed *ACM P'ship* in three subsequent decisions involving similar facts and held for the Government.[1260] The taxpayer's only temporary victory was in *Boca Investerings* at the district court, but on appeal, the D.C. Circuit reversed and held for the Government.[1261]

2. ACM P'ship v. Commissioner

The Third Circuit affirmed in part the Tax Court's application of the two-prong test to disallow the tax benefits derived by

[1250] *Id.* at 354. ("We reject the government's argument and agree with IES that the law supports our contrary conclusion: the economic benefit to IES was the amount of the gross dividend, before the foreign taxes were paid. IES was the legal owner of the ADRs on the record date.")

[1251] *Id.* at 355.

[1252] *Id.*

[1253] *Id.*

[1254] *See* Temp. Reg. §15A.453-1.

[1255] Temp. Reg. §15A.453-1(c)(7)(iii).

[1256] *Id.*

[1257] *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

[1258] T.C. Memo 1997-115.

[1259] *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

[1260] *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000); *Saba P'ship v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2000); *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003).

[1261] *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003).

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a partner of a domestic from a CINS transaction.[1262] The Third Circuit and the Tax Court disallowed the domestic partner's losses on grounds that the transactions lacked economic substance.

a. Facts

Colgate entered into a partnership (ACM) that had three partners: (i) a wholly owned domestic subsidiary of Colgate-Palmolive; (ii) a Netherlands Antilles subsidiary of ABN (a large Dutch bank); and (iii) a domestic subsidiary of Merrill Lynch. The partnership deposited $175 million in interest-bearing accounts and a short while later bought private placement notes (PPNs) for $175 million. Less than a month after the purchase of the Citicorp debt, the partnership sold the debt to unrelated foreign banks for $140 million in cash and six-year contingent installment notes (CINs) that entitled ACM to 5 annual payments based on the product of LIBOR and a notional principal amount with a fair market value of approximately $35 million. The transaction was reported under the installment method of Temp. Reg. §15A.453-1 as a contingent installment sale under §453(b). The tax result of the transaction would have been to reduce the LIBOR notes to their fair value of $35 million, generate a so-called "gain ratio" under the installment method of 0%, and apply that ratio to each payment of principal. The regulations then in effect, however, established a "default rule" that forced the taxpayer to recover basis in equal amounts over the period of the contingent payments; this resulted in the recovery of only one-sixth of the basis in the first year.

The default rule produced gain of approximately $110 million in the first year, i.e., the $140 million received less $30 million basis recovered. Pursuant to the partnership agreement, over 80% of this gain was allocated to the foreign entity. The remaining five-sixths of basis, approximately $145 million, was left in the $35 million of LIBOR notes, thereby leaving a "built-in loss" of $110 million in the LIBOR notes. Had the foreign entity remained in the partnership, it would have recovered more than 80% of this loss, offsetting the income it recognized in the year of sale. Similarly, the capital account of the foreign partner, increased by its share of the $110 million gain in year one, would have decreased by its share of the $110 million loss. In fact, after absorbing the majority of income, the foreign entity was redeemed by the partnership for an accommodation fee, leaving the taxpayer to recognize all of the built-in loss.

Colgate argued that it had business purpose and economic substance for the transaction and, therefore, that the losses ought to be allowed.

b. Tax Court

The Tax Court described the economic substance doctrine as follows:

> The tax law … requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[1263]

The Tax Court acknowledged that the transaction was not a factual sham: "The CINS transaction was not a sham in the sense that it was fictitious but it was a sham in the sense that the sec. 453 investment strategy lacked economic substance."[1264] As the Tax Court indicated, to satisfy the economic substance requirement, "the transaction must be rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and … economic situation."[1265] The taxpayer argued that under certain circumstances, it could have made a profit from this transaction. In particular, such circumstances consisted of a sudden significant rise in interest rates by 400–500 basis points. The Tax Court concluded that this was an unrealistic expectation. Specifically, the Tax Court stated that "Considering the high costs of the financial engineering it required and ABN's unwillingness to have Kannex share any of these costs or be exposed to any of the entrepreneurial risks it entailed, the §453 investment strategy would not have been consistent with rational profit-motivated behavior in the absence of the expected tax benefits."[1266]

The Tax Court examined several investment alternatives and concluded that neither of these alternatives could have offset the transaction costs of $2–3 million incurred by the taxpayer.[1267] The court also compared the alternative of purchasing the debt for $175 million and selling it for $140 million and $35 million in LIBOR notes to leaving the entire $175 million in interest-bearing accounts for an additional few weeks and then simply purchasing equivalent LIBOR notes. The Tax Court noted that the transitory purchase and sale of the debt produced only an additional $3,500 in interest income, an amount that was "obliterated" by transaction costs associated with the transaction. Thus, the court rejected the taxpayer's purported non-tax motive on the grounds that the taxpayer did not intend to earn any pre-tax profit.[1268]

The taxpayer also argued that the holding of the CINs served the purpose of a hedge. The Tax Court dismissed this argument.[1269] Accordingly, the Tax Court concluded that the transaction had neither economic substance nor business purpose.[1270]

c. Third Circuit

The Third Circuit affirmed the Tax Court's decision. With respect to the two-prong test, the Third Circuit applied the same flexible test:

> The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for

[1262] 157 F.3d 231 (3d Cir. 1998).

[1263] *ACM P'ship v. Commissioner*, T.C. Memo 1997-115, at 107–08.

[1264] *Id.* at 113–114, n. 21.

[1265] *Id.* at 118.

[1266] *Id.* at 137.

[1267] *Id.* at 125–29.

[1268] *Id.* at 137.

[1269] *Id.*, at 160–61.

[1270] *Id.* at 171. ("But for the $100 million of tax losses it generated for Colgate, the section 453 investment strategy would not have been consistent with rational economic behavior. The section 453 investment strategy lacked economic substance. It served no useful non-tax purpose.")

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> tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them.[1271]

However, the Third Circuit also acknowledged that:

> [T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.[1272]

With respect to the objective prong, the Third Circuit held that the objective prong is satisfied in the case where "the transaction has any practical economic effects other than the creation of income tax losses."[1273] The Third Circuit elaborated that transactions that do not "appreciably affect [the taxpayer's] beneficial interest except to reduce his tax" have no economic substance.[1274] While the Tax Court focused on "the lack of non-tax purposes behind ACM's transactions rather than on their objective economic consequences," the Third Circuit applied the profit potential (or lack thereof) under the objective prong.[1275]

In other words, the court examined whether aside from tax consequences, there had been a net change in the taxpayer's economic position. The Third Circuit concluded that the transactions lacked economic substance because the transactions had "no net effect on ACM's financial position."[1276]

3. ASA Investerings P'ship v. Commissioner

a. Facts

The Tax Court in *ASA Investerings P'ship v. Commissioner*,[1277] in response to virtually identical facts to those in *ACM*, also held for the IRS, but on different grounds. Specifically, the Tax Court chose the "re-characterization" route, disallowing the losses on the grounds that the domestic taxpayer (AlliedSignal) and the foreign bank (ABN Amro) never entered into a partnership. The Tax Court observed that "To form a valid partnership, AlliedSignal and ABN must have intended to join together in the present conduct of an enterprise."[1278]

b. Tax Court

The Tax Court examined each partner's motives in entering into the partnership agreement:

> AlliedSignal and ABN had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses to shelter an anticipated capital gain. In pursuing this goal, AlliedSignal chose to ignore transaction costs, profit potential, and other fundamental business considerations. In fact, AlliedSignal's Board and the Board's Executive Committee focused only on potential tax benefits when they approved the plan. In contrast, ABN entered into the venture for the sole purpose of receiving its specified return. This return was independent of the performance of ASA's investments (e.g., the profitability of the LIBOR notes) and the success of the venture (i.e., whether AlliedSignal succeeded in generating capital losses). Moreover, … ABN did not have any profit potential beyond its specified return and did not have any intention of being AlliedSignal's partner.[1279]

Accordingly, the Tax Court concluded that the parties "did not have the requisite intent to join together for the purpose of carrying on a partnership and sharing in the profits and losses therefrom."[1280] Conducting a substance-over-form analysis, the Tax Court also examined whether AlliedSignal and ABN had a debtor-creditor relationship. The court observed that "ABN merely sought its specified return. This return was equivalent to interest and was guaranteed by AlliedSignal. The parties agreed that ABN would be repaid according to a specified schedule, which established fixed maturity dates when ABN was to be repaid."[1281] The Tax Court observed that ABN treated the transaction as a lending transaction and expected to receive a fixed return accordingly.[1282] The Tax Court concluded, therefore, that AlliedSignal owned all of the relevant assets and derived all of the relevant income (including the gains for the first year) and ABN Amro was merely a lender rather than a partner.[1283]

c. D.C. Circuit

The D.C. Circuit affirmed the Tax Court's decision. The taxpayer's first argument was that ASA was engaged in business activity and, therefore, under *Moline Properties*, it must be treated as having economic substance. The D.C. Circuit first discussed the application of *Moline Properties* to this case:

> [I]f engaging in business activity were sufficient to validate a partnership ASA would qualify. It was infused with a substantial amount of capital … and invested it … over a period of two years. In fact, however, courts have understood the "business activity" reference in *Moline* to exclude activity whose sole purpose is tax avoidance. This reading treats "sham entity" cases the same way the law treats "sham transaction" cases, in which the existence of formal business activity is a given but the inquiry turns on the existence of a non-tax business motive. Thus, what the [taxpayer] alleges to be a two-pronged inquiry is in fact a unitary test — whether the "sham" be the entity or the transaction — under which the absence of a non-tax business purpose is fatal.[1284]

[1271] *ACM P'ship v. Commissioner*, 157 F.3d at 247.
[1272] *Id.* The Third Circuit observed, however, that even though it applies the unitary analysis, "it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations." *Id.* at 248, note 31.
[1273] *Id.* at 248 (citing *Jacobson v. Commissioner*, 915 F.2d at 837).
[1274] *ACM P'ship*, 157 F.3d at 248.
[1275] *Id.* at 249.
[1276] *Id.* at 250.
[1277] T.C. Memo 1998-305.
[1278] *Id.* at 35.
[1279] *Id.* at 35–36.
[1280] *Id.* at 44.
[1281] *Id.* at 47.
[1282] *Id.*
[1283] *Id.* at 48–49.
[1284] *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512.

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The D.C. Circuit held that the partnership had no business activity on the grounds that: (i) the purchase and sale of the PPNs did not constitute business activities,[1285] and (ii) the taxpayer structured the transaction so that it could yield no profit or loss on the purchase and sale of the PPNs.[1286] The D.C. Circuit also affirmed the Tax Court's determination that ABN was a creditor rather than a partner. The D.C. Circuit examined ABN's potential for gain and loss. On the gain side, the D.C. Circuit first observed that:

> the direct payments made to ABN were to compensate it merely for its funding costs. Petitioner says that there was no explicit agreement that ABN would receive a return of LIBOR plus 75 basis points, pointing to the fact that the payments actually made by AlliedSignal to ABN did not produce such a return… But petitioner makes no argument that these payments were related to the success of the partnership's investments (*i.e.*, the PPNs and LIBOR notes), and under the circumstances it is reasonable to infer that they were made pursuant to a pre-arranged agreement to compensate ABN for its funding costs (plus some amount above LIBOR, even if not 75 basis points).[1287]

On the risk of loss side, the D.C. Circuit continued and held that:

> at no point during the transaction did ABN assume greater than de minimis risk. The PPNs were essentially risk free: not only were they issued by banks with the highest credit ratings but they were held for a mere three weeks. Moreover, because of the side agreement under which any loss on the PPNs would be embedded in the value of the LIBOR notes, AlliedSignal would bear any shortfall over the brief period in which PPNs were held. Petitioner argues that ABN was subject to the risk that AlliedSignal would ultimately decide not to acquire the LIBOR notes. This seems unlikely to the point of triviality, however, for two reasons: first, this step was integral to AlliedSignal's tax objective, and to the entire transaction; and second, at the point when the LIBOR notes would be distributed, Dominguito still owned over 40% of ASA, and according to the partnership agreement, any act of the partnership committee would require the consent of partners whose interest equaled or exceeded 95%. Nor was there any real hazard that AlliedSignal might agree to distribute the LIBOR notes but refuse to make the adjustment for any loss on the PPNs: as den Baas had stated in a memorandum to ABN officials, the SPCs could counter by refusing consent for the distribution of the notes altogether.

The LIBOR notes certainly had greater inherent risk than the short-term PPNs; ABN, however, entered into hedge transactions outside the partnership to reduce the risk to a de minimis amount.[1288]

Accordingly, the D.C. Circuit concluded that ABN was a creditor rather than a partner and, therefore, concluded that the parties did not intend to create a partnership.[1289]

4. *Saba Partnership v. Commissioner*

a. *Facts*

The transaction in *Saba P'ship v. Commissioner*[1290] was also similar to the transaction in *ACM P'ship v. Commissioner*. The Tax Court's decision was issued after the Third Circuit's decision in *ACM P'ship v. Commissioner*, and the Tax Court principally relied on *ACM P'ship v. Commissioner* in its decision. In contrast to *ASA Investerings*, however, the Tax Court in *Saba P'ship v. Commissioner* found it unnecessary to discuss the validity of the partnership.[1291]

b. *Tax Court*

The Tax Court first discussed the two-prong test and asserted that: An evaluation of the economic substance of the CINS transactions requires: "(1) A subjective inquiry whether the partnerships carried out the transactions for a valid business purpose other than to obtain tax benefits and (2) an objective inquiry whether the CINS transactions had practical economic effects other than the creation of tax benefits."[1292]

With respect to whether to apply a conjunctive or disjunctive test, the Tax Court clearly applied a disjunctive test: "A transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a non-tax business purpose."[1293] Since the Tax Court's decision was appealed to the D.C. Circuit, the Tax Court could follow the disjunctive test in accordance with *Horn v. Commissioner*.[1294] Thus, as opposed to *ACM P'ship*, potentially the taxpayer had

[1285] *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 513 ("Although [ASA's] investment in LIBOR Notes might have had a business purpose, the prior three-week investment in and subsequent sale of PPNs was … a business activity merely conducted for tax purposes."). *See also Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003) ("We then approved the Tax Court's approach to the Supreme Court's test set out in *Culbertson* which determined that the existence of a partnership would depend on whether, 'considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.' … We stated that 'the Tax Court was, we think, sound in its basic inquiry, trying to decide whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance.' … . Finally, we affirmed the Tax Court's conclusion that AlliedSignal and ABN did not have 'the requisite intent to join together for the purpose of carrying on a partnership.'").

[1286] *Id.* at n. 5 ("The PPNs cost $850 million. When an expert was later engaged by [the taxpayer] to evaluate the partnership's gains and losses, [the taxpayer] asked that he assign to the LIBOR Notes a value which, together with the cash, would bring the total value of the PPNs to $850 million. [The taxpayer] evidently did not believe that the initial investment in PPNs increased the return from the transactions in the aggregate.").

[1287] *Id.* at 514.

[1288] *Id.* at 514–15.

[1289] The D.C. Circuit applied the test set forth by the U.S. Supreme Court in *Commissioner v. Culbertson*, 337 U.S. at 742, pursuant to which the existence of a partnership for tax purposes depends on whether, "considering all the facts … the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

[1290] 273 F.3d 1135 (D.C. Cir. 2000).

[1291] T.C. Memo 1999-359, at 106.

[1292] *Id.* at 137.

[1293] *Id.* (citing *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 12 and *Larsen v. Commissioner*, 89 T.C. at 1253).

[1294] 968 F.2d 1237. *See also Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003).

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better chances of winning the case, since it only needed to satisfy one prong of the test. Nevertheless, the Tax Court also held that the taxpayer had neither business purpose nor economic substance.[1295]

The Tax Court first dismissed the taxpayer's argument that the partnerships were created to achieve non-tax business objectives. The Tax Court observed that "there is overwhelming evidence in the record that [the partnerships] were organized solely to generate tax benefits for [the taxpayer]."[1296] The evidence showed, according to the Tax Court, that the parties clearly understood that the partnership is entered into to generate the tax benefits to the U.S. partner. The Tax Court, therefore, could not find sufficient evidence for establishing a non-tax business purpose.

In finding that the transaction lacked economic substance, the Tax Court also held that relatively modest profits are insufficient, standing alone, to clothe the disputed CINS transactions with economic substance.[1297] The Tax Court analyzed the cash flow associated with the transaction, and found that the taxpayer effectively lost a total of $543,340 on the transaction and that even if there was a possibility of profit, it was insignificant.

In particular, the court held that even if the partnerships reasonably could have expected profits of up to $10,800,000 on a five-year investment amount of $200,000,000 in the LIBOR notes (as the taxpayer argued), such profits would be inconsequential when compared with the capital losses of approximately $170,000,000 that the CINS transactions were designed to generate.[1298] This conclusion suggests that the court favored an approach that not only disregards potential insignificant profits but also compares tax benefits to pre-tax profits — an approach consistent with §7701(o)(2)(A) (effective for transactions entered into after March 30, 2010) but inconsistent with most cases on point, which were decided before §7701(o) was enacted.[1299]

The Tax Court, however, cited *Yosha v. Commissioner* for a different approach:

> A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages — may indeed have had no other interest in the transaction.[1300]

c. D.C. Circuit

The case was appealed to the D.C. Circuit and was remanded to the Tax Court for reconsideration in view of the *ASA Investerings P'ship v. Commissioner* decision.[1301] The D.C. Circuit observed that while the Tax Court applied the sham transaction analysis consistent with *ACM P'ship v. Commissioner*, the alternative route taken by the Tax Court in *ASA Investerings P'ship v. Commissioner* may result in different consequences. As the D.C. Circuit clearly stated, "[a]ll parties agree that the sham transaction and sham partnership approaches yield different results."[1302] In spite of the Commissioner's request to affirm the case based on the sham partnership doctrine (as applied in *ASA Investerings P'ship v. Commissioner*), the D.C. Circuit decided not to affirm on this ground but rather to remand to the Tax Court. The D.C. Circuit explained that:

> Although the present record might strongly suggest that [the partnerships] were sham partnerships organized for the sole purpose of generating paper tax losses for [the taxpayer], fairness dictates that we ought not affirm on this ground. In particular, in presenting its case in the Tax Court, [the taxpayer] may have acted on the mistaken belief that the Supreme Court's decision in *Moline Props., Inc. v. Commissioner*, 319 U.S. 436, 87 L. Ed. 1499, 63 S. Ct. 1132 (1943) established a two-part test under which [the partnerships] must be respected simply because they engaged in some business activity, an interpretation that *ASA* squarely rejected…[1303]

d. Remand to Tax Court

On remand, the Tax Court focused solely on comparing between this case and *ASA Investerings P'ship v. Commissioner*. The Tax Court first observed that "when an ostensible partner is guaranteed a specified or minimum return on its capital contribution, that factor is one of many that must be considered in determining whether the arrangement constitutes a partnership that will be recognized for Federal tax purposes."[1304] Thus, the Tax Court held that the fact that the foreign partner had a guaranteed return is only one factor in determining if a partnership existed.

Nevertheless, the Tax Court reinstated its previous decision stating that "Brunswick and ABN did not have a non-tax business purpose for entering into the partnerships, whether the amounts that Brunswick transferred to ABN are properly characterized as a specified return or a guaranteed minimum return is not dispositive."[1305]

The Tax Court also applied the *Moline Props.* standard and observed that if "[the partnerships] are to be recognized as valid entities for Federal tax purposes, petitioner must show that the partnerships engaged in business activity for a purpose other than tax avoidance."[1306] The taxpayer argued that the partnerships engaged in business activity that would satisfy the threshold required under *Moline Props.* The court, however, rejected this argument and followed *ASA Investerings P'ship v. Commissioner* in the decision that "[t]he minimal business activity that petitioner cites does not amount to a non-tax business purpose for the partnerships."[1307]

[1295] T.C. Memo 1999-359, at 160 ("we conclude that the CINS transactions were economic shams that neither appreciably affected the partnerships' beneficial interests or materially altered the partnerships' economic positions.").

[1296] *Id.* at 139–40.

[1297] *Id.* at 155–56.

[1298] *Id.*

[1299] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. at n. 33.

[1300] T.C. Memo 1999-359, at 156 (citing *Yosha v. Commissioner*, 861 F.2d at 499).

[1301] 273 F.3d 1135 (D.C. Cir. 2001).

[1302] *Id.* at 1140.

[1303] *Id.* at 1141.

[1304] *Id.* at 19–20.

[1305] *Id.* at 20.

[1306] *Id.* at 28–9.

[1307] *Id.* at 32.

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5. Boca Investerings v. Commissioner

a. Facts

The D.C. District Court held that a CINS transaction entered into by Boca Investerings had economic substance.[1308] This decision, however, was subsequently reversed by the D.C. Circuit.[1309] The order and composition of the transactions in *Boca Investerings v. Commissioner* parallel closely the facts in *ACM P'ship v. Commissioner*. In October 1990, AHP invested $623,000,000 in the Boca Investerings partnership, with a rate of return of 6%. In October 1991, AHP invested an additional $657,000,000 in the partnership, with a rate of return of 5.5%. As of September 17, 1991 (i.e., even before the second investment), AHP had made a profit of $33,073,640.

b. District Court

The district court began with examining the economic substance of the Boca partnership. The court applied the standard suggested in *Commissioner v. Culbertson* pursuant to which a partnership is respected for tax purposes if:

> considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[1310]

Based on this standard, the district court examined several aspects of the partnership and concluded that the partnership ought to be recognized for tax purposes because:

> (i) all four partners intended to, and did, organize Boca as an investment partnership…; (ii) all four contributed substantial capital to the partnership…; (iii) all four participated on the Partnership Committee and jointly controlled Boca, since the agreement of owners of 95 percent of the Partnership was required in order to take action…; and (iv) all four jointly shared in the income, gain, losses, and expenses from Boca's investments pursuant to the Partnership Agreement.[1311] In addition, there was a legitimate business purpose for the creation of the partnership and the purchase of the PPNs.[1312]

The next step was an evaluation of the economic substance of the AHP transaction. First, the district court established that "A transaction is not a sham and will be recognized for tax purposes if the taxpayer satisfies either part of the test for economic substance — if either (1) using a subjective analysis, the transaction has a non-tax business purpose, or (2) using an objective analysis, the transaction has a reasonable possibility of generating a profit, ex-ante."[1313] Thus, consistent with the application of the two-prong test in the D.C. Circuit, the district court applied a disjunctive test.[1314]

In addition, consistent with *Horn v. Commissioner*, the court determined that the objective prong should be "did the transaction have a reasonable prospect, *ex ante*, for economic gain (profit)."[1315] The IRS argued that AHP could not be said to have the above amount of profit, since it incurred significant transaction costs. Further, the IRS argued that opportunity costs should be considered in determining the taxpayer's profit from a transaction. Finally, the IRS argued that even if the taxpayer made the above amount of profit, such an amount is insignificant in comparison with the expected tax benefits.

The district court dismissed all three arguments. First, the court held that the $33 million profit was calculated after taking into account all the costs that were associated with the transaction. Second, the court rejected the IRS's definition of "economic loss," which was investment costs minus opportunity costs; the court held that economic loss is a means to determine the taxpayer's best investment alternative, but is not the right measurement of determining whether the taxpayer's economic position had been changed. In other words, the court stated that for the purposes of the economic substance standard, it is the expected change in the taxpayer's position, and not the best alternative investment, that should be considered. Finally, the court determined that the taxpayers had reasonable expectation to believe that they would make a profit from the transaction and in fact, had interest rates not fallen, the taxpayer could have made a higher profit. The district court, therefore, held that the expected profit could have been much higher. As the court indicated:

> The record developed at trial establishes that AHP evaluated all of the transactions in issue, including the purchase of the PPNs and the LIBOR Notes, from an investment perspective on a pre-tax basis and entered into the transactions in order to make a profit.[1316]

With respect to business purpose, the record before the court also showed that AHP would not have invested in the

[1308] 167 F. Supp.2d 298 (D.D.C. 2001).

[1309] *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003).

[1310] 167 F. Supp.2d at 367 (citing *Commissioner v. Culbertson*, 337 U.S. at 742).

[1311] *Id.* at 372–73 (citing *Luna v. Commissioner*, 42 T.C. at 1077–78 (Factors on which courts have focused in attempting to determine whether the parties truly intended to form a partnership include: "the agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to [the Internal Revenue Service] or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture, and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.")).

[1312] *Id.*

[1313] *Id.* at 375 (citing *Horn v. Commissioner*, 968 F.2d at 1237 ("For the instant case, it is important to recognize that a transaction undertaken for a non-tax business purpose will not be considered an economic sham even if there was no objective reasonable possibility that the transaction would produce profit.")).

[1314] *Id. See also Saba P'ship v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001).

[1315] *Id.* at 377, n. 19.

[1316] *Id.* at 380.

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partnership if AHP did not think it could make a profit from the investment. In particular, representatives from AHP's Treasury department specifically testified that if they had thought that AHP would lose money on this investment, they would not have recommended the investment.[1317]

c. D.C. Circuit

In a short opinion, the D.C. Circuit held that the district court erred when it did not follow the decision in *ASA Investerings P'ship v. Commissioner*:

> We reverse the judgment below because the district court erred as a matter of law when it did not properly apply the holding of *ASA Investerings*, requiring that a legitimate non-tax business necessity exist for the creation of the otherwise sham entity inserted into the partnership for tax avoidance reasons in order to meet the intent test of *Commissioner v. Culbertson*, 337 U.S. 733, 93 L. Ed. 1659, 69 S. Ct. 1210 (1949) as applied to this type of partnership transaction.[1318]

The D.C. Circuit observed that the similarity of facts in both cases is an important factor in its determination to reverse the District Court's decision.[1319] Citing *ASA Investerings P'ship v. Commissioner*,[1320] the D.C. Circuit acknowledged that while taxpayers are allowed to structure their business transactions in such a way as to minimize their tax, these transactions must have a legitimate non-tax avoidance business purpose to be recognized for tax purposes.[1321] As noted by the D.C. Circuit, the reasoning behind this principle is that:

> A tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated — in every respect except for differing investments in tax avoidance.[1322]

The D.C. Circuit acknowledged that "*ASA* makes clear that 'the absence of a non-tax business purpose is fatal' to the argument that the Commissioner should respect an entity for federal tax purposes."[1323] Thus, the D.C. Circuit concluded that there was no business purpose for the partnership apart from tax benefits. The D.C. Circuit, however, did not discuss the potential profit that could have been generated from the transaction and simply stated that there was no evidence in this case for a non-tax purpose.

[1317] *Id.* at 378.

[1318] *Boca Investerings P'ship v. United States*, 314 F.3d at 630.

[1319] *Id.*

[1320] *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000).

[1321] *Boca Investerings P'ship v. United States*, 314 F.3d at 631 (citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 513).

[1322] *Id.*

[1323] *Id.* at 630 (citing *Saba P'ship v. Commissioner*, 273 F.3d at 1141 (quoting *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512)).

C. Corporate Owned Life Insurance (COLI)

1. Overview

This series of cases involved taxpayers who received substantial tax savings by participating in transactions involving COLI. In *Winn Dixie Stores Inc. v. Commissioner*,[1324] the Tax Court held, and the Eleventh Circuit affirmed, that the taxpayer had neither economic substance nor business purpose for entering into the transaction, and denied the associated tax benefits. Subsequently, in *IRS v. CM Holdings*,[1325] the United States District Court (Delaware) held that the COLI program of CM Holding's subsidiary, Camelot Music, was a sham. The third case was *Am. Elec. Power Co. v. United States*,[1326] where the district court held that the taxpayer's COLI transaction was a sham. *Dow Chemical* was the first COLI case in which the taxpayer prevailed. The district court in *Dow Chemical* held that as opposed to the facts in the other COLI cases, the present transaction did not lack economic substance.[1327] However, the Sixth Circuit reversed and remanded the district court decision and held that the COLI plans were economic shams and that the IRS properly disallowed Dow's deductions.[1328]

2. Winn Dixie Stores Inc. v. Commissioner

a. Facts

In 1993, Winn Dixie (a major food retailer) entered into a broad-based leveraged COLI group plan covering its 36,000 employees and borrowed against the cash value of the policies to fund the premiums. The decision to enter into the contract was made pursuant to a proposal that indicated the tax advantages of the program. The taxpayer expected that annual premiums, fees, and interest would exceed the projected annual death benefits and net cash value of the policies. Thus, the transaction was expected to generate a pre-tax loss but an after-tax gain. In particular, the taxpayer was expected to have a pre-tax loss totaling $755 million between 1993–2052, but as a result of the expected tax savings, would realize after-tax gains of more than $2.2 billion for the same period.

In 1997, §264 was amended to deny interest deductions for interest on loans with respect to company-owned life insurance, except for certain key-person policies. The taxpayer argued that for the years before the amendment, former §264 did not disallow such deductions. The IRS claimed that the transaction was tax motivated, without any independent business purpose, and lacked economic substance.

[1324] 254 F.3d 1313 (11th Cir. 2001).

[1325] 301 F.3d 96 (3d Cir. 2002).

[1326] 136 F. Supp.2d 762 (S.D. Ohio 2001).

[1327] In *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003), the district court decided to validate the transaction utilizing both the economic substance and sham transaction doctrines. Subsequently, on facts similar to those in *Dow Chem.*, the Sixth Circuit in *AEP v. United States* held that the COLI transaction was a "sham in substance" (a standard that is equivalent to the economic substance standard), but not a "sham in fact" (the traditional sham transaction analysis). *Am. Elec. Power Company v. United States*, 326 F.3d 737 (6th Cir. 2003).

[1328] *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007).

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b. Tax Court

The Tax Court in *Winn Dixie*[1329] first discussed the difference between "sham-in-substance" and "sham-in-fact":

> Courts have recognized two basic types of sham transactions. Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.[1330]

The Tax Court concluded that "[b]ecause the transactional events at issue in this case actually occurred, we limit our inquiry to the question of whether the substance of the COLI transaction corresponds with its form."[1331] Thus, the Tax Court applied the sham-in-substance test, which is similar to the two-prong economic substance doctrine, using the unitary analysis: "In determining whether a transaction or series of related transactions constitute a substantive sham, both this Court and a majority of the Courts of Appeals have utilized a flexible analysis that focuses on two related factors, economic substance apart from tax consequences, and business purpose."[1332]

The Tax Court held that the transaction had neither economic substance nor business purpose.

The court began with the objective prong and set forth that "Economic substance depends on whether, from an objective standpoint, the transaction was likely to produce economic benefits aside from tax deductions."[1333] Accordingly, the Tax Court applied the profit potential test under the objective prong. The taxpayer argued that the transaction could have produced non-tax benefits if a catastrophic event produced large, unexpected death benefits. The Tax Court rejected this argument. In evaluating the profit potential, the Tax Court observed that the transaction must be viewed "in its entirety rather than any single step."[1334] Accordingly, viewing the plan in its entirety, the Tax Court held that the transaction's sole motivation was to reduce tax liabilities. The court observed that "[w]ithout the tax deductions for policy interest and fees, there would have been a substantial negative cash-flow in each year, and the costs of maintaining the COLI plan would have greatly exceeded benefits."[1335]

The taxpayer also argued that the fact that there was an enforceable real debt ought to result in a determination that the interest thereon should be deductible. The Tax Court, however, held that the existence of an enforceable debt is not dispositive of whether interest arising from the debt is deductible.[1336]

With respect to the business purpose prong, the taxpayer argued that the tax benefits from the transaction were to be used to fund a flexible benefits program (Winn-Flex) for its employees. The Tax Court rejected this argument, stating that:

> [t]he possibility that such tax benefits could have been used as a general source of funds for petitioner's Winn-Flex obligations (or any other business purpose) does not alter the fact that the COLI plan itself had only one function and that was to generate tax deductions which were to be used to offset income from its business and thereby reduce petitioner's income tax liabilities in each year.[1337]

The Tax Court also determined that the taxpayer did not provide adequate evidence to support its argument.

c. Eleventh Circuit

In a short opinion, the Eleventh Circuit affirmed the Tax Court's decision on the grounds that the program had neither a business purpose nor economic substance and, thus, was a sham.

Before discussing the two-prong test, the Eleventh Circuit addressed the taxpayer's argument that §264 as well as its legislative history indicated that Congress intended to bless deductions associated with similar transactions.[1338] The Tax Court rejected this argument, noting that the right to deduct interest on an insurance policy loan is based on §163, not §264. Citing *Knetsch v. United States*,[1339] the Tax Court held that "we find nothing in the more recent legislative history of §264 suggesting that Congress intended to allow deductions arising from sham transactions that lacked economic substance and business purpose."[1340]

Although the Eleventh Circuit affirmed the Tax Court's decision, it showed some understanding to the legislative history argument. The Eleventh Circuit, however, noted that "*Knetsch* was then, and this is now, but we are not the court to make that call."[1341] Therefore, the Eleventh Circuit concluded that the Tax Court properly applied the sham transaction doctrine.[1342]

The United States Supreme Court later denied review of the Eleventh Circuit's holding.[1343]

Comment: The court's main reason for its decision was that the taxpayer's could not have reasonably expected a minimum profit from the transactions.[1344]

3. IRS v. CM Holdings, Inc.

a. District Court

On facts similar to AEP (see below), a U.S. District Court (Delaware) held that the leveraged COLI program of CM Holding's subsidiary, Camelot Music, was a sham.[1345] The court denied Camelot's policy loan interest deductions and imposed accuracy-related penalties for substantial understatement. The

[1329] 113 T.C. 254 (1999).
[1330] *Id.* at 279 n. 35 (citing *Kirchman v. Commissioner*, 862 F.2d at 1492).
[1331] 113 T.C. at 278–79.
[1332] *Id.* at 279–80.
[1333] *Id.* at 285.
[1334] *Id.*
[1335] *Id.*
[1336] *Id.* at 279–80.
[1337] *Id.* at 287–88.
[1338] 254 F.3d at 1315–16.
[1339] 364 U.S. 361 (1960).
[1340] 113 T.C. at 293–94.
[1341] 254 F.3d at 1316.
[1342] *Id.*
[1343] 536 U.S. 986 (2002).
[1344] *See* McMahon, *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, Tax Notes, Feb. 25, 2002, at 1017 n. 10.
[1345] 254 B.R. 578 (D. Del. 2000), aff'd, 301 F.3d 96 (3d Cir. 2002).

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IRS urged the court to decide that the COLI transactions were both factual shams and substantive shams.

Turning first to the factual sham analysis, the court stated that "Factual shams are transactions which were created on paper but '[did] not occur in fact,' or that 'were performed in violation of some of the background assumptions of commercial dealing.'"[1346] Thus, the court observed, to satisfy this standard, "[the taxpayer] must prove the purported transaction actually took place in a manner which did not deviate from relevant commercial norms."[1347] The IRS argued that the following components of the transaction were factual shams: the policy loans, the loading dividends, the partial withdrawals, and the annual premiums.

The court first concluded that the policy loans were not factual shams. The court explained that "Camelot's policy loans have the same risk characteristics as typical life insurance policy loans. Because the risk characteristics do not vary from norms in the life insurance industry, the risk characteristics do not indicate the policy loans are factual shams."[1348] In addition, with respect to the high interest on the loans, the court held that "even though Camelot's policy loan interest rate was set at the highest value possible in a collusive transaction and was excessive compared to the riskless nature of the policy loans, this is not enough for the Court to find the policy loans were factual shams."[1349]

In contrast, with respect to the loading dividends for years four through seven, the court first observed that:

> [u]nlike the transaction involving the policy loans in years one through three, the netting transactions involving the loading dividends in years four through seven were cleverly designed accounting entries which occurred on paper but not in reality. A close examination of what occurred reveals that the loading dividends were not dividends, but rather paper transactions that had the sole purpose of reducing the amount of annual premiums that Camelot has to pay in cash.[1350]

In addition, the court compared these arrangements with what is common in the industry and held that "the loading charges and loading dividends [in this case] function in a manner which departs from many, if not all, accepted practices in the life insurance industry because: (1) the magnitude of the loading charges was excessive; (2) the loading dividends were not paid from surplus; (3) the loading dividends were paid at the beginning, rather than the end, of the policy year; (4) the loading dividends were not sourced from all experience factors; (5) the loading dividends were virtually guaranteed; and, (6) MBL and Hartford failed to properly account for the loading dividends."[1351] Thus, the court concluded that the loading dividends for years four through seven were factual shams.[1352]

Turning to the partial withdrawals, the court refused to treat them as factual shams because "the partial withdrawals were sourced from the policy value, but applied to payment of loan interest, they were not created in a circular transaction, so as to make them factual shams."[1353] Finally, the court found that the annual premiums for all seven years were not factual shams.[1354]

The next step was examining the economic substance of the transaction as a whole. The court first acknowledged that the doctrines of economic substance and substantive sham are similar. Second, relying on *ACM P'ship*, the court stated that it is applying the unitary test, but will examine each prong separately.[1355]

The court followed *Winn Dixie v. Commissioner* and held that the objective test turns on the question whether the taxpayer "would have achieved any economic benefit from purchasing its COLI VIII policy plan absent the interest deductions."[1356] The court also observed that the profit potential test is relevant to both the subjective and objective prongs.[1357] The taxpayer argued that it had a reasonable expectation of profit from the COLI program, i.e., that it would benefit from inside build-up of cash value and profit from death benefits on covered employees. However, the record indicated that the program was specifically designed not to generate those values and death benefits, but to generate the most tax deductions possible, i.e., a high interest rate, maximum borrowing, and so forth.

The court observed that the only financial benefit to the company was the tax benefit attributable to the policy loan interest deductions. The court used the analysis that the taxpayer received from an expert prior to entering into the transaction and observed that "All of the illustrations received by Camelot prior to and contemporaneous with its COLI VIII purchase show the same phenomenon: for each and every plan year and on an aggregate basis, over the period of the illustration, cash flows from the plan were projected to be positive with the interest deductions and negative without them."[1358]

Thus, the court held that in the absence of the tax benefits, the transaction would be a losing transaction under all reasonable scenarios. The taxpayer attempted to argue that because its employees were young and because of the larger death benefits the taxpayer anticipated receiving in later plan years, the relevant term for purposes of the profit potential test should be 81 years. Some of the illustrations that were received from the taxpayer's expert for 81 years showed a positive cash flow even before the interest deductions. The court, however, held that the taxpayer's calculations were unreliable and applied the wrong discount rate, and refused to accept them.[1359] For these reasons, the court found that the COLI program lacked economic substance other than to generate tax deductions.

[1346] 254 B.R. at 600 (citing *Peerless Indus., Inc. v. United States*, 94-1 USTC ¶ 50,043 (E.D. Pa. 1994), aff'd, 37 F.3d 1488 (3d Cir. 1994)).

[1347] *Id.*

[1348] *Id.* at 604–05.

[1349] *Id.* at 606.

[1350] *Id.* at 607.

[1351] *Id.* at 609.

[1352] *Id.* at 618.

[1353] *Id.* at 619.

[1354] *Id.* at 620.

[1355] *Id.* at 621 ("The IRS asserts Camelot's COLI VIII plan lacks both objective economic substance and subjective business purpose. Although these inquiries do not constitute two distinct prongs of analysis, the Court will address these component inquiries in turn.").

[1356] *Id.* at 622 (citing *Winn Dixie v. Commissioner*, 113 T.C. at 260–61).

[1357] *Id.* at 624 n. 51.

[1358] *Id.* at 625.

[1359] *Id.* at 626–31.

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With respect to the subjective prong, the court stated that "the test for business purpose is whether the underlying transaction has a purpose beyond creating tax deductions."[1360] The taxpayer made an argument similar to the one made in *Winn Dixie v. Commissioner*, namely that it purchased the COLI plan for the purpose of offsetting the costs of its employee medical benefits program. Consistent with the decision in *Winn Dixie v. Commissioner*, the court held that "even if Camelot's purpose for purchasing the COLI plan was to provide funds for employee medical benefits, such a purpose, standing in isolation, is not sufficient to imbue what is otherwise an economically empty transaction with economic substance."[1361] Accordingly, the court concluded that "The preponderance of the evidence convincingly demonstrates that policy loan interest tax deductions were the predominant consideration in Camelot's decision to purchase broad-based leveraged COLI as well as the selection of premium level and interest rates."[1362]

Alternatively, the IRS attempted to convince the court that the transaction constituted a "generic tax shelter" under the test articulated by the Tax Court in *Rose v. Commissioner*.[1363] Stating that the "generic tax shelter" test has never been accepted in the Third Circuit and that, in general, this standard has not been accepted by other circuits as well, the court declined the IRS's attempt to apply the generic tax shelter standard to this case.

Finally, with respect to the four-out-of-seven safe harbor of §264, the court noted that Camelot paid the first three premiums through a combination of policy loans (about 88%) and cash (about 12%). Premiums in years four through seven were paid from a combination of cash (about 12%) and "loading dividends" (about 88%) and partial withdrawal. The loading dividends assured Camelot of a return of most of the premium it paid after the third policy year. As set forth above, the court found that these loading dividends were not dividends in the usual sense, but rather paper transactions that simply reduced Camelot's cash outlay and were factual shams. The court concluded that because the premiums in years four through seven were sourced from and were the basis for the loading dividends in a circular transaction, the premiums did not occur in reality. Therefore, the court concluded that Camelot did not comply with the "four-out-of-seven test" of §264, which requires payment of level premiums for the first seven policy years, four of which have to be paid without borrowing.[1364]

The court concluded that the interest deductions would be disallowed under §163, in part, because they were created as part of a transaction that was a sham in substance.

b. Third Circuit

The Third Circuit affirmed the trial court's decision.[1365] Consistent with *ACM P'ship v. Commissioner* and *Winn Dixie v. Commissioner*, the Third Circuit applied the unitary analysis and examined both prongs.

With respect to the objective prong, the Third Circuit acknowledged that there are several formulations of this test, and observed that all of these formulations generally address the simple question: "absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way."[1366] The Third Circuit affirmed the lower court's decision that absent tax benefits, the COLI plans would never be profitable.[1367] Similar to the court in *Am. Elec. Power v. United States*, the Third Circuit also compared the present case and *Knetsch v. United States* to illustrate that the COLI transaction had no substance.[1368]

With respect to the subjective prong, the taxpayer revised its argument on appeal and argued that subjective intent is irrelevant for purposes of the economic substance test. The Third Circuit disagreed, however, and held that "From the time of Gregory's analysis of the 'rational business purpose,' courts have evaluated taxpayers' purposes when determining whether a transaction has economic substance."[1369]

Finally, with respect to the loading dividends for years four through seven, the Third Circuit held that:

> A circular netting transaction, where different loans and payments are deemed to occur simultaneously (and thereby offset each other), is not by definition a factual sham. As the District Court pointed out, the simultaneous netting of the payment and the loan with the policy value as collateral that occurred in years 1–3 is common in the industry, and is a transaction with economic substance. [citation omitted] The loading dividends of years 4–7 were similar simultaneous netting transactions that "actually occurred," and are therefore not factual shams. They were not "performed in violation of some of the background assumptions of commercial dealing, for example arms-length dealing at fair market values." *Horn v. Commissioner of Internal Revenue*, 968 F.2d 1229, 1236 n. 8 The fact that these dividends were not industry practice is, however, evidence that they were economic shams.[1370]

Thus, the Third Circuit concluded that the loading dividends were factual shams primarily because they were inconsistent with the industry practice. The court concluded that:

> Camelot's COLI plan lacked economic substance. It fails the objective prong because, outside of tax considerations, the transaction had no net economic effect on Camelot's financial position. It fails the subjective prong because at the time the plan was under consideration and agreed on, all parties focused solely on the tax benefits the plan provided. Ultimately the most damning piece of evidence against Camelot is that the marketing information presented to its executives showed that, absent tax deductions, the plan would lose money. Camelot agreed to the plan know-

[1360] *Id.* at 639.
[1361] *Id.* at 638 (citing *Winn Dixie v. Commissioner*, 113 T.C. at 287–88).
[1362] *Id.* at 639.
[1363] 88 T.C. 386 (1987).
[1364] 254 B.R. at 645–47.
[1365] 301 F.3d 96 (3d Cir. 2002).
[1366] *Id.* at 103.
[1367] *Id.*
[1368] *Id.* at 104.
[1369] *Id.* at 105–06.
[1370] *Id.* at 108.

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ing the tax deductions were the only thing that made it worthwhile.[1371]

4. Am. Elec. Power, Inc. v. United States

a. Facts

The facts in *Am. Elec. Power, Inc. v. United States*[1372] were similar to the facts in *IRS v. CM Holdings*. Both cases involved the same policies, same insurer, same witnesses, and same broker. The taxpayer purchased broad-based leveraged COLI on 20,000 employees, calling for premiums for the first three years to be paid substantially (90%) by loans, and for premiums and interest for the subsequent four years to be paid from dividends and partial withdrawals. Interest after the seventh year would be paid from policy withdrawals. While the amount of death benefit would vary depending on the age of the insured employee, each policy called for an annual premium of $16,667. This premium would generate very high early cash value, which, in turn, would accumulate as quickly as possible the maximum of $50,000 of policy loan indebtedness.

As a result of the deductibility of interest, the tax deferral on cash value buildup, and the tax-free nature of any death benefits, the taxpayer would have positive cash flow and earnings on an after-tax basis for every year for the life of the plan. The plan would be managed to have no net equity at the end of a policy year; that is, the cash surrender value would be entirely encumbered by the policy loans and accrued interest. The plan was to be "mortality neutral," which meant that the cost of insurance in the policies would essentially be offset by death benefits, and vice versa.

b. District Court

Discussing the sham transaction doctrine, the district court first observed that "Courts have recognized two basic types of sham transactions: (1) 'shams in fact,' in which the reported transactions never occurred; and (2) 'shams in substance' in which the transactions 'actually occurred but which lack the substance their form represents.'"[1373] Consistent with the other COLI cases, the IRS argued that some elements of the transaction (loading dividends, policy loans, and partial withdrawals) were shams in fact and that the transaction as a whole was a sham in substance because it was devoid of economic substance apart from the policy loan interest deductions.[1374]

The district court first held that the policy loans were not factual shams because they "were considered real debts of AEP, which had to be repaid when the insured employee died or if the policy lapsed."[1375]

The district court found that the backdating of the loans and the creation of an interest obligation for years four through seven were shams in fact. The court found that they bore no relationship to the insurer's anticipated policy expenses.[1376] The court observed that the loading dividends existed "only to offset most of the premium charges ostensibly due in years four through seven." The premiums for years four through seven were set artificially high to make sure the policies did not violate the four out of seven rule of §264(c)(1). The court concluded that: "The loading dividends were devised as a way to immediately return the unnecessary and excessive portion of the premiums in years four through seven. This so-called dividend was in reality a rebate or reduction of premium. As dividends, they were, therefore, a sham in fact."[1377]

The next step was evaluating the economic substance of the COLI transaction as a whole. Citing *ACM P'ship v. Commissioner*, the district court acknowledged that the prevailing standard in the Sixth Circuit is similar to the one in the Third Circuit, namely the unitary analysis.[1378]

AEP argued that, with respect to the objective economic substance of the transaction, the court should not consider the plan solely on a pre-tax basis, since life insurance has a built-in tax preference of deferred inside build-up.[1379] The court, however, observed that the transaction was entered into for tax purposes; therefore, the court held that "AEP never considered financing its MBL COLI plan with cash but, instead, made its decision to purchase the MBL COLI VIII policies based on projections of after-tax cash flow and earnings generated by the maximum amount of policy loans permitted under the law and the highest policy loan interest rate it thought would pass IRS scrutiny. Therefore, it is appropriate to consider the economic substance of the COLI plan in the usual way by comparing the plan's economic effects on a pre-tax and post-tax basis."[1380]

In its search for objective economic substance, the district court set forth the following test:

> The objective element of the economic sham analysis requires the court to search the transaction to determine whether it has any practical or economic effects, other than the creation of income tax losses. This requires the court to examine the transaction to see if it appreciably affected the taxpayer's beneficial interest except to reduce its tax. An investment in whole life insurance offers two potential economic benefits: 1) a death benefit which exceeds the cost of insurance in the event of the premature death of the insured person and 2) the accumulation of tax-deferred inside buildup. Mortality neutrality and zero net equity eliminated both of these economic benefits in the AEP COLI plan.[1381]

Although cash value life insurance policies generally can provide death benefits in excess of the cost-of-insurance and a tax-deferred growth of the cash value, the mortality neutrality of this plan and the managed zero net equity eliminated both such benefits. Therefore, the court concluded that the plan did not appreciably affect AEP's beneficial interest except to reduce its tax.[1382]

Next, the district court addressed the taxpayer's business purpose for participating in the COLI plan. The court accepted

[1371] *Id.* at 102–03.
[1372] 136 F. Supp.2d 762 (S.D. Ohio 2001).
[1373] 136 F. Supp.2d at 779–80.
[1374] *Id.* at 780.
[1375] *Id.*
[1376] *Id.* at 783.
[1377] *Id.*
[1378] *Id.* at 786.
[1379] *Id.*
[1380] *Id.* at 786–87.
[1381] *Id.* at 787.
[1382] *Id.* at 787–88.

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that AEP purchased the COLI plan for the purpose of funding employee benefits but found that this was irrelevant because the correct issue was "whether the transaction had a purpose other than creating tax deductions, not how the taxpayer intended to use the tax-driven proceeds." In short, the court held that AEP's intended use of the COLI cash flows is irrelevant to the subjective prong of the economic substance analysis. "If a legitimate business purpose for the use of the tax savings were sufficient to breathe substance into a transaction whose only purpose is to reduce taxes, then every sham tax-shelter device might succeed."[1383]

The district court compared between the present case and *Knetsch v. United States*,[1384] where the taxpayer managed an annuity in a similar fashion to the way AEP managed its COLI plan; that is, the taxpayer borrowed heavily against the plan, leaving virtually no equity in the cash value. The borrowings wiped out the potential benefits of the annuity, which would have been substantial payments in future years. The only real benefit to the taxpayer was the interest deductions, which were disallowed.

The district court observed that:

> The similarities between Knetsch's annuity transactions and the AEP COLI VIII plan are striking. They include first-day, first-year loans, which paid for all but a small percentage of the total premium and generated substantial interest deductions. There was a pattern of annual borrowings, which consumed nearly all of the equity in the annuity bonds and produced even more tax-deductible interest expense. The potential economic benefit of the annuity bonds, substantial annuity payments thirty years hence, was wiped out by the borrowings. The only real benefit to Knetsch was the tax deductions. [footnote 15 omitted] Although three Justices dissented in *Knetsch*, it remains the law of the land and this court can find no principled way to distinguish the essential features of the AEP MBL COLI VIII plan from the essential features of the annuity transactions in *Knetsch*.[1385]

Finally, a critical point for all COLI cases was the four-out-of-seven safe harbor of §264, which requires that no part of four of the first seven premiums may be paid in whole or in part by means of indebtedness. The court observed that implicit in this rule is that the premiums in the first seven years have to be level. AEP used loading dividends and withdrawals to pay the premiums in years four through seven. The Court found those loading dividends to be a factual sham. In fact, the real premiums in years four through seven were a small fraction of the premiums in years one through three. Thus, the court concluded that AEP violated the four out of seven rule, and, therefore, the interest deductions were not allowable under §264(a)(3).[1386]

In conclusion, the court found that the first-year policy loans, the loading dividends, and corresponding portions of the premium charges in years four through seven were factual shams. The court also found that the whole plan was a sham in substance.[1387]

c. Sixth Circuit

The Sixth Circuit affirmed the district court's decision. The Sixth Circuit first stated that the relevant standard in the Sixth Circuit is the unitary analysis.[1388] The Sixth Circuit also examined whether the COLI plan constitutes "economic sham" (a standard similar to the economic substance test). The court observed that "[t]he main non-tax benefits insurance plans generally offer are mortality gains to the beneficiary, who does not pay tax on proceeds, and interest-free inside build-up [the accrual of interest on the policy value] … AEP was unable to realize either benefit on its COLI plan, however, because the plan was mortality-neutral and had zero net equity at the end of each policy year."[1389]

Turning to the business purpose prong, the Sixth Circuit affirmed the District Court's decision that the subjective prong applies to "the taxpayer's subjective intent with respect *to the transaction itself*, not its intent with respect to potential uses for the tax savings to be derived from a sham transaction."[1390] (Emphasis in original) Thus, the court affirmed that intent to use the tax savings for a business purpose is not a part of the economic substance inquiry.

Finally, the Sixth Circuit held that the district court erred in deciding that the dividends in years four through seven were factual shams. Citing *CM Holdings*, the Sixth Circuit observed that factual shams are "'transactions' that never actually occurred."[1391] The court stated that "there is nothing in the record indicating that [the dividends] did not actually occur. The district court's holding therefore seems to be extending the factual-sham doctrine beyond its generally accepted definition."[1392]

Thus, although the results remain the same, the Sixth Circuit held that no part of the COLI transaction in this case was a factual sham.

The taxpayer's motion for rehearing was denied by the Sixth Circuit.[1393] In addition, the United States Supreme Court denied certiorari.[1394]

5. Dow Chem. Co. v. United States

A U.S. district court in Michigan held that the IRS improperly disallowed Dow Chemical's interest deductions on the company's COLI plans.[1395] The court applied the economic substance doctrine and held that the transaction was neither a "sham in substance" nor a "sham in fact." However, the Sixth

[1383] *Id.* at 791–92.
[1384] 364 U.S. 361 (1960).
[1385] 136 F. Supp.2d at 793.
[1386] *Id.* at 794–95.
[1387] *Id.* at 795.
[1388] 326 F.3d at 741 (citing *Rose v. Commissioner*, 868 F.2d at 853 ("In [the sixth] circuit, the proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses. A taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to this inquiry.")).
[1389] *Id.* at 742.
[1390] *Id.* at 744.
[1391] *Id.* at 745 (citing *In Re CM Holdings*, 301 F.3d at 108).
[1392] *Id. See also In Re CM Holdings*, 301 F.3d at 108 ("The loading dividends of years 4–7 were similar simultaneous netting transactions that 'actually occurred,' and are therefore not factual shams.").
[1393] 338 F.3d 534 (6th cir. 2003).
[1394] 540 U.S. 1104 (2004).
[1395] *Dow Chem. Co. v. United States*, 250 F. Supp.2d 748 (E.D. Mich. 2003).

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Circuit reversed and remanded the district court decision and held that the COLI plans were economic shams and that the IRS properly disallowed Dow's deductions.[1396]

a. Facts

During the years 1988–1991, Dow Chemical Co. ("Dow") purchased COLI policies on its upper-management and other employees. The manager's insurance required annual premiums of $10,000, and the employees' policies each required eight level annual premiums of $10,000. Dow took policy loans to pay the premiums for all of the policies for the first through third and eighth and ninth policy years. With respect to years four through seven, Dow took partial withdrawals to pay the premiums on the policies for these years. On Dow's 1989–1991 returns it claimed deductions for interest payments on the loans and consulting fees for the administration of the policies. The IRS disallowed the deductions. Dow asserted that the COLI plans complied with the tax law when they were purchased and that expenses in developing the plans should, therefore, be deductible as ordinary and necessary business expenses. The IRS claimed that the COLI plans lacked economic substance and had no real economic effect other than to create tax deductions. In addition, the IRS argued that the plans failed §264(c)(1)'s four-of-seven test as factual shams because the premium payments were circular transactions paid by policy withdrawals. Finally, the IRS asserted that Dow had no insurable interest on the lives of the employees covered by the policies.

b. The Decision

The court rejected most of the IRS's arguments and held for the taxpayer. The court determined that although the tax deductions were taken into consideration, Dow's COLI plans had real economic effect.[1397] The court contrasted this case from the plans in the previous COLI cases, *IRS v. CM Holdings, Inc.*,[1398] *Winn-Dixie*,[1399] and *Am. Elec. Power, Inc. v. United States*[1400] and concluded that as opposed to the facts in these cases, the present transaction did not lack economic substance.

Focusing on the question whether the transaction had real potential for profit, the court acknowledged that the policies would produce positive pre-tax cash flow after 18 years,[1401] and that such expected cash-flows were consistent with subjective business purpose. The court also found that over the life of the plans, Dow would realize substantial economic gain from the inside buildup on the policies.[1402] The court also rejected the IRS's assertion that the policy loan transactions were circular transactions and concluded that the loans were real and consistent with commercial norms.[1403] However, the court determined that the partial withdrawals were factual sham transactions.[1404]

(1) Economic Substance Analysis

The court began its economic substance analysis with thorough discussions on *Gregory v. Helvering*[1405] and *Knetsch v. United States*.[1406] The court acknowledged that under the economic substance standard, the three previous challenges to similar highly leveraged COLI plans were devoid of economic substance.[1407] The court, however, cited another case, *Campbell v. Cen-Tax*,[1408] where a comparable transaction was upheld. In *Campbell*, the court concluded that even though the taxpayer had substantial tax-saving motive, this motive was not the taxpayer's sole motive because the taxpayer could reasonably expect positive cash-flows after 20 years. The district court observed that *Campbell* was adopted by the Sixth Circuit in *Woodson-Tenent v. United States*.[1409]

(2) Sham Transaction Analysis

The court restated two types of sham transaction standards: (i) "sham in substance," which is the general two-prong economic substance standard and (ii) "sham in fact" in which the disputed transaction really never occurred.[1410]

(3) Sham in Substance

The district court started with the two-prong test, stating that a transaction has economic substance if it satisfies both objective and subjective standards.[1411] In applying this standard, the court focused on the taxpayer's profit motive — whether, objectively, the taxpayer had reasonable possibility for profit, and, subjectively, did the taxpayer intend to make such a profit. Because the cash-flows analysis reveals that the transaction could generate positive cash-flows after 18 years,[1412] the court held that the taxpayer:

> [h]as established by a preponderance of the evidence that both its Great West and MetLife COLI plans were imbued with economic substance. The plans had substantial effects on the beneficial interest of the taxpayer apart from the income tax deductions. Although, from a subjective standpoint, tax deductions were discussed and considered by Dow's COLI task forces, focus on the tax deductions themselves did not predominate. In this respect, this case differs markedly from the prior COLI cases in which "the marketing information presented to [the other taxpayers'] executives showed that, absent tax deductions, the plan would lose money [, but they] agreed to the plan knowing the tax deductions were the only thing that made it worthwhile." *In re CM Holdings*, 301 F.3d at 103. Dow's COLI plans are not economic shams.

[1396] *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007).

[1397] 250 F. Supp.2d at 811.

[1398] 301 F.3d 96 (3d Cir. 2002).

[1399] 254 F.3d 1313 (11th Cir. 2001).

[1400] 136 F. Supp.2d 762 (S.D. Ohio 2001).

[1401] *Id.* at 806. The court contrasted this factual circumstance with *IRS v. CM Holdings*, 254 B.R. at 629, in which pre-tax cash flow was negative until year 53.

[1402] *Id.* at 807.

[1403] *Id.* at 813.

[1404] *Id.* at 815.

[1405] 250 F. Supp.2d at 796–77 (citing *Gregory v. Helvering*, 293 U.S. 465 (1935)).

[1406] *Id.* at 797–98 (citing *Knetsch v. United States*, 364 U.S. 361 (1960)).

[1407] *Id.* at 798–99.

[1408] 377 F.2d 688 (5th Cir. 1967).

[1409] 250 F. Supp.2d at 799 (citing *Woodson-Tenent Labs., Inc. v. United States*, 454 F.2d 637 (6th Cir. 1972)).

[1410] *Id.* at 799.

[1411] *Id.*

[1412] *Id.* at 806. The court observed that expected positive cash-flows after 18 years are reasonable for this kind of transaction.

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(4) Sham in Fact

The IRS argued that the loans and premiums in years 1–3 and 8–9, and the partial withdrawals and premiums in years 4–7, constituted "circular" cash-flows. The district court held that "the policy loans were real transactions consistent with commercial norms, and therefore were not factual shams."[1413] The court, however, concluded that with respect to the partial withdrawals, the cash-flows were circular, and therefore this portion of the transaction was a sham in fact. As the district court elaborated:

> The problem with [the partial withdrawals] does not stem from the practice of netting the withdrawals against the premium obligation. Rather, the transaction was a sham because there was no value in the policy that could be withdrawn to pay the premium, according to the limitations in the respective insurance contracts. Unlike the policy loans, which were made from the insurance company's general funds, the source of the partial withdrawals must be the accessible cash value in the policies themselves … . Since the unencumbered cash value in the policies at the beginning of the fourth through seventh years was zero, there was nothing available to withdraw or to offset against the premium obligation. There was no basis upon which the premiums for that year could be "deemed" paid, except for the 10% that did not look to the partial withdrawal as the source of payment. The "payment" of 90% of the premium was not real, since it essentially came from nothing. That portion of the transaction in each plan, therefore, was a sham in fact.[1414]

Despite the latter conclusion, the court held that the taxpayer's COLI transaction had economic substance and allowed the deductions. In a motion for amendment of the decision submitted by the Government, the Government argued that the decision pertaining to the partial withdrawals should have resulted in disallowance of the interest deductions for years four through seven.[1415] The district court reexamined its previous decision pertaining to the partial withdrawals. The decision on the motion was issued after the Sixth Circuit affirmed the district court's decision in *Am. Elec. Power Co. v. United States*.[1416] First, the district court observed that both the Sixth (in *AEP*) and Third Circuits (in *IRS v. CM Holdings, Inc.*) held that the factual sham analysis "focuses simply on whether the transactions actually occurred."[1417] Although both circuits made this determination in dictum, the district court stated that the similarity of facts in all cases should provide support for following the Court of Appeals' dictum. Thus, the district court amended its prior decision and held that "the transactions which comprised the partial withdrawals actually occurred and caused real economic consequences. Accordingly, they do not fit within the revised definition of 'sham in fact.'"[1418] As a result, the Government's motion on this point became moot. The district court denied the other Government's motions and did not further amend its decision.

c. Sixth Circuit

The Sixth Circuit relied on *Knetsch v. United States*[1419] and reversed the lower court's decision,[1420] mainly on the grounds that the future positive cash flows should have been ignored. The Sixth Circuit elaborated that future profits may be relevant in evaluating whether a transaction has economic substance only if such profits are contingent on the taxpayer's action, which is consistent with the taxpayer's actual past conduct. Accordingly, the Sixth Circuit held that the district court properly considered whether Dow's plans would be profitable in the future, but erred in considering positive cash flows that were contingent on Dow's eventual spending of significant amounts of cash. The court found that the COLI plans would become profitable only upon Dow's large future outlay of additional cash, which would be a significant departure from Dow's past conduct.

Citing the previous COLI cases, the Sixth Circuit further observed that since Dow maintained very little equity, the District Court erred in its analysis of the potential profit from the inside build-up. The Sixth Circuit held that Dow would have been unable to realize the benefit of inside build-up.

Finally, the Sixth Circuit concluded that the district court erred in finding that the COLI plans were not mortality neutral because neither one "contain[ed] a 100% retrospective adjustment mechanism." The court stated that the COLI plans were designed to reduce Dow's ability to realize mortality gains. The Sixth Circuit found sufficient similarity between the present case and the other COLI cases and held that Dow would not significantly benefit from mortality gains.

Comment: In a dissent, Judge Ryan stated that the primary question in this case is what the taxpayer intended. Judge Ryan observed that the district court made two findings of fact: (1) Dow intended to realize the benefits of tax-deferred inside buildup; and (2) Dow intended to transfer mortality risk to the insurers. Judge Ryan concluded that the district court correctly concluded that, unlike the other three COLI cases, Dow's plans had economic substance.

Judge Ryan elaborated that the district court correctly applied the economic substance doctrine, as it has been applied in the Sixth Circuit.

D. Lease Stripping Cases

1. Andantech, LLC v. Commissioner

a. Facts

In *Andantech, LLC v. Commissioner*,[1421] the Tax Court disallowed losses from a lease stripping transaction. Andantech, LLC (treated as a partnership for U.S. federal income tax purposes) was formed by two Belgian individuals with

[1413] *Id.* at 813–14.
[1414] *Id.* at 815.
[1415] *Dow Chem. Co. v. United States*, 278 F. Supp.2d at 847.
[1416] *Am. Elec. Power Co. v. United States*, 326 F.3d 737 (6th Cir. 2003).
[1417] 278 F. Supp.2d at 849–50 (citing *Am. Elec. Power Co.*, 326 F.3d at 745 and *IRS v. CM Holdings*, 301 F.3d at 108).
[1418] *Id.* at 850.
[1419] 364 U.S. 361 (1960).
[1420] *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007).
[1421] T.C. Memo 2002-97.

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$200,000 of equity ($196,000 by one partner and $4,000 by the other) and a $14.9 million loan from a Swiss Bank. Andantech purchased computers from Comdisco for $14.9 million in cash and $107 million in notes and leased them back to Comdisco for 36 months. The computers were re-leased to end-users. Andantech sold the rents due from Comdisco to a U.S. bank for $87.8 million. This sale resulted in redemption of $87.8 million of the notes due from Andantech to Comdisco, leaving approximately $19.5 million of the notes outstanding.

Shortly after, the Belgian members assigned their interests in Andantech to U.S. entities (2% to an entity ultimately owned by a charitable trust and 98% interest to RDL Leasing, Inc.). In return for the assignment, the assigning members holding 98% interest received preferred shares in RDL that provided for a 6.878 dividend rate and a liquidation preference or $615,000. The loan from the Swiss Bank was accelerated by virtue of the assignment; therefore, the new domestic members contributed capital to repay the loan. The members treated the assignments of interests as a termination of a partnership; therefore, the income from the sale of the rent income would not be subject to U.S. tax. RDL viewed its basis in Andantech the same as the transferor's basis under §362(a). Andantech treated the assignment of interests as a deemed distribution and re-contribution of partnership property to a *new partnership* under Reg. §1.708-1(b)(1)(iv). Accordingly, Andantech took the view that it has a substituted basis in the computers equal to the computers' adjusted basis in the hands of the contributing partners, and that such computers are eligible for depreciation in the hands of the new U.S. partners.

b. Tax Court

The Tax Court disallowed the tax benefits under a number of theories. First, the Tax Court observed that Andantech did not constitute a valid partnership for federal income tax purposes because the partners never intended to join together for the purpose of carrying on a business and sharing in the profits and losses from an equipment leasing activity. The Tax Court tested the economic substance of the partnership over two separate periods: the period when the Belgian members held the interests[1422] and the period when the U.S. members held the interests.[1423] Citing *Commissioner v. Tower* and *ASA Investerings P'ship v. Commissioner*, the Tax Court concluded that:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses [citation omitted]. When the existence of an alleged partnership is challenged, the question arises whether the partners truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.[1424]

The Tax Court observed that for this purpose, "'[b]usiness activity' excludes activity whose sole purpose is tax avoidance."[1425] Accordingly, the Tax Court held that "[t]he record reveals that Andantech-Foreign was not created for the purpose of carrying on a trade or business but rather to strip the income from the transaction and avoid U.S. taxation. Consequently, we will not recognize Andantech-Foreign as a partnership for Federal income tax purposes."[1426]

Second, the Tax Court applied the step transaction doctrine and concluded that even if Andantech constituted a valid partnership for federal income tax purposes, the period when Andantech was owned by the Belgian members, through the sale of the rent income, should be disregarded under the step-transaction doctrine because the involvement of the Belgian members was merely to act as a shell or conduit to strip the rental income from the overall transaction.[1427]

The Tax Court observed that "Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result."[1428] To illustrate the application of the step transaction doctrine in general, and how it would ultimately apply to the current case, the Tax Court elaborated:

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. [Citation omitted.][1429]

Under this standard, thus, the Tax Court held that the transaction should be treated as directly between Comdisco and RDL (the majority U.S. member who would enjoy the rental income as well as deductions associated with the computers). The Tax Court discussed all three alternative tests under the step transaction doctrine (binding commitment, end result and interdependence test) and held that "More than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate."[1430] The Tax Court first turned into the binding commitment test and observed that "Because the transactions in the present case do not span a long period of time or involve a binding commitment to pursue successive steps, we do not analyze them under the binding commitment test. Thus, in this case, only the end result and interdependence tests are relevant to our step transaction analysis."[1431]

The Tax Court continued and applied the end result test. The Tax Court first explained the application of the end result test: "The end result test combines into a single transaction sep-

[1422] *Id.* at 91–3.
[1423] *Id.* at 93–96.
[1424] *Id.* at 91 (citing *Commissioner v. Tower*, 327 U.S. at 286 and *ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000)).
[1425] *Id.* at 91, citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512.
[1426] *Id.* at 95, citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 512.
[1427] *Id.* at 96.
[1428] *Id.* at 98.
[1429] *Id.* at 97.
[1430] *Id.* at 99.
[1431] *Id.* at 101.

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arate events that appear to be components of something undertaken to reach a particular result. [citations omitted] Under the end result test, if we find that a series of closely related steps in a transaction is merely the means to reach a particular end result, we will not separate the steps but instead will treat them as a single transaction."[1432] Applying this standard to the present case, the Tax Court observed that it must examine "whether Comdisco and Norwest intended from the outset to transfer the benefits and burdens of the sale-leaseback of the equipment to RD Leasing."[1433] Accordingly, the court continued "[i]f the intended end result was for RD Leasing to have those benefits and burdens, then petitioners cannot claim a right to favorable tax treatment for the various intermediate transactions leading up to that intended result."[1434]

The Tax Court concluded that "The record clearly indicates that every step taken by the parties (the formation of Andantech, the sale-leaseback of the equipment between Comdisco and Andantech, the sale of the Comdisco rents to NationsBank, and the contribution by Mr. Parmentier of his interest in Andantech to RD Leasing) were but transitory steps."[1435]

Finally, the Tax Court reached the same result under the interdependence test. First, the Tax Court explained the essence of this test: "The interdependence test requires a court to find whether the individual steps had independent significance or had meaning only as part of the larger transaction."[1436] Reviewing all the steps of the transaction, the Tax Court concluded that:

> Standing alone, none of the individual steps in the transaction at issue is the type of business activity one would expect to see in a bona fide, arm's-length business deal between unrelated parties, and none of them makes any objective sense standing alone without contemplation of the subsequent steps in the transaction. Each step in the transaction leads inexorably to the next. Consequently, the interdependence test is satisfied for application of the step transaction doctrine.[1437]

The next step in the Tax Court's analysis involved an economic substance/business purpose analysis of the sale-leaseback transaction. The Tax Court held that even if Andantech constituted a valid partnership for federal income tax purposes, the sale-leaseback should be disregarded because it too lacked economic substance. Thus, the Tax Court separated between the substance of the *partnership* and the substance of the partnership's *transactions* (although it reached the conclusion that neither had substance).[1438]

In evaluating the economic substance of the sale-leaseback transactions, the Tax Court (whose decision was appealed to the D.C. Circuit) followed the D.C. Circuit's decision in *Horn v. Commissioner*,[1439] applied the disjunctive test, and concluded that "the sale-leaseback should not be respected for tax purposes because (1) no reasonable possibility for profit existed, and (2) RD Leasing was not motivated by any business purpose other than obtaining tax benefits."[1440]

The Tax Court applied the profit potential test under the objective prong. Focusing solely on the residual value of the leased computers in comparison with the projected balance due on the balloon notes (an analysis consistent with most lease cases discussed herein), the Tax Court observed that:

> [A]t the time of the transaction, the estimated residual value of the equipment for the final termination dates was no greater than $10,616,524 and for the early termination dates was no greater than $25,626,591. The projected balance due on the balloon notes at the end of the full term of the lease was $20,335,186, and at the early termination date the projected balance was $25,582,611. Consequently, RD Leasing had no realistic potential to recover its investment or to earn a pre-tax profit. In sum, we conclude that under the objective economic substance test, the leveraged sale-leaseback transaction involved herein had no reasonable opportunity for economic profit.[1441]

Turning to the subjective business purpose prong, the Tax Court first acknowledged that "[t]he proper inquiry for the business purpose test is 'whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved.'"[1442] The Tax Court observed that in making the business purpose determination, several factors are important: (1) The presence or absence of arm's-length price negotiations; (2) the relationship between the selling price and the fair market value; (3) the structure of the financing; (4) the degree of adherence to contractual terms; (5) the reasonableness of the income and residual value projections; and (6) the insertion of other entities.[1443]

Examining these six factors in detail, the Tax Court concluded that (1) there was no evidence of any arm's-length negotiations by anyone in connection with the disputed transaction;[1444] (2) the selling price and fair market value of the computers had little effect on the transaction's profitability;[1445] (3) most of the purchase price of the computers was financed by debt functionally identical to nonrecourse obligations;[1446] (4) the parties did not adhere to the contractual terms;[1447] (5) at the

[1432] *Id.* at 101–02.
[1433] *Id.* at 103.
[1434] *Id.*
[1435] *Id.* at 103–04.
[1436] *Id.* at 106.
[1437] *Id.* at 111.
[1438] *Id.* at 114. *See also ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) (The Tax Court and the D.C. Circuit applied a separate analysis for the transaction's substance and the entity's substance).
[1439] 968 F.2d 1229 (D.C. Cir. 1992).
[1440] T.C. Memo 2002-97 at 116, citing 968 F.2d at 1237 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and [2] that the transaction has no economic substance because no reasonable possibility of profit exists.").
[1441] *Id.* at 129–30.
[1442] *Id.* at 131 (citing *Shriver v. Commissioner*, 899 F.2d at 726).
[1443] *Id.*
[1444] *Id.* at 133–34.
[1445] *Id.* at 134.
[1446] *Id.* at 137–38. Such a disproportionately large amount of nonrecourse debt indicates that a transaction lacks economic substance. In addition, the cost of computers, financing of the purchase price, rents, and estimated residual values, were manipulated to project a pre-tax profit. Thus, "there was no substance to the financing of the transaction."
[1447] *Id.* at 140–41.

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time the transaction was entered into, the parties did not reasonably believe that an economic profit was attainable and that a genuine risk of loss existed;[1448] and (6) the parties created and/or used various intermediate entities to participate in the sale-leaseback transaction in order to strip the income from the transaction and for no other valid business purpose.[1449]

The Tax Court concluded, accordingly, that there was neither economic substance nor business purpose for the sale-leaseback transaction.

Finally, the Tax Court examined whether the sale from Comdisco to the taxpayer constituted a "sale" for federal income tax purposes. The Tax Court stated the basic principle pursuant to which "[a] sale-leaseback will not be respected for Federal tax purposes unless the lessor retains significant and genuine attributes of a traditional owner-lessor. [citations omitted] Accordingly, it is the existence of the benefits and burdens of ownership that determines how a sale-leaseback agreement will be treated for tax purposes."[1450] The Tax Court then enumerated the typical factors in determining whether a taxpayer is the owner of property and held that Comdisco never intended to permanently transfer ownership of the computers.[1451] Moreover, the Tax Court observed that the nonrecourse seller financing did not constitute genuine indebtedness because there was no realistic possibility that the notes would be paid in full due to unrealistic residual value projections for the computers.[1452]

c. D.C. Circuit

The D.C. Circuit affirmed the Tax Court's decision that the partnership formed to engage in a lease stripping transaction should be disregarded for tax purposes.[1453] The D.C. Circuit only focused on the economic substance of the partnership, and agreed with the Tax Court that the record established that the parties never intended to join together as partners to run a business and that the partnership had no legitimate non-tax purpose. The D.C. Circuit followed its decision in *ASA Investerings P'ship v. Commissioner* and stated that "the absence of a non-tax business purpose for a partnership is fatal to its validity."[1454]

Comment: The D.C. Circuit affirmed the Tax Court's decision that the partnership had no economic substance. The D.C. Circuit did not address the remaining Tax Court holdings invalidating the entire transaction on economic substance and similar grounds. Instead, the D.C. Circuit remanded the case to the Tax Court to determine whether the Tax Court had jurisdiction to decide the tax consequences of the individual "partners" on a separate taxpayer basis.

2. CMA Consolidated Inc. v. Commissioner

a. Facts

CMA Consol. Inc. v. Commissioner[1455] involved equipment leasing transactions and the structuring of equipment financing. During the early 1990s, the taxpayer began to arrange deals designed to separate equipment rental income from the related rental expenses. In those deals, the rental income was allocated to a tax-indifferent or tax-neutral party in order to allow another party to claim a greatly disproportionate share of the related tax benefits. The specific lease stripping transaction in this case involved computer and photo processing equipment, which was subject to two existing end-user leases and a prior lease stripping arrangement. An "upper lease" interest was created between the equipment owner and the existing head lease and user lease. The arrangement involved the purchase of the lease by a partnership where 99% of the taxable income resulting from a "rent sale to finance" the purchase was allocated to a tax-exempt Indian nation. The property then was transferred to the taxpayer in exchange for preferred stock of minor value. As structured, the lease strip interest was intended to generate over $4.2 million of potential tax deductions at an out-of-pocket cost of $40,000.

b. Economic Substance Analysis

The Tax Court held that the lease stripping transactions should be treated as lacking economic substance.[1456] Similar to the analysis in *Andantech LLC v. Commissioner*, the factual circumstances in this case consisted of a "Byzantine labyrinth of complex transactions," the Tax Court said.[1457] The Tax Court further noted that most of the transactions were undertaken solely to achieve a tax effect.[1458]

In evaluating whether the transaction lacked economic substance, the court applied the two-pronged inquiry: (1) A subjective inquiry as to whether the transaction(s) was carried out for a valid business purpose and (2) an objective inquiry concerning the non-tax economic effect of the transaction(s).[1459] The Tax Court noted, however, that "the two tests have much in common and are not necessarily discrete prongs of a 'rigid two-step analysis.'" (i.e., the "unitary" or flexible analysis).[1460] Similarly to *ACM P'ship v. Commissioner*, *Sheldon v. Commissioner* and *Rice's Toyota World v. Commissioner*, the court focused on the profit potential test in applying both prongs. Most notably, the court observed that "De minimis or inconsequential pre-tax profits relative to a taxpayer's artificially and grossly inflated claim of potential tax benefits may be insufficient to imbue an otherwise economically questionable transaction with economic substance."[1461]

[1448] *Id.* at 143.
[1449] *Id.* at 144.
[1450] *Id.* at 147.
[1451] *Id.* at 147–48.
[1452] *Id.* at 148–50.
[1453] 331 F.3d 972 (D.C. Cir. 2003).
[1454] 331 F.3d at 979–80 (citing *ASA Investerings P'ship v. Commissioner*, 201 F.3d at 513).
[1455] T.C. Memo 2005-16.
[1456] *Id.*
[1457] *Id.* at 65.
[1458] *Id.*
[1459] *Id.* at 69 (citing *ACM P'ship v. Commissioner*, 157 F.3d at 247–248; *Casebeer v. Commissioner*, 909 F.2d at 1363; *Kirchman v. Commissioner*, 862 F.2d at 1490–1491).
[1460] *Id.* (citing *Casebeer v. Commissioner*, 909 F.2d at 1363).
[1461] *Id.* at 70 (citing *ACM P'ship v. Commissioner*, at 257; *Sheldon v. Commissioner*, 94 T.C. at 767–68).

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With regard to the first prong of this test, the taxpayer argued that it expected to earn a pre-tax profit from the equipment rental income or the income produced from disposition of the residual interests. The court found that the taxpayer's behavior was "inconsistent with a genuine pre-tax profit motive for entering into the second lease strip deal."[1462] The court further held that the lease strip deals in this case "are mere tax-avoidance devices or subterfuges mimicking a leasing transaction."[1463] The court further noted that the obvious purpose was to obtain unwarranted and substantial tax benefits. The taxpayer could only enjoy a return from the lease rentals after expiration of the user leases and prior to the ultimate equipment return but the documents were incorrectly drafted with incorrect dates that eliminated this period entirely, thus even though taxpayer argued that this should be corrected, the fact that no attention was paid to the error, which was never corrected, is evidence that the taxpayer had no interest in the underlying leasehold interest.[1464]

With regard to the second prong, the court stated that under the objective prong, it must "examine the potential for economic profit" from the disputed transaction.[1465] Obviously, the taxpayer's expert attempted to prove that the taxpayer could have reasonably expected a profit from the transaction, while the government's expert argued that there was no realistic profit potential. The court concluded that the IRS's appraisal expert was correct in determining that there was no expectation of any residual value even if the drafting error were corrected, thus there could be no reasonable expectation of a more than de minimis pre-tax return.[1466] Furthermore, in reaching the conclusion that the transaction "did not have any objectively demonstrable, practical economic profit potential" for the taxpayer, the court also observed that the disputed transaction was consummated through various entities, a number of which either were related to, or were owned and/or controlled by others who regularly cooperated with, the taxpayer.[1467] The court also noted that the other participants involved in the lease strip deals, in most instances, were not acting at arm's length and shared a common interest in inflating the values of the underlying equipment and the values of the leases and residual interests to generate substantial potential tax benefits for the ultimate beneficiaries/customers.[1468] As such, the court held that the second lease strip lacked objective economic substance.

The court briefly discussed the economic substance of the debt issued in connection with both lease strip deals, and observed that even if debt were labeled a "recourse" note, it could be treated as nonrecourse debt and be disregarded if the expectation of repayment of such debt is illusory and unrealistic.[1469] The court concluded that the creditor had no intention of enforcing its right for repayments, while it was questionable whether the borrowers possessed sufficient resources to meet their respective obligations. Thus, the court disallowed the interest deduction on the debt.[1470]

c. Accuracy-Related Penalties

The court further imposed penalties on the taxpayer for negligence and valuation overstatement.[1471] The taxpayer argued that it had relied on a tax opinion and appraisal information provided to the original lease strip investors in the equipment but did not receive any such assurance itself. The court determined that this did not rise to reasonable cause or good faith supporting removal of the asserted penalties.[1472]

E. Partnership Cases — TIFD III-E Inc. v. United States

1. Facts

In *TIFD III-E Inc. v. United States*,[1473] the United States District Court in Connecticut (in the Second Circuit) ordered the IRS to refund $62 million to the tax matters partner of Castle Harbour-I LLC, finding that the LLC's creation was not a sham designed solely to avoid taxes.

TIFD III-E is a wholly owned subsidiary of the General Electric Capital Corporation (GECC), a subsidiary of the General Electric Company (GE). GECC leased commercial aircrafts. In 1992, at least partially in response to concerns about the number of airlines going into bankruptcy, GECC decided to create a separate entity to which it would contribute a number of aircrafts.[1474] First, three GECC subsidiaries formed a limited liability company (Summer Street) and transferred to it aircrafts, nonrecourse debt, rents receivable, cash, and all the stock of a GECC subsidiary (TIFD VI) which had zero value. Second, the GECC subsidiaries sold $50 million of their interest in Summer Street to two Dutch banks. The Dutch banks also contributed an additional $67.5 million, bringing their total investment to $117.5 million. Summer Street then changed its name to Castle Harbour-I Limited Liability Company (Castle Harbour), and TIFD VI changed its name to Castle Harbour Leasing, Inc. (CHLI).

The partnership allocations under the operating agreement were as follows: each year the Dutch banks were to have their capital accounts debited or credited, depending on whether the partnership had received a gain or suffered a loss, and each year the Dutch banks were to have a significant portion of their ownership interest bought out by the partnership ("Exhibit E payments"). At the end of eight years, if the Dutch banks' capital accounts had actually earned a rate of return of 9.03587%, the Dutch banks' capital accounts (i.e., ownership interests) would be decreased to near zero. If the Dutch banks' capital accounts were credited at a rate less than 9.03587%, the accounts would

[1462] *Id.* at 84–85.
[1463] *Id.*
[1464] *Id.*
[1465] *Id.* at 86.
[1466] *Id.* at 103-05.
[1467] *Id.* at 106–07.
[1468] *Id.*
[1469] *Id.* at 108–12.
[1470] *Id.*
[1471] *Id.* at 150–57.
[1472] *Id.*
[1473] 342 F. Supp.2d 94 (D. Conn. 2004), rev'd, 459 F.3d 220 (2d Cir. 2006), cert. denied, No. 15-331 (U.S. Jan. 11, 2016). For an in-depth discussion of the case and how the economic substance doctrine applies to the case, see Burke, *Castle Harbour: Economic Substance and the Overall-Tax-Effect Test*, 2005 TNT 104-39 (May 10, 2005).
[1474] The result would be that GECC would trade some of the risks and returns of those aircraft to the outside foreign (tax neutral) investors in exchange for a cash contribution to the newly created entity. The plan was implemented in two stages.

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be negative after eight years, and if the accounts were credited at a rate greater than 9.03587%, the capital accounts would be positive. Positive capital accounts would result in payments to the banks when the partnership wound up and negative accounts would mean the banks owed money to the partnership. If the banks' interests were not liquidated after eight years, the banks would still have their capital accounts credited or debited by allocations of income or loss in successive years.

Castle Harbour was required to maintain "investment accounts" for the Dutch banks. No cash was paid into these accounts; they merely kept track of a hypothetical balance. The opening balance of these accounts was the initial investment made by the Dutch banks, which was to be recalculated at the time the Dutch banks exited the partnership as if every year the balance had been increased by a defined applicable rate but also reduced by the Exhibit E payments. If, when the Dutch banks exited Castle Harbour, the investment account sum exceeded a specific allocation formula, that amount would be paid to the Dutch banks, instead of the amount in their capital accounts.

The operating agreement defined two categories of income: operating income and disposition gains/losses.[1475] Once operating income had been calculated, it was allocated to the capital accounts as follows: if operating income was positive (i.e., an operating gain), it was allocated 98% to the Dutch banks and 2% to the GECC entities. If operating income was negative (i.e., an operating loss), then (a) it was first allocated in an amount sufficient to offset the cumulative disposition gains allocated to any of the partners in previous years; (b) the remainder was then allocated 98% to the Dutch Banks until they had been allocated, cumulatively, $3,854,493 of operating losses; and (c) the rest was allocated 99% to the GECC entities and 1% to the Dutch banks.

Disposition gains and losses were allocated much like operating losses: (a) first, disposition gains were allocated to offset prior disposition losses and prior operating losses; disposition losses offset prior disposition gains; (b) the remainder was then allocated 90% to the Dutch banks until they had been allocated $2,854,493 of either disposition gains or losses; (c) the rest was allocated 99% to the GECC entities and 1% to the Dutch banks.

2. District Court

a. Economic Substance Analysis

The court first outlined the basic principle pursuant to which "a transaction will be deemed a 'sham' and disregarded when calculating taxes if it has no business purpose or economic effect other than the creation of tax benefits [citation omitted]. There is no dispute that the Castle Harbour transaction created significant tax savings for GECC. The critical question, however, is whether the transaction had sufficient economic substance to justify recognizing it for tax purposes."[1476]

The court continued to discuss the two-prong test:

> To determine whether a transaction has economic substance or is, instead, a "sham" a court must examine both the subjective business purpose of the taxpayer for engaging in the transaction and the objective economic effect of the transaction.[1477]

The taxpayer argued that, consistent with other Second Circuit cases, the court must apply the disjunctive test. The Government, however, urged the court to apply the unitary standard. The court asserted that the decisions in the Second Circuit are inconsistent with respect to which test to apply. It also cited *Long Term Capital Holdings v. United States*[1478] as an example for applying the unitary analysis. The court, however, asserted that it did not have to decide which standard to apply because, as the court stated, "under either reading I would conclude that the Castle Harbour transaction was not a 'sham.' The transaction had both a non-tax economic effect and a non-tax business motivation, satisfying both tests and requiring that it be given effect under any reading of the law."

The Government argued that because the return earned by the Dutch banks was essentially guaranteed, they had no risk with respect to the transaction, and this means, according to the Government, that they were not partners. The court dismissed this argument. In return for a significant portion of Castle Harbour's operating income, stated the court, the Dutch banks contributed approximately $117 million dollars, which was used by Castle Harbour's subsidiary CHLI either to purchase aircraft or to retire GECC debt. Although the investment accounts provided the Dutch banks with some guarantee of return, the court held that the *lack of risk* is not enough to make a transaction economically meaningless. The court elaborated that even with an 8.5% guaranteed return, the Dutch banks still participated in the economically real upside of the leasing business. Further, the court asserted that participating in upside potential, even with some guarantee against loss, is economically substantial. Finally, the court observed that the Government's premise that a guarantee of a positive return indicates no risk, is simplistic; whether an investment is "risky" to the investor depends on a number of factors, including the investor's cost of capital and opportunity costs. The court concluded that "[t]he economic reality of such a transaction is hard to dispute."

b. Business Purpose

The court stated that "[i]n evaluating the economic substance of a transaction, courts are cautioned to give more weight to objective facts than self-serving testimony."[1479] The court found that the transaction had a legitimate business purpose; specifically, that GECC entered into the transaction to raise capital and, more importantly, to demonstrate to investors, rating agencies, and GECC senior management that it *could* raise capital on its fleet of aging Stage II aircraft. In light of the economic reality of the Castle Harbour transaction, the court found persuasive the testimony of five GECC executives, who all swore that "demonstrating liquidity" and "monetizing" Stage II aircraft were important motivations. The court found

[1475] Operating income comprised income less expenses. Income was rent and interest on investments. Expenses consisted of normal administrative expenses, interest owed on aircraft debt, depreciation of the aircraft, and guaranteed payments to GECC entities. A disposition gain or loss was the result of the difference between the sale price of an asset, usually an aircraft, and its book value.

[1476] Citing *Newman v. Commissioner*, 902 F.2d at 163.

[1477] Citing *Gilman v. Commissioner*, 933 F.2d at 148.

[1478] 330 F. Supp.2d 122 (D. Conn. 2004).

[1479] Citing *Lee v. Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998).

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the testimony of GECC's executives persuasive. Consequently, it held that GECC was subjectively motivated to enter into the Castle Harbour transaction, at least in part, by a desire to raise capital and a desire to demonstrate its ability to do so.

c. Economic Substance of the Partnership

Alternatively, the Government argued that even if the transaction as a whole had economic substance, for tax purposes the Dutch banks were not partners of the GECC entities but rather were their creditors. The court identified two circumstances under which the Dutch banks would not be considered partners: (1) if there was no economic reality to the label "partner" and (2) if, regardless of the economics of the situation, the Code would simply classify them as something else. The court applied a separate economic substance analysis to the first circumstance, but rather than examining the substance of the entire transaction, it focused on "whether there was any economic reality to the choice of the partnership form." As to the second circumstance, the court held that there is no current authority for it to re-classify an interest in a partnership as something else.

First, the court emphasized that:

> I concluded that the transaction that created Castle Harbour was not a sham. In other words, I concluded there was valid business purpose and economic reality in the arrangement by which the GECC entities and the Dutch Banks came together to form Castle Harbour, *i.e.*, there was economic substance in not only the actions, but also the formation, of the partnership.

The decision to form a partnership, noted the court, may be economically insubstantial, even though the partnership undertakes a legitimate business. Here, the court found that there was economic substance in not only the actions, but also the formation, of the partnership. The court distinguished this case from the situations in *ASA Investerings P'ship v. Commissioner*, mainly on the grounds that in *ASA*, the foreign partners were entirely indifferent to the partnership's activities (because their return was 100% guaranteed), as opposed to the present case where the Dutch banks could have suffered some downside (albeit limited) and could have earned more profit than the guaranteed return. In the present case, the Dutch banks had a very real stake in the transaction because their return was tied directly to the performance of the aircraft leasing business.

3. Second Circuit

The Second Circuit reversed the district court's decision, primarily on the grounds that the Dutch banks were not bona fide equity participants but rather secured lenders.[1480] The Second Circuit concluded that in determining whether the Dutch banks were partners in Castle Harbour for federal tax purposes, the district court erred in relying on the sham transaction doctrine rather than the totality-of-the-circumstances test set forth by the Supreme Court in *Commissioner v. Culbertson*.[1481]

The Second Circuit stated that the district court should not have rejected the government's contention that the Dutch banks' interests were not bona fide equity interests without examining that question under *Culbertson*. The Second Circuit elaborated that the district court erred in conducting the debt/equity analysis when it accepted "at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities."

The court found that the following elements of the transaction supported debt treatment: (1) the rate was an agreed upon rate of return, pursuant to an agreed upon payment schedule; (2) in the event of a default, the Dutch banks had creditors' rights by virtue of the power to liquidate the partnership and to receive their principal at the agreed rate of return; and (3) the payments to the Dutch banks were to be made regardless of the fortunes of the partnership (payments were also guaranteed by GECC).

The court, however, found the following elements to support equity treatment: (1) the Dutch banks ran a small risk of repayment shortfall in the event of a catastrophic loss and (2) the Dutch banks participated in unexpected profits of the partnership. The court noted that the risk of a shortfall was, however, very small. The court also noted that the partnership agreement gave the taxpayer the right to take actions that would severely limit the Dutch banks' ability to share meaningfully in any unexpected profits.

The Second Circuit concluded that

> … the Dutch banks' interest was overwhelmingly in the nature of a secured lender's interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits. The banks had no meaningful stake in the success or failure of Castle Harbour. While their interest was not totally devoid of indicia of an equity participation in a partnership, those indicia were either illusory or insignificant in the overall context of the banks' investment. The IRS appropriately rejected the equity characterization.

The Second Circuit remanded the case to the district court for further proceedings, including consideration of the taxpayer's argument that the partnership was a family partnership. In the case on remand, the district court held that a number of banks were owners of capital interests in a family partnership in which capital was a material income-producing factor, and therefore, the banks were partners. Without denying that *Culbertson* remains good law, the district court on remand nevertheless concluded that a party can fail the *Culbertson* test and still be treated as a partner under §704(e)(1).[1482]

After the 2009 district court decision, the decision was again appealed to the Second Circuit. The Second Circuit overturned the lower court's decision because based on the facts,

[1480] *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006), cert. denied, No. 15-331 (U.S. Jan. 11, 2016). For a discussion on debt/equity distinction in the partnership context, see Dantzler, *Debt vs. Equity in the Partnership Context*, 2006 TNT 20-37 (Jan. 11, 2006).

[1481] Citing 337 U.S. 733, 742 (1949) ("whether, considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.").

[1482] *TIFD III-E, Inc. v. United States*, 660 F. Supp.2d 367 (D. Conn. 2009).

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the partners at issue failed to qualify as partners under both the *Culbertson* test and §704(e)(1).[1483]

Editor's Note: The substance of §704(e)(1) has been moved to §761(b) (definition of a "partner"), effective for partnership tax years beginning after December 31, 2015.[1484] For a further discussion of the definition of "partner," see 710 T.M., *Partnerships — Conceptual Overview*.

F. Restructuring of Business Activity — UPS of America, Inc. v. Commissioner

1. Facts

UPS had engaged in the delivery of packages domestically and overseas. In general, for packages with a value of less than $100, the rate charged by UPS covered loss from damage. For other packages, UPS collected premium (excess value charges or EVC) to packages with a value of more than $100. The amount of these premiums was equal to 25 cents for each additional $100 in value. Thus, the EVCs resembled insurance premiums. In 1983, UPS restructured its EVC treatment. UPS formed an offshore Bermuda subsidiary (OPL) and distributed the subsidiary's stock to its shareholders (equal to one share of OPL stock for each share of UPS stock held) as a dividend. UPS also entered into an agreement with a domestic insurer (NUF) pursuant to which UPS would collect and remit the premiums to NUF.

In December 1983, NUF and OPL entered into a reinsurance contract pursuant to which NUF would remit to OPL the "reinsurance" premiums received from UPS less certain commissions and expenses. NUF was reimbursed for expenses and received a share of the premiums capped at $1 million annually. Prior to 1984, UPS reported the premiums as income and deducted expenses actually paid for damaged packages. Because the premium income earned by OPL was not subject to U.S. tax until the income was repatriated back into the United States (i.e., as a dividend to its shareholders), the transaction would have resulted in deferral of tax on the income attributable to the premiums.

In *UPS of Am., Inc. v. Commissioner*,[1485] UPS argued that NUF earned the EVCs as insurance premium income and that, in turn, OPL earned reinsurance premium income. Accordingly, UPS argued that it did not earn any income with respect to the EVCs.

2. Tax Court

The Tax Court first observed that the separate existence of OPL is not disputed. Thus, the Tax Court stated, the core question was "whether the restructuring of petitioner's EVC activity in 1984 by inserting NUF and OPL as part of the EVC transactions had substance."[1486] The Tax Court observed that because all the disputed transactions actually took place, they are not factual shams.[1487] As to the question whether the transactions were substantive shams, the Tax Court applied the unitary test pursuant to which "The objective and subjective prongs of the inquiry are related factors, both of which form the analysis of whether the transaction had sufficient substance apart from its tax consequences."[1488]

The Tax Court stated that "determination of whether the taxpayer had a legitimate purpose in entering into the transaction involves a subjective analysis of the taxpayer's intent."[1489] UPS argued that it had non-tax business reasons for the restructuring, which was the concern that state insurance regulators might find that UPS conducts an illegal insurance business. The Tax Court dismissed this argument and held that "[n]o contemporaneously prepared documentary evidence was presented to indicate that petitioner had such concerns … ."[1490] The Tax Court concluded that it did "not believe that [UPS] would have restructured a significant portion of its business in order to avoid a potential state law problem without having thoroughly analyzed and considered the matter and the ramifications that any proposed change might have."[1491]

UPS also argued that another business reason for the transaction was to leverage the income from EVC by creating a new reinsurance company (i.e., OPL). The Tax Court dismissed this argument as well, stating that "any investment of money into OPL could accomplish this purpose. The question here is whether petitioner earned, and must pay tax on, the funds ultimately transferred to OPL or whether the EVC profits were earned by NUF and OPL. The purpose for which the profits were ultimately used, or intended to be used, does not answer the question before us."[1492]

Concluding that the transaction had no business purpose, the Tax Court continued and stated that: "Another factor in determining whether a particular transaction was a sham is the presence or absence of arm's-length price negotiations and the relationship between the price and fair market value."[1493] The Tax Court reviewed the experts' reports on the transaction and concluded that "we are persuaded that the price of 25 cents per $100 of excess value liability paid to NUF pursuant to the Shippers Interest contract that petitioner and NUF agreed to was not a result of arm's-length negotiations and that the price of 25 cents per $100 was far in excess of the price that could have been negotiated by petitioner."[1494]

The Tax Court concluded that UPS "has failed to prove that the restructuring of its EVC activity was motivated by nontax business reasons or that the restructuring had economic substance. Rather, we find that the restructuring was done for the purpose of avoiding taxes and that the arrangement between petitioner, NUF, and OPL had no economic substance or business purpose."[1495] In accordance with the determination that the restructuring was a sham transaction, the Tax Court held that UPS was not entitled to deduct the amounts retained by NUF as ordinary and necessary expenses under §162 because "ex-

[1483] *TIFD III-E, Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012), cert. denied, No. 15-331 (Jan. 11, 2016).
[1484] See the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §1102.
[1485] T.C. Memo 1999-268.
[1486] *Id.* at 80.
[1487] *Id.* at 81.
[1488] *Id.* at 80.
[1489] *Id.* at 82.
[1490] *Id.* at 86.
[1491] *Id.* at 92.
[1492] *Id.* at 104–05.
[1493] *Id.* at 122.
[1494] *Id.* at 133.
[1495] *Id.* at 137.

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penses incurred in furtherance of a sham transaction are not deductible."[1496]

3. Eleventh Circuit

The Eleventh Circuit reversed and remanded the Tax Court's decision.[1497] The Eleventh Circuit stated that "Even if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance."[1498] Turning first to the objective prong, the Eleventh Circuit described the economic substance doctrine as follows: "[the] economic-substance doctrine, also called the sham-transaction doctrine, provides that a transaction ceases to merit tax respect when it has no 'economic effects other than the creation of tax benefits.'"[1499] The Eleventh Circuit cited *Frank Lyon Co. v. United States* for the proposition that "The kind of 'economic effects' required to entitle a transaction to respect in taxation include the creation of genuine obligations enforceable by an unrelated party."[1500] Based on this standard, the court concluded that "[t]he restructuring of UPS's excess-value business generated just such obligations. There was a real insurance policy between UPS and National Union that gave National Union the right to receive the excess-value charges that UPS collected."[1501] Thus, the court concluded that the transaction had economic substance.

The Eleventh Circuit continued to the subjective prong. The court first stated the bedrock principle that "A 'business purpose' does not mean a reason for a transaction that is free of tax considerations."[1502] The Eleventh Circuit immediately observed that a transaction has "a 'business purpose' when we are talking about a going concern like UPS, as long as it figures in a bona-fide, profit seeking business."[1503] The Eleventh Circuit also acknowledged that choosing one form over another solely for tax purposes may still satisfy the business purposes test. As the Eleventh Circuit illustrated, when a business chooses between debt and equity financing, there may be no tax-independent reason to choose between these different ways of financing but it does not mean that the taxpayer lacks a business purpose.[1504] The Eleventh Circuit distinguished the facts in this case from the facts in other cases involving economic substance analysis on the grounds that "Many of the cases where no business purpose appears are about individual income tax returns, when the individual meant to evade taxes on income probably destined for personal consumption; obviously, it is difficult in such a case to articulate any *business* purpose to the transaction."[1505] In addition, another group of cases that were identified by the court as having no business purpose were "tax-shelter transactions or investments by a business or investor that would not have occurred, *in any form*, but for tax-avoidance reasons."[1506] (emphasis in original).

The Eleventh Circuit concluded that:

> The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive. True, UPS's restructuring was more sophisticated and complex than the usual tax-influenced form-of-business election or a choice of debt over equity financing. But its sophistication does not change the fact that there was a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure. We therefore conclude that UPS's restructuring of its excess-value business had both real economic effects and a business purpose, and it therefore under our precedent had sufficient economic substance to merit respect in taxation.[1507]

In conclusion, the Eleventh Circuit concluded that the transaction had economic substance and business purpose.

G. High-Basis Low-Value Stock

1. Long Term Capital Holdings v. United States

A United States district court held that a transaction involving the contribution of stock with a built-in loss to a partnership lacked economic substance and had been entered into without any business purpose other than tax avoidance.[1508] Alternatively, the court held that the transaction could be recast under the step-transaction doctrine as a taxable transfer of the loss stock from the contributing partner to the general partner, followed by a sale of the stock by the general partner. Additionally, the court upheld penalties assessed by the IRS despite the taxpayer's argument that it had obtained and relied on two separate law firm "should" level opinions supporting its position.

a. Facts

The essence of the transaction was to allow loss duplication through the contribution by Onslow Trading & Commercial LLC (OTC) of stock with a built-in loss to a partnership, the sale of the contributor's partnership interest to the general partner, and the subsequent sale of the loss stock by the partnership. The stock with the built-in loss (i.e., stock with low value but high tax basis) was created by contributing cash subject to a pre-paid lease obligation to two different corporations in a §351 transaction.[1509]

[1496] *Id.* at 139.

[1497] 254 F.3d 1018 (11th Cir. 2001).

[1498] *Id.*

[1499] *Id.*

[1500] *Id.*, citing 435 U.S. at 582–83.

[1501] *Id.*

[1502] *Id.* at 1019.

[1503] *Id. See also ACM P'ship v. Commissioner*, 157 F. 3d at 251.

[1504] *Id.* at 1019.

[1505] *Id.* (citing for this view *Gregory v. Helvering*, 293 U.S. 465 (1935); *Knetsch v. United States*, 364 U.S. 361 (1960); *Neely v. United States*, 775 F.2d 792 (9th Cir. 1985) (taxpayers formed a trust, controlled by them, and diverted personal earnings to it)).

[1506] *Id.* (citing for this view *ACM P'ship v. Commissioner*, 157 F.3d at 252; *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Karr v. Commissioner*, 924 F.2d at 1023; *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 91).

[1507] 254 F.3d at 1020.

[1508] *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004).

[1509] The key was that the lease obligations were not treated as a liabilities under §357, so the basis in the preferred stock was amount of cash contributed, even though its value was much lower (because it reflected the liabilities).

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During 1996, OTC contributed cash and the loss stock to Long-Term Capital Partners LP (LTCP), a hedge fund, in exchange for a partnership interest in LTCP. OTC borrowed the cash component of its contribution from Long-Term Capital Management UK, a U.K. entity related to Long-Term Capital Management LP (LTCM), the general partner of LTCP. In addition, OTC purchased from LTCM a "liquidity put" and a "downside put" with respect to its interest in LTCP.[1510] In December 1997, LTCP sold some of the preferred stock with a basis of $107 million for approximately $1 million, producing a loss of $106 million, which was allocated to LTCM under §704(c).

Babcock & Brown, which designed the transaction, received a partnership interest in LTCP and a 12-month consulting arrangement for which it was paid $1.2 million.

As manager of the underlying portfolio, LTCM earned fees for assets under management, proportional to the return achieved for the investors. Long Term relied on the additional fees it would earn from both the OTC and the B&B investment to justify its ability to earn a pre-tax profit. The IRS disallowed the loss otherwise allocable to LTCM and assessed penalties.

b. District Court

(1) Economic Substance Analysis

The taxpayer first argued that the standard in the Second Circuit is a disjunctive test. The court, however, held that the prevailing standard in the Second Circuit is the unitary test. Nevertheless, even if the court would have accepted the disjunctive test, it would not matter because the court held that the transaction lacked objective economic substance and also concluded that the taxpayer entered into the transaction without any business purpose other than tax avoidance.

(2) Objective Economic Substance

The taxpayer argued that the objective economic substance test ought to be whether there was a meaningful change in the taxpayer's economic position. The court, however, rejected the argument that a meaningful change in the parties' economic positions is enough to give economic substance. Applying instead a cost v. benefit analysis similar to the one in *Goldstein v. Commissioner*, the court held that LTCM had no realistic expectation of economic profit after taking into account fees. The court reviewed the costs incurred by LTCM with respect to the transaction and held that the taxpayer could not have reasonably expected to generate a pre-tax profit after considering these costs and fees.[1511] With respect to the potential profit, the court considered only the management fees LTCM could earn on the OTC investment, not the B&B/UBS investment, because the latter didn't contribute to the obtaining of the tax benefits. As a result, maximum reasonably expected gross earnings were estimated at $2 million.

(3) Subjective Business Purpose

The court found that the transaction was purely tax-motivated, notwithstanding the parties' efforts to imbue it with a business purpose (earning fees). Most notably, the court asserted that the transaction was brought to the taxpayer as a tax product.

The transaction was far more complex than necessary to accomplish the stated business purpose, which was to bring in a new investor so additional fees could be generated.[1512] The court elaborated with respect to the business purpose subjective standard that Long Term did not carry out the transaction in a way that indicated it had any motive other than tax savings.

(4) Step Transaction Analysis

Alternatively, the court held that under the "end result" test of the step transaction doctrine, the court collapsed the several steps taken by the taxpayer and held that OTC ought to be viewed as if it sold its preferred stock to LTCM, so LTCM had a cost basis in the stock.

(5) Penalties

The court found the taxpayers liable for valuation overstatement and substantial understatement penalties. The court held that the legal opinions did not allow the taxpayers to qualify for the "reasonable cause/good faith" exception to the penalties because: (i) the K&S written opinion was delivered late, and the record did not establish that Long Term had reasonably relied on K&S's oral advice; (ii) there was no evidence that any of the Long Term partners other than Myron Scholes actually read the K&S opinion; (iii) the favorable authorities cited in the K&S opinion were based on facts materially different from those found by the court, so could not be relied upon; (iv) the K&S opinion did not adequately address Second Circuit precedent, nor the "end result" variation of the step-transaction doctrine; and (v) Long Term lacked good faith, as evidenced by the steps it took to conceal the preferred stock losses on its tax return.

c. Second Circuit

In affirming the district Court's decision, the Second Circuit upheld the IRS's imposition of penalties. The Second Circuit found ample evidence in the record to support the District Court's finding that LTCH had made a number of assumptions that it knew to be false and that it was unreasonable for its tax advisors to rely on those assumptions when a reasonably diligent review of the pertinent facts and circumstances would have shown those assumptions to be false.

LTCH argued that the 40% penalty should not be applied because (1) there was not a misstatement of value, only a misstatement of basis; (2) the basis misstatement was the result of a legal dispute, not a factual dispute; and (3) the underpayment was not attributable to the basis misstatement. The

[1510] In general, these puts, each of which could only be exercised on or between October 27, 1997 and October 31, 1997, gave OTC the right to put its interest in LTCP to LTCM for an amount equal to the greater of (i) the value of such interest at the date of the put or (ii) OTC's original capital investment in LTCP. OTC exercised its liquidity put on October 28, 1997, selling its entire interest in LTCP to LTCM for $12,614,188, representing approximately a 22% return on OTC's investment. Of course, no §754 election was made.

[1511] In particular, the costs included legal fees of $1 million, the B&B fee of $1.2 million, the Turlington settlement of $1.25 million, and various internal allocations and bonuses paid to Long-Term principals.

[1512] "[T]he construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees points to Long Term's true motivation, tax avoidance."

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court found that LTCH's arguments were without merit because (1) §6662(e)(1)(A) defines a valuation misstatement to include misstatements concerning the correct amount of the valuation or adjusted basis; therefore, valuation misstatement as it appears in §6662(b)(3) includes both valuation and basis misstatements; (2) §6662(e)(1)(A) does not differentiate between factual and legal determinations and it is incorrect that "the penalty cannot apply where the transaction is 'recast' for tax purposes using a legal doctrine such as the step transaction or economic substance doctrine;" and (3) the underpayment was directly dependent on the valuation misstatement because the amount of the tax benefit was determined by the amount of the misstatement.

Comment: The Second Circuit's decision highlights the importance of analyzing the objective economic substance and subjective business purpose of any transaction involving tax planning. The court emphasized that if a taxpayer wants to rely on an opinion of its tax advisor for penalty protection, that opinion cannot be based on any false or unreasonable assumptions. According to the District Court's opinion, "a reasonably diligent analysis of all facts and circumstances would have revealed at least some of those assumptions to be unreasonable and unsupportable."

2. Santa Monica Pictures, LLC v. Commissioner

a. Overview

Santa Monica Pictures, LLC v. Commissioner[1513] involved high-basis, low-value assets, which the Tax Court described as having "tantalizing tax attributes." The government argued that the taxpayers entered into the partnership transactions designed to allow the tax losses from certain assets to be deducted by parties that had not suffered the losses and, to some extent, to allow the same economic losses to be deducted twice. To achieve this result, the parties entered into the following steps: (1) the owners of the high-basis assets transferred them to a partnership in exchange for partnership interests while the taxpayer contributed cash to the same partnership; (2) within the same month, the high-basis partnership interests were sold to another partner, at a time when the partnership had not made a §754 election that would have stepped down the basis of the assets to their fair market value; and (3) shortly thereafter, some of the high-basis, low-value assets were sold by the partnership, with the loss being allocated to the partner that had purchased the partnership interest of the original asset owner.

The Tax Court held that the transactions lacked economic substance and business purpose. In spite of the taxpayer's reliance on various opinions from several tax professionals, the court also imposed accuracy-related penalties. The facts in this case were arguably more extreme than in *Long Term Capital Holdings*, particularly, as the court pointed out, because three weeks after the formation of the partnership, the original partners that contributed the loss assets to the partnership exited that same partnership.

The substantive question discussed by the Tax Court was whether the claimed losses ought to be disallowed even though the taxpayer literally satisfied the applicable provisions of the Code concerning relevant partnership basis and loss allocations. Applying the economic substance doctrine, and, alternatively, the step-transaction doctrine, the Tax Court rejected the taxpayer's argument that formalistic compliance with statutory provisions necessarily entitles them to the tax benefits provided therein, and held that "Notwithstanding its form, the transaction did not, in substance, represent contributions of property in exchange for partnership interests … ." The Tax Court concluded that none of the parties to the transaction had business purpose or economic substance and denied the claimed losses on those grounds. Based on the transitory nature of the partnership interests held by the Credit Lyonnais Group (described below), the Tax Court concluded that the transaction should be taxed as though the Credit Lyonnais Group members had transferred their assets to the partnership for cash. As an alternative rationale, the Tax Court held that the contributed loss assets were worthless. Under this rationale, no property had been contributed to the partnership under §721 that would provide the partnership with a carryover basis in the loss assets under §723.

Additionally, the Tax Court upheld the IRS asserting a 40% penalty for gross valuation misstatements to the underpayments resulting from adjustments to the tax bases that the partnership had reported on its tax returns for the relevant years. The Tax Court observed that the gross valuation misstatement penalty applies to inflation of basis and is not limited to cases of overvaluing property, as the taxpayer had. Furthermore, the Tax Court refused to allow the taxpayer to rely on the "reasonable cause" exception by virtue of obtaining several opinions from tax professionals, and held that none of these opinions could be "reasonably" relied on by the taxpayer to satisfy the exception. Unlike in *Long Term Capital Holdings*, it appears that the taxpayer obtained the opinions in a timely manner and had actually reviewed them. The Tax Court, however, refused to allow the exception.

b. Facts

In 1996, Peter Ackerman, his business partner Perry Lerner, and their related entities (the "Ackerman Group") organized a consortium that bid on buying MGM from Credit Lyonnais, but lost to Kirk Kerkorian. Subsequently, Lerner was contacted by a representative from CDR (Credit Lyonnais' wholly owned subsidiary), Rene Claude Jouannet, who had been assigned the task of selling the remaining assets in MGM's parent company, MGM Group Holdings (later renamed SMHC), which Credit Lyonnais still owned.

SMHC owed approximately $1 billion to Credit Lyonnais and its subsidiaries, adjuncts, and associated companies (Credit Lyonnais Group). This debt was part of approximately $2 billion that the Credit Lyonnais Group had advanced to MGM during its brief relationship with MGM, first as lenders and then, after foreclosing, as owners. Credit Lyonnais had permitted the transfer of approximately $1 billion in debt from the MGM operating company to MGM Group Holdings to facilitate the 1996 sale of MGM to Kerkorian. Because SMHC had no significant assets, the value of Credit Lyonnais's debt and ownership interest in SMHC was nearly worthless. Credit Lyonnais's purported tax basis in the SMHC debt was about $1 billion; its purported tax basis in SMHC stock was about $665 million.

[1513] T.C. Memo 2005-104. For an in-depth discussion on this case, see Leeds, *The Pendulum Swings Back: IRS Successfully Challenges Loss Shifting In Santa Monica Pictures*, 2005 TNT 123-32 (June 14, 2005).

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To acquire SMHC, the Ackerman Group formed a new limited liability company, Santa Monica Pictures, LLC (SMP), which elected to be treated as a partnership for federal tax purposes. In late 1996, the Credit Lyonnais Group (which included Generale Bank and CLIS) contributed to SMP the high-basis, low-value receivables and SMHC stock, after first contributing to SMHC a library of "B-grade" films. In exchange, the Credit Lyonnais Group received preferred interests in SMP and a $5 million advisory fee (to be paid to CLIS). In exchange for common interests in SMP, the Ackerman Group contributed $20 million in cash or marketable securities.

In a side agreement, Rockport Capital, a member of the Ackerman Group, agreed to buy Generale Bank's and CLIS's preferred interests in SMP upon a written notice. The put rights were exercisable during a one-year period beginning December 31, 1996. The deal including capital contributions to SMP closed on December 11, 1996. Three weeks later, on December 31, 1996, the banks exercised their put rights. Somerville S Trust (standing in for Rockport Capital) bought the banks' preferred interests in SMP. SMP still owned the high-basis, low-value stock and debt of SMHC that the Credit Lyonnais Group had contributed and, indirectly, through SMHC, the B-grade films. Relying on partnership basis rules under §704(c), §743 and §754, the Ackerman Group claimed to succeed to Credit Lyonnais's $1 billion tax basis in the contributed SMHC debt and $665 million tax basis in the SMHC stock. SMP had not elected under §754 to adjust basis in ownership assets under §743(b) upon a transfer of partnership interests. Consequently, SMP was not required to reduce its basis in these assets (with respect to Somerville S Trust) to reflect the lower amount that Somerville S Trust had paid the banks for their interests in SMP.

In 1997, SMP sold part of the SMHC debt ($150 million face) to TroMetro Films, LLC for $2,514,000 (i.e., $147,486,000 less than the claimed basis). Also in 1997, SMP contributed a $79 million receivable to a newly formed partnership, Corona Film Finance Fund, LLC (Corona), and then sold 79.2% and 14.65% membership interests in Corona to Imperial Credit Industries, Inc. (Imperial), for much less than the basis SMP claimed in these membership interests.

The transactions produced losses for SMP of $62,237,061 and $11,647,367, which were allocated to Somerville S Trust. In 1997, Corona sold the $79 million receivable to TroMetro, generating a $78,768,955 loss; $74,671,378 of this loss flowed through to Imperial and $4,097,577 flowed through to SMP and then to Somerville S Trust. This loss essentially duplicated losses SMP had claimed from its sale to Imperial of SMP's ownership interest in Corona. Most of Corona's claimed loss passed through for the benefit of Imperial. As a "fee" for the tax benefits it received, Imperial paid, indirectly to SMP through Corona, almost $15 million. In 1998, SMP sold to TroMetro an $81 million receivable for a claimed loss of $80,190,418.

The IRS issued final partnership administrative adjustments (FPAAs) to Lerner as tax matters partner for SMP and Corona, for their partnership tax years ended December 31, 1997, and December 31, 1998. The IRS disallowed SMP's and Corona's claimed capital losses.

c. Issues

The Tax Court addressed the following issues: (1) whether SMP was entitled to a $147,486,000 capital loss on its sale to TroMetro of the $150 million receivable in 1997; (2) whether SMP was entitled to capital losses of $11,647,367 and $62,237,061 on its sales to Imperial of part of its Corona membership interest in 1997; (3) whether SMP was entitled to an $80,190,418 capital loss on its sale to TroMetro of the $81 million receivable in 1998; (4) whether Corona was entitled to a capital loss on its sale to TroMetro of the $79 million receivable in 1997; and (5) whether accuracy-related penalties under §6662(a) or (h) applied to the partnership adjustments to SMP's 1997 and 1998 returns and Corona's 1997 return.

d. Application of the Partnership Rules

Except for the alternative holding that the assets were worthless and thus not contributed property under §721, the IRS did not dispute (and the Tax Court did not discuss) the operation of the applicable technical rules concerning partnership basis and losses. The IRS also did not challenge whether SMP and Corona were bona fide partnerships or whether those entities should be respected for federal tax purposes. It did, however, address whether the Credit Lyonnais Group should be considered partners in the partnerships. The IRS had no strong technical arguments, so it had to rely on common law doctrines.

The taxpayer's position was that when the Credit Lyonnais Group contributed the receivables and SMHC stock to SMP in exchange for the preferred interests, the transaction was a non-taxable event under §721; SMP received bases equal to the banks' bases in the contributed properties. When the banks sold their preferred interests to Somerville S Trust, their inside basis in the contributed properties went to the Trust, as transferee partner, per §704(c). Because SMP did not make an election under §754, Somerville S Trust's inside basis in the properties was not adjusted. When SMP subsequently sold parts of the $974 million in receivables from Generale Bank, the Trust was allocated the losses on those sales.

The Ackerman group created a nearly identical scenario when SMP contributed the $79 million receivable to Corona in exchange for a membership interest. The taxpayer's position was that SMP received an outside basis in Corona equal to SMP's basis in the $79 million receivable. SMP then sold parts of its Corona membership interest to Imperial at a substantial loss. Under §704(c), Imperial succeeded to SMP's inside basis in the $79 million receivable. When the receivable was sold at a substantial loss to TroMetro, Imperial (and to some extent SMP) was allocated the loss from that sale, effectively duplicating the loss that SMP had realized on the sales of its Corona membership interest. The taxpayers generated sufficient basis in their partnership interests to deduct the losses by purchasing United States Treasury bills each year-end and simultaneously entering into a repurchase agreement to sell those Treasury bills back at the beginning of the next year.

e. Economic Substance Analysis

The IRS argued that the transaction had neither economic substance nor business purpose. Alternatively, under the step transaction doctrine, the IRS argued that "Generale Bank and CLIS should be disregarded as members of SMP and their 'con-

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tributions' to SMP followed by their 'sale' of the preferred membership interests to Rockport should be recast as a direct sale of the high basis/low value assets to Rockport for $10 million." As a second alternative, the IRS argued that the loss assets were worthless when Generale Bank and CLIS purportedly contributed them to SMP. Thus, the loss assets did not constitute a "contribution of property" within the meaning of §721 and the partnership basis rules and SMP obtained no basis in the SMHC receivables pursuant to §723. Finally, the IRS argued that the "partnership anti-abuse regulation" (Reg. §1.701-2) applied to recast the banks' contributions of the high-basis, low-value receivables and SMHC stock as direct sales of assets to Rockport Capital (or Somerville S Trust). However, because the Tax Court reached its decision using judicial doctrines, it did not decide whether the partnership anti-abuse regulation is valid or whether it applied to the transactions.

The taxpayer insisted that the transaction should be respected, arguing that there were valid business reasons for it. The taxpayer maintained that the Ackerman Group and the banks entered into the transactions as part of a plan to partner in a film distribution business, and that it chose the partnership form because it was the only vehicle flexible enough to accommodate the business objectives and complexities of the transactions.

The Tax Court concluded that the transaction in which the banks allegedly became partners in SMP, only to exit three weeks later, was not in substance what it appeared to be in form. Under the subjective business purpose prong, the Tax Court determined that neither the banks nor the Ackerman Group had a valid non-tax purpose for entering into the transaction; the sole purpose of the transaction was to transfer to the Ackerman Group enormous tax attributes associated with the banks' high-basis, low-value receivables and SMHC stock. In essence, according to the Tax Court, the banks joined the partnership so that they could withdraw from it — a "schizophrenic purpose" that contradicted the apparent transaction. The court concluded that, in substance, the banks did not become partners of SMP. Instead, they transferred their high-basis, low-value receivables and SMHC stock, along with whatever associated tax attributes might survive the transfer, to the Ackerman Group for $10 million and the Ackerman group then contributed the assets, with a new basis, to SMP.

As to the objective economic substance prong, the Tax Court observed that a transaction has economic substance if it has any economic significance beyond the creation of tax benefits. Accordingly, the Tax Court examined whether the banks and/or the Ackerman Group obtained economic benefits from the transaction beyond tax benefits and concluded that, because the assets contributed to SMP had little value, neither of the parties could realize significant non-tax benefits from the transaction.

The Tax Court summarized its conclusions and holdings as follows:

> We conclude that the banks' contribution of the SMHC receivables to SMP lacked economic substance and cannot be respected for federal tax purposes. We also conclude that SMP obtained no basis in the SMHC receivables under §723 (because the receivables were worthless), or in the $79 million receivable (because that debt did not represent bona fide indebtedness when it was assumed by MGM Group Holdings). In addition, we conclude that the Corona transaction lacked economic substance and likewise cannot be respected for federal tax purposes. For these reasons, we conclude: (1) SMP had no basis in the $150 million receivable and the $81 million receivable when those receivables were sold to TroMetro in 1997 and 1998; (2) SMP had no basis in the $79 million receivable when it contributed that receivable to Corona in 1997, and SMP's basis in its Corona membership interest under §722 was limited to the $250,000 cash contribution that it made to Corona; and (3) Corona obtained no basis from SMP under §723 in the $79 million receivable on its contribution and had no basis in that receivable when it was sold to TroMetro in 1997. Consequently, we hold: (1) SMP is not entitled to a $147,486,000 capital loss on its sale to TroMetro of the $150 million receivable in 1997; (2) SMP is not entitled to capital losses of $11,647,367 and $62,237,061 on its sales to Imperial of portions of its Corona membership interest in 1997; (3) SMP is not entitled to an $80,190,418 capital loss on its sale to TroMetro of the $81 million receivable in 1998; and (4) Corona is not entitled to a capital loss on its sale to TroMetro of the $79 million receivable in 1997.

Comment: The Tax Court did not address the issue whether the economic substance test is a conjunctive, disjunctive, or a unitary standard. However, it discussed both prongs in-depth, examining each party's subjective purpose and objective substance. Thus, it was implicit that the court must find the lack of *both* business purpose and economic substance to disregard the transaction. Moreover, the Tax Court's in-depth subjective business purpose analysis of each party to the transaction implies that the business purpose prong is equally important in relation to the objective prong.

f. Step Transaction

The Tax Court also concluded that the step-transaction doctrine applied to recast the banks' contributions of the SMHC receivables and stock as direct sales of those properties from the banks to Somerville S Trust, followed by the Trust's contributions of the properties to SMP in exchange for preferred interests in SMP. Presumably, the Trust would be entitled to a cost basis totaling $10 million in the receivables and stock, which would carry over to SMP under §723. The parties did not address how the $10 million basis amount would be divided among the receivables and stock. Because the court decided on alternative grounds that SMP received a zero basis in the SMHC receivables, the court did not decide the issue.

g. Penalties

The Tax Court agreed with the penalties that the IRS had asserted. The IRS had determined that accuracy-related penalties should be imposed under §6662 with respect to the partnership adjustments for SMP and Corona. For SMP, the IRS determined that the §6662(h) 40% penalty for gross valuation misstatements applied to the underpayments that resulted from adjustments to the tax bases SMP reported on its 1997 and 1998 partnership tax returns in the $974 million in receivables, the

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$79 million receivable, and SMP's interest in Corona. Alternatively, the IRS determined that the §6662(a) 20% penalty for negligence and/or substantial understatement applied to the underpayments resulting from these adjustments.

For Corona, the IRS argued that the penalty for gross valuation misstatements applied to the underpayment resulting from an adjustment to the tax basis that Corona reported on its 1997 partnership tax return in the $79 million receivable. Again, the IRS also argued that, alternatively, the §6662(a) 20% accuracy-related penalty applied here, as well.

Specifically, on its 1997 return, SMP reported a $150 million basis in the receivable it sold to TroMetro and claimed a $147,486,000 loss. Additionally, SMP reported a $63,489,061 basis in the 79.2% Corona membership interest it sold to Imperial and claimed a $62,237,061 loss ($1,252,000 sale price – $63,489,061 adjusted basis). SMP reported a $11,864,117 basis in the additional 14.65% Corona membership interest it sold to Imperial and claimed an $11,647,367 loss ($216,750 sale price – $11,864,117 adjusted basis).

The Tax Court concluded that SMP obtained a zero basis in the $974 million in receivables from Generale Bank and the $79 million receivable from CLIS. Because the $79 million receivable had a zero basis in SMP's hands, SMP received no carryover basis under §722 in its Corona membership interest on the contribution of that receivable to Corona. Corona received no carryover basis under §723 in the contributed $79 million receivable. Consequently, SMP's and Corona's basis reporting for the receivables was far more than 400% of the amount determined to be the correct basis.

As set forth above, the Tax Court concluded that the step transaction doctrine applied to recast Generale Bank's and CLIS's contributions of the receivables and Somerville S Trust's purchases of Generale Bank's and CLIS's preferred interests in SMP as direct sales of the SMHC receivables and stock from Generale Bank and CLIS to Somerville S Trust, followed by the Trust's contributions of those items for preferred interests in SMP. Under this holding, Somerville S Trust seemingly received a $10 million cost basis in the SMHC receivables and stock, which would carry over to SMP. In any event, the basis amounts SMP reported on its 1997 and 1998 tax returns and Corona reported on its 1997 return would still exceed by more than 400% a $10 million cost basis in the receivables.

The taxpayer argued that §6662(e) and (h) cannot apply when the alleged gross valuation misstatement penalty is not directly attributable to an erroneous overvaluation. The Tax Court disagreed, concluding that as a result of claiming inflated basis amounts SMP's 1997 and 1998 returns and Corona's 1997 return contained gross valuation misstatements for purposes of §6662(e) and (h).

As noted above, in the alternative, the IRS determined that 20% accuracy-related penalties applied under §6662(a) to the adjustments to SMP's 1997 and 1998 returns and Corona's 1997 return. The IRS offered two grounds for imposing the penalties: negligence and substantial understatement of income tax.

With respect to the former, the Tax Court held that a reasonable and prudent person would recognize that the tax losses were "too good to be true," especially given that SMP, Corona, Somerville S Trust, and Imperial did not bear any economic losses associated with the tax losses. The court concluded that reasonably prudent persons with Lerner's tax experience would not have conducted themselves as he did in reporting the bases in the SMHC receivables and the substantial losses from the TroMetro and Imperial transactions. As a result, the court sustained the IRS's alternative determination that negligence penalties were appropriate.

As set forth above, the Tax Court also concluded that the transaction had no economic substance; therefore, it was a "tax shelter" for purposes of §6662(d)(2)(C)(ii)(III), and the taxpayer had to demonstrate a reasonable belief that SMP's and Corona's tax treatment of the transactions was more likely than not the proper treatment. Given Lerner's education, sophistication, and tax experience, as well as the circumstances involved, the Tax Court did not believe there was such a reasonable belief.

Finally, the taxpayer attempted to rely on the "reasonable cause" exception under §6664, emphasizing that it had relied on "outside" professional tax advice. To support its position, the taxpayer presented several different opinions obtained from several tax advisers pertaining to different aspects of the transaction. The Tax Court reviewed each of these opinions and concluded that none of them could provide the basis for the exception, mainly because they did not address the controversial issues of the transaction and/or made unreasonable assumptions, including that the transaction had a business purpose.

Comment: The Tax Court followed the footsteps of the courts in *Long Term Capital Holdings* and *CMA* and held that when a transaction has no economic substance, the reasonable cause exception is generally not available. In this case, the Tax Court went even further than in *Long Term Capital Holdings*; although the taxpayer presented six different opinions from different tax professionals, the Tax Court refused to allow the taxpayer to rely on the exception. Another important element of the penalty imposition in this case was the Tax Court's decision that a gross valuation misstatement includes situations of inflated basis and not just, as the taxpayer argued, understatement of assets' value. Stated differently, in the cases of a high-basis low-value asset, if the taxpayer's determination of basis is successfully challenged in court, the 40% penalty would normally apply.

H. Contingent Liabilities

1. Black & Decker Corp. v. United States

A United States District Court (in the Fourth Circuit) in Maryland granted Black & Decker Corp.'s (B&D) motion for summary judgment in its refund suit for over $57 million in federal taxes arising from a contingent liability transaction.[1514]

a. Facts

In 1998, B&D created Black & Decker Healthcare Management Inc. (BDHMI) and transferred approximately $561 million to BDHMI along with $560 million in contingent employee healthcare claims in exchange for newly issued stock in BDHMI, in a §351 transaction. Subsequently, B&D sold its stock in BDHMI to a third party for $1 million. B&D argued

[1514] *Black & Decker Corp v. United States*, 340 F. Supp.2d 621 (D. Md. 2004), aff'd in part, rev'd in part, 436 F.3d 431 (4th Cir. 2006). For an in-depth discussion on the *Black & Decker* case, see Yale, *Reexamining Black & Decker's Contingent Liability Tax Shelter*, 108 Tax Notes 223 (July 11, 2005).

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that its basis in the BDHMI stock was $561 million (i.e., equal to the value of the property it had transferred to BDHMI). Thus, B&D claimed approximately $560 million in capital loss on the stock sale, and used a portion of the capital loss to offset capital gains it had from selling three businesses in 1998, and the remaining loss to offset gains in prior and future tax years.[1515]

b. District Court

The United States argued that the BDHMI transaction was a tax avoidance vehicle that must be disregarded for tax purposes under the economic substance doctrine. B&D argued that because the BDHMI transaction had economic substance, it must be validated. Both parties stipulated that the transaction had no business purpose.

Under the Fourth Circuit's disjunctive test, a court will not disallow the tax benefits if the taxpayer can show either subjective business purpose or an objective economic substance (i.e., a disjunctive test).[1516] Thus, for purposes of its motion for summary judgment, B&D conceded that tax evasion was its sole motivation and focused on establishing objective economic substance. The district court applied a combination of the *Moline Properties* doctrine and objective economic substance analysis to conclude that a corporation *and its transactions* are objectively valid, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically based business transactions.[1517]

The Court looked at the facts and noted:

> that BDHMI: (1) "assumed the responsibility for the management, servicing, and administration of plaintiff's employee and retiree health plans;" [footnote omitted] (2) has considered and proposed numerous healthcare cost containment strategies since its inception in 1998, many of which have been implemented by B&D; [footnote omitted] and (3) has always maintained salaried employees. [footnote omitted]. Moreover, as a result of the BDHMI transaction, BDHMI became responsible for paying the healthcare claims of B&D employees, and such claims are paid with BDHMI assets.

As a result, the court held that "[t]he BDHMI transaction, therefore, had very real economic implications for every beneficiary of B&D's employee benefits program, as well as for the parties to the transaction." Under the disjunctive test, therefore, the court held for the taxpayer.

c. Fourth Circuit

In *Black & Decker Corp. v. United States*,[1518] the Fourth Circuit partially affirmed and partially reversed the district court's decision, held that B&D was not required to reduce its subsidiary's stock basis when the corporation transferred contingent liabilities to the subsidiary, but remanded to determine whether the transaction had a reasonable profit expectation. While the Fourth Circuit affirmed the disjunctive two-prong test it set forth in *Rice's Toyota World, Inc. v. Commissioner,* it said that the District Court erred in its objective analysis by focusing on the general business activities of BDHMI and not the taxpayer's reasonable expectation of profit from the transaction. Thus, the Fourth Circuit emphasized that the test for economic substance in the Fourth Circuit is an objective analysis of any reasonable expectation of profit. In conclusion, the appellate court concluded that the IRS offered ample evidence to permit a reasonable trier of fact to find the transaction lacked any reasonable expectation of profit.

2. Coltec Indus. Inc. v. United States

The United States Court of Federal Claims ordered the IRS to refund to Coltec Industries Inc. $82.8 million in federal taxes arising from a contingent liability transaction.[1519] The first paragraph of the decision provided a clear indication of what the decision is going to be. The court cited *Atl. Coast Line v. Phillips*[1520] quoting from prior decisions of Justice Holmes and Judge Learned Hand:

> As to the astuteness of taxpayers in ordering their affairs so as to minimize taxes we have said that "the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it." This is so because [there is no] "public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions."[1521]

a. Facts

Coltec Industries, Inc. (Coltec), a publicly traded holding company, owns Garlock, Inc. (Garlock). Garlock's companies include Garlock Mechanical Packing Company, Stemco, Inc. and Anchor Packing (Anchor). Anchor utilized asbestos in manufacturing these products. In 1993, Coltec decided to discontinue Anchor's business operations and by 1996, Anchor's only assets were nearly depleted insurance coverage and a small building in Louisiana. By the early 1990's, Anchor and Garlock were or had been defendants in approximately 100,000 asbestos cases.

In 1996, Coltec established "Garrison," a "case management subsidiary," to handle the asbestos cases. Garrison authorized the issuance of 300,000 shares of common stock and 1,500,000 shares of Class A stock. Coltec contributed $998,000 to Garrison in exchange for 99,800 shares of Garrison common stock and $13,000,000 in exchange for 1,300,000 shares of Garrison Class A stock.

To effect capitalization of Garrison, Garlock caused Stemco to issue a promissory note to Garlock in the amount of $375 million. Garlock contributed to Garrison the Stemco Note, the outstanding stock of Anchor, the rights to any future asbestos

[1515] Note that in Notice 2001-17, 2001-9 I.R.B. 730, the IRS identified as listed transactions such transactions "involving a loss on the sale of stock acquired in a purported §351 transfer of a high basis asset to a corporation and the corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes." The transaction in the present case occurred prior to the issuance of Notice 2001-17.

[1516] The court stated that it "may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes." (citing *Rice's Toyota*, 752 F.2d at 96).

[1517] Citing *N. Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d at 512; *Moline Props. Inc. v. Commissioner*, 319 U.S. at 438–39; *Frank Lyon Co. v. United States*, 435 U.S. at 583–84.

[1518] 436 F.3d 431 (4th Cir. 2006).

[1519] *Coltec Indus. Inc. v. United States*, 62 Fed. Cl. 716 (2004).

[1520] 332 U.S. 168 (1947).

[1521] 332 U.S. 168, 172–73.

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insurance recoveries, furniture, fixtures, and equipment, and all of the files, records, and data of the Asbestos Litigation Department. In exchange, Garrison issued 100,000 shares of its common stock to Garlock and assumed defense and payment of Garlock's and Anchor's contingent asbestos liabilities.

On December 1996, several banks' subsidiaries purchased 50,000 shares of Garrison common stock for $250,000 or 100,000 shares for a total of $500,000 or $5 per share. In return, Coltec agreed to indemnify the Banks for any asbestos related claims that may arise in the future. An exit strategy was set forth in a separate agreement wherein the banks were granted the right to put the Garrison shares to Coltec at fair market value, and Coltec had the right to call or buy back the shares at a fixed price; each option right was executable after five years. The banks have not exercised their put rights, and Coltec has not exercised its call options.

b. Court of Federal Claims

The court examined the transaction using a three-step analysis. First, the court held that the contribution of the stock and the promissory notes to Garrison satisfied §351 because (i) Coltec and Garlock transferred qualifying "property" (i.e., the stock and notes) to Garrison; (ii) Coltec and Garlock received only stock from Garrison (Coltec received 93% of the equity of Garrison and Garlock received 7% of the equity of Garrison); and (iii) immediately after the exchange, Coltec and Garlock owned and controlled 100% of the total combined voting power of all classes of Garrison stock entitled to vote. Thus, the requirements of §351 were met in this case.

Second, the court held that the asbestos liabilities assumed by Garrison were contingent, since both of the events necessary to establish the fact of the liability had not occurred, i.e., the filing of a lawsuit asserting a claim and an adjudication of liability.[1522]

Finally, the court concluded that the sale of the stock should be respected as a true sale. The court restated the principle that a sale occurs if the benefits and burdens of ownership have passed from the seller to the buyer. The Government attempted to show that the purchasers of the Garrison stock did not obtain the burdens and benefits of ownership on the stock. The court, however, rejected the Government's arguments on the following grounds: (i) the stock entitled the banks to a proportionate distribution upon liquidation, similarly to the stock, but were only required to provide Coltec with notice on such a sale; (ii) regarding the control issue, the banks acquired a minority position in Garrison, and their rights were typical to any minority interest in a company (i.e., they could not be expected to control the company); (iii) the banks had stakes in Garrison through the life of the venture; and (iv) the banks were concerned about veil piercing and they too formed separate corporations to insulate their main business and required further indemnification from Coltec. The court also concluded that the transaction was made at arm's length.

(1) Section 357(b) — Tax Avoidance (or Business Purpose) Test

The court tested to see if Garrison's assumption of the Garlock liabilities was not undertaken for "the principal purpose … to avoid federal income tax[.]" under §357(b). In addition, the court stated that Coltec must demonstrate that assumption of such liabilities also had a "bona fide business purpose." Both of these tests, said the court, must be established by a "clear preponderance of the evidence" under §357(c).

The court reviewed several cases discussing §357(b) and set forth the following prevailing principles:

> (i) Business purpose is to be examined "narrow[ly] to a purpose 'with respect to the assumption' [of a liability] and to a purpose to avoid income tax 'on the exchange,'"[1523] (ii) the closer the nature of the liabilities to the customary business of the transferee and its continued viability, the more likely that §357(b)'s principal "business purpose" test will be satisfied;[1524] (iii) if the liabilities were incurred well before the transfer of stock, the more likely it is they will be considered as incurred for a business purpose and not tax avoidance;[1525] and (iv) the longer the life span of the corporate vehicle utilized and term of any promissory notes issued, the more likely a court will find the transaction to have been undertaken for a "business purpose."[1526]

The court concluded that the taxpayer satisfied these tests. First, the contingent liabilities assumed "clearly were related to Anchor's, Garlock's, and Garrison's ordinary business, and the management and minimization of such liabilities was essential to the continued viability of Anchor and potentially Garlock." Second, the court noted that the events that gave rise to the contingent liabilities "took place well before the Garrison transaction." In addition, the court observed that "the fact that the Stemco promissory note had a 15-year term and that Garlock, Stemco, and Garrison continue to function today — eight years after the formation of Garrison also weighs in favor of the Garrison transaction being viewed as having a bona fide business purpose." Finally, the court evaluated the overall result of establishing Garrison and held that "the separate Garrison structure became an important factor in Coltec's ability to sell the company to B.F. Goodrich Corporation in 1999."

The court concluded that "for these reasons, the court has determined that the record in this case establishes that Garri-

[1522] Pursuant to §358(d)(1), in a stock exchange to which §351 applies, the assumption of liabilities by another party to the stock exchange is treated as money received by the distribute upon the exchange, and therefore, the distributee's basis in the stock received ought to be reduced to the extent of the amount of the liabilities assumed. Reg. §1.461-1(a)(2) provides that, for an accrual method taxpayer, a liability "is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability [and] the amount of the liability can be determined with reasonable accuracy." Note that because §358(h) was enacted only in 1999 and did not apply to the transaction, the court held that Garlock would reduce its basis in the Garrison stock if and when the liabilities accrue and are satisfied by Garrison.

[1523] *Coltec Indus. Inc.*, 62 Fed. Cl. 716 (quoting *Drybrough v. Commissioner*, 376 F.2d 350, 356 (6th Cir. 1967)).

[1524] *Coltec Indus. Inc.*, 62 Fed. Cl. 716 (quoting *Drybrough*, 376 F.2d 350, 356).

[1525] *Coltec Indus. Inc.*, 62 Fed. Cl. 716 (citing *Drybrough*, 376 F.2d 350, and *Easson v. Commissioner*, 294 F.2d 653, 659 (9th Cir. 1961)).

[1526] *Coltec Indus. Inc.*, 62 Fed. Cl. 716 (citing *Gregory v. Helvering*, 293 U.S. 465, 469–70 (1937), and *Estate of Kanter v. Commissioner*, 337 F.3d 833, 865–66 (7th Cir. 2003)).

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son's assumption of Garlock's contingent asbestos liabilities had a 'bona fide' business purpose that satisfied §357(b) by a clear preponderance of the evidence."

(2) Economic Substance Analysis

The court began by stating the principle that the economic substance doctrine is "a composite of the 'business purpose' doctrine, the 'substance over form' doctrine, and the 'sham transaction' doctrine." Thus, the court, in one sentence, collapsed all four common law doctrines into one single standard. The Government provided the court with the usual list of "binding precedent" that "supports the principle that economic substance, and not mere formal compliance with the Code, must inform the interpretation and application of the tax law," including *Gregory v. Helvering* and *Commissioner v. Court Holding Co.* The court emphasized that "[a] careful reading of other cases cited by the Government, however, reveals that the Court resolved the tax question at issue first by looking to the Code and utilized doctrinal language only to further support its conclusion." Thus, as set forth in greater detail below, the court held that it would apply common law doctrines only where the statute is unclear and open to several interpretations.

Furthermore, the Federal Court of Claims reviewed the three cases cited by the government from the Federal Circuit to conclude that all three did not endorse the use of the economic substance doctrine.[1527]

The court, however, stated that even if it was required to apply the economic substance test, "Coltec has satisfied the test because it satisfied the business purpose of section 357(b), and, therefore the 'economic substance' doctrine is satisfied, since that doctrine requires proof of at least one of these tests."[1528]

Finally, the court supported its conclusion that the transaction had economic substance on the grounds that "from the 'standpoint of the prudent investor,' the Garrison transaction not only appeared to place one more barrier in the way of veil piercing claims, but it provided the B.F. Goodrich Corporation with a sufficient comfort level to purchase all of the Coltec Group in 1999."[1529]

The court cited Joseph Bankman with agreement, stating that "Congress may have no choice but to engage in substantive law reform. Some shelter activity will take place under even the most utopian tax structure. However, the current tax treatment of capital needlessly multiplies shelter opportunities and provides a fertile breeding ground for shelter development."[1530]

Thus, the court concluded that "[u]nder our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare. Accordingly, the court has determined that where a 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."

c. Federal Circuit

The Federal Circuit vacated the Court of Federal Claims decision.[1531] The court first examined whether the transaction satisfied the literal requirements of the Code. Stating that "Garlock's loss from the sale of its Garrison stock falls within the literal terms of the statute," the Federal Circuit turned to the government's economic substance argument and found that the transaction had no substance aside from tax benefits. The court first acknowledged that it disagreed with the lower court's holding that the economic substance doctrine could be viewed as opposing the separation of power principle and held that "The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code." Thus, the Federal Circuit observed that even though the taxpayer satisfied the literal application of the statute in this case, the court must still review the transaction under the common law economic substance standard.

In applying the economic substance principle to this case, the Federal Circuit first observed that the test should be a conjunctive test. In particular, in footnote 14, the court observed that it disagrees with the disjunctive test set forth by the Fourth Circuit and stated that the Supreme Court's decision in *Frank Lyon* should be interpreted to mandate a conjunctive test.

Furthermore, the court also stated that "the economic substance of a transaction must be viewed objectively rather than subjectively." Thus, the court held that in the present case, nothing indicated that "the transfer of liabilities in exchange for the note effected any real change in the 'flow of economic ben-

[1527] Discussing *Holiday Vill. Shopping Ctr. v. United States*, 773 F.2d 276 (Fed. Cir. 1985), the court in *Coltec* asserted that "[i]n light of the fact that the federal appellate court undertook no analysis of the 'economic realities' attributed to Gregory and clearly limited its holding to the facts of the case, the court does not discern any directive requiring it to resolve the instant case under the economic substance doctrine." 62 Fed. Cl. 716; *see also Exec. Jet Aviation, Inc. v. United States*, 125 F.3d 1463 (Fed. Cir. 1997) (cited by the *Coltec* court for the view that "where the language of the Code is clear, the 'substance rather than form' doctrine is irrelevant"); *Rubin v. Commissioner*, 429 F.2d 650, 653 (2d Cir. 1970) ("Resort to 'common law' doctrines of taxation … have no place where, as here, there is a statutory provision adequate to deal with the problem presented.").

[1528] *See Frank Lyon Co. v. United States*, 435 U.S. 561, 583–84 (1978) ("[W]here, as here, there is a genuine multi-party transaction with economic substance which is compelled … by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties,"); *UPS of Am. v. Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("This economic-substance doctrine … provides that a transaction ceases to merit tax respect when it has no 'economic effects other than the creation of tax benefits [i.e., tax avoidance].'"); *N. Ind. Pub. Serv. v. Commissioner*, 115 F.3d 506, 512 (7th Cir. 1997) ("[The economic substance doctrine] engender[s] the principle that a corporation and the form of its transactions are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions."); *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction[.]"); *Black & Decker Corp v. United States*, 340 F. Supp.2d 621 (D. Md. 2004) (holding that a court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes).

[1529] *Coltec Indus. Inc.*, 62 Fed. Cl. 716 (citing *Gilman v. Commissioner*, 933 F.2d 143, 148 (2d Cir. 1991) ("[A] court could either inquire whether there were any non-tax economic effects or use the analysis under §183. Whether the terminology used was that of 'economic substance, sham, or Section 183 profit motivation' was not critical; what was important was reliance on objective factors in making the analysis.") [citations omitted]).

[1530] Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 29–30 (2000–01).

[1531] *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 127 S. Ct. 1251 (2007).

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efits,' provided any real 'opportunity to make a profit,' or 'appreciably affected' Coltec's beneficial interests aside from creating a tax advantage." Accordingly, the court vacated the lower court's decision and disallowed the loss.

I. Custom Adjustable Rate Debt Structures (CARDS)

In *Country Pine Fin. LLC v. Commissioner*,[1532] the Tax Court examined a custom adjustable rate debt structure (CARDS) transaction and concluded that it lacked economic substance.

During 2001, the members of Country Pine Finance, LLC (Country Pine), sold an unrelated insurance business, generating gain and leaving them facing a contingent tax liability. The members entered into a CARDS transaction to reduce their tax liabilities. The transaction generated a loss on Country Pine Finance's 2001 partnership return. The issue for decision was whether Country Pine Finance is entitled to that loss.

A CARDS transaction has three phases: the loan origination phase, the loan assumption phase, and the operational phase. In general, three parties are required to carry out a CARDS transaction: a bank (lender), a borrower, and an assuming party. Zurich Bank acted as the lender in the CARDS transaction in *Country Pine*. The borrower, Fairlop, was a Delaware LLC with two UK citizens and residents as its members. Fairlop was set up solely to take part in this CARDS transaction. The Fairlop members contributed $6,296 in cash and $437,885 in notes payable. The assuming party, Country Pine, likewise was formed solely to carry out the CARDS transaction. The Country Pine members ("the members") made capital contributions to Country Pine on November 21, 2001, and February 27, 2002. Country Pine was dissolved on November 14, 2002, one year after its incorporation.

On November 9, 2001, Zurich Bank and Fairlop entered into a credit agreement. Fairlop had to pledge collateral in order to borrow funds. Zurich Bank applied a "haircut" to any pledged collateral. The haircut, the size of which varied depending on the type of collateral pledged, effectively required the borrower to contribute or acquire additional assets to serve as collateral. Fairlop borrowed euro 16,613,000 from Zurich Bank, then exchanged the borrowed funds for Zurich Bank promissory notes worth euro 16,613,000. This left Fairlop owing Zurich Bank euro 16,613,000, and Zurich Bank owing Fairlop euro 16,613,000. The promissory notes were pledged as collateral for the loan. Zurich Bank did not apply a haircut to promissory notes issued by Zurich Bank pledged as collateral, so Fairlop did not have to contribute additional collateral. The terms of the loan from Zurich Bank to Fairlop matched the terms of the promissory notes except that Fairlop was required to pay 50 additional basis points of interest. This 50-basis-point spread served as a portion of the fees paid to Zurich Bank for entering into the CARDS transaction. The euro 13,662,660 note remained with Fairlop. The euro 2,990,340 note was later exchanged for a new euro 1,981,671 note from Zurich Bank and euro 1,015,493.60. Fairlop immediately pledged the note and the euro as collateral.

On December 26, 2001, the members entered into an agreement to purchase the promissory note and euro from Fairlop. The members contributed the euro 1,981,671 note and euro 1,015,493.60 to Country Pine. In exchange, Country Pine guaranteed the loan. Country Pine claimed bases in the note and the euro of $9,658,146 and $4,938,036, respectively, based on the members' purportedly becoming jointly and severally liable for the entire euro 16,613,000. Shortly thereafter, Country Pine pledged the note and the euro as collateral for the loan. All amounts lent by Zurich Bank were guaranteed by collateral purchased from Zurich Bank with those loan proceeds. None of the "liable" parties ever contributed any additional collateral. If Country Pine had wanted to substitute collateral for the note and euro, Zurich Bank would have had to consent.

On December 28, 2001, Country Pine and Zurich Bank entered into a cross-currency swap. The cross-currency swap was a combination of an interest-rate swap and a foreign exchange forward contract. The interest-rate swap allowed Country Pine to receive interest payments equal to the amount of interest it would eventually owe on the euro 1,981,671 note and the euro 1,015,493.60. The foreign exchange forward contract allowed Country Pine to convert the value of the promissory note purchased from Zurich Bank back into euro on December 4, 2002, at the same rate used to convert the euro into dollars on December 28, 2001. This, in effect, allowed Country Pine to end up in the same economic position upon the closing of the cross-currency swap (December 4, 2002) as it was on the day it entered into the swap (December 28, 2001).

The members asserted that the purpose for entering into the CARDS transaction was to finance a real estate investment. According to the members, they would purchase real estate and use the real estate as collateral. If the members' investment was profitable, earnings from the real estate would exceed the costs of the CARDS transaction. Zurich Bank told the members at the initiation of the CARDS transaction at issue that they would not be able to use real estate as collateral. Real estate was never substituted as collateral, and neither the members nor Country Pine ever attempted to substitute any specific piece of real estate as collateral. On August 15, 2002, Zurich Bank informed Fairlop and the members that it was no longer willing to maintain the loan. All borrowed funds were paid back with the pledged collateral, and no additional capital contributions were made. Country Pine was dissolved on November 14, 2002.

Country Pine claimed losses for tax year 2001 resulting from Country Pine's swap of the note and euro for U.S. dollars as part of the cross-currency swap. Country Pine's claimed basis of $14,596,182 in the euro was the U.S. dollar value of the euro 16,613,000 initial loan from Zurich Bank to Fairlop. The members claimed this high basis in the euro because of the members' agreeing to be liable for the amount of the entire loan from Zurich Bank to Fairlop. When Country Pine exchanged the euro 2,997,640 for $2,633,308, it claimed a loss

[1532] T.C. Memo 2009-251. *Accord Kerman v. Commissioner*, 713 F.3d 849 (6th Cir. 2013), aff'g T.C. Memo 2011-54; *Curtis Inv. Co. v. Commissioner*, T.C. Memo 2017-150, aff'd, 909 F.3d 1339 (11th Cir. 2018), aff'd sub nom, 910 F.3d 150 (4th Cir. 2018); *Hunter v. Commissioner*, T.C. Memo 2014-132; *Kipnis v. Commissioner*, T.C. Memo 2012-306; *Crispin v. Commissioner*, T.C. Memo 2012-70, aff'd, 708 F.3d 507 (3d Cir. 2013), cert. denied, 134 S. Ct. 784 (2013) (similar CARDS transaction lacked economic substance); *Gustashaw v. Commissioner*, T.C. Memo 2011-195, aff'd, 696 F.3d 1124 (11th Cir. 2012) (taxpayers conceded that their CARDS transaction lacked economic substance). *See also Putanec v. Commissioner*, T.C. Memo 2016-221 (recourse liabilities assumed in CARDS transaction not included in basis to extent taxpayer was unlikely to repay); Cummings, *What Do 'Country Pine' and Barry Goldwater Have in Common*? 222 BNA Daily Tax Rpt. J-1 (Nov. 20, 2009).

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on the disposition of the euro equal to the difference between $14,596,182 and $2,633,308.

The IRS's notice of adjustment claimed that (1) the CARDS transaction lacked economic substance, was entered into primarily for tax-avoidance purposes, and was prearranged; (2) application of the substance-over-form or step transaction doctrine would disallow the loss; or (3) neither Country Pine nor any member was entitled to a deduction under §165, §465, or §988.

The Tax Court first analyzed the objective profit potential of the transaction giving rise to the claimed tax loss and concluded that Country Pine and the members engaged in the CARDS transaction to create a tax loss and that the transaction had no profit potential. The Tax Court noted that the CARDS transaction consisted of prearranged steps entered into to generate a tax loss; none of the loan proceeds ever left Zurich Bank's control; the loan proceeds were never at risk because the various loan agreements required Fairlop, the members, and Country Pine to immediately pledge trustworthy collateral for the loan amounts. Furthermore, the court noted that, after entering into the CARDS transaction, none of the parties ever made any additional contributions to capital or ever attempted to use the loan proceeds, and the terms and interest rates of the currency swap and the forward contract allowed Country Pine to back out of the transactions without paying any amounts other than the fees required as part of the transaction. In sum, there was no chance that Zurich Bank, Fairlop Trading, or the members would ever lose any money on the CARDS transaction. Moreover, the Tax Court reasoned, the transaction giving rise to the tax loss was cashflow negative, that is, the transaction had a negative net present value and rate of return relative to the capital invested.

Following an objective analysis, the court concluded that the claimed loss is also disallowed because the members did not have a nontax business purpose for entering into the CARDS transaction. Although the members testified that the decision was made to secure financing for future real estate investments, the court found their testimony not credible, citing substantial evidence that the decision to enter into the CARDS transaction was solely tax motivated. The court pointed out that the members knew in October 2001 that real estate could not be substituted at that time but decided to enter into the CARDS transaction anyway. The court found that the decision to proceed even without real estate as viable collateral was driven by the desire for a tax loss. Furthermore, Country Pine testified that the decision to enter into the transaction in 2001 was to take advantage of the tax benefits; notes taken by the members during presentations in which the transaction was being proposed and considered focused on the tax benefits; and the members never researched or evaluated an investment in real estate. The members repeatedly testified that they did not read any of the relevant documents but only signed the signature pages. According to the court, the members' lack of due diligence in researching the CARDS transaction indicates that they knew they were doing nothing more than purchasing a tax loss and not entering into a legitimate business or financing transaction with any nontax objectives.

Having found that the CARDS transaction had neither an objective profit potential nor a subjective business purpose, the court concluded that the transaction lacked economic substance.

J. Offshore Portfolio Investment Strategy (OPIS)

From about 1996 through 2003, KPMG marketed and sold a packaged tax shelter called "Offshore Portfolio Investment Strategy" (OPIS).[1533] In Notice 2001-45,[1534] the IRS stated that it became aware of these types of basis shifting tax shelters and "alerted" taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes.

The transaction involved the use of the attribution rules of §318 and Reg. §1.302-2(c) to increase the basis of stock owned by a taxpayer that claims a loss upon disposition of that stock. In the transaction, there is a redemption of stock that is owned by a person (other than the taxpayer) that is not subject to U.S. tax or is otherwise indifferent to the federal income tax consequences of the redemption. Purportedly as a result of the application of the attribution rules of §318, the redemption of stock is claimed to be a dividend under §301 rather than a payment in exchange for stock under §302(a). A variety of devices, often including options, is employed to treat the redeemed shareholder as owning stock in the redeeming corporation owned or treated as owned by the taxpayer under the attribution rules of §318. The attribution of ownership of such shares purportedly prevents the redemption of stock from reducing the redeemed shareholder's ownership interest in the redeeming corporation, thereby causing the redemption to be treated as a dividend. As a result of the redemption, the taxpayer takes the position that under Reg. §1.302-2(c) all or a portion of the basis of the redeemed stock is added to the basis of stock in the redeeming corporation that the taxpayer owns. The taxpayer then sells the stock and claims a loss.

The taxpayer's argument centers round Reg. §1.302-2(c), *Ex. 2*. Reg. §1.302-2(c) provides that when an amount received in a redemption of stock is treated as a distribution of a dividend, "proper adjustment" of the basis of the remaining stock will be made with respect to the stock redeemed. *Example 2* illustrates a proper adjustment where the entire amount received in redemption of the stock held by one spouse is treated as a dividend because the redeemed spouse is treated as owning stock held by the other spouse. In that example, the basis of the stock of the nonredeemed spouse is properly increased by the basis of the stock of the redeemed spouse.

In Notice 2001-45, the IRS stated its position that such an adjustment is not proper in every case in which the redeemed shareholder retains no stock in the redeeming corporation. According to the IRS, the example in the regulations is premised on the concept that an adjustment is appropriate where the redeemed spouse is required to include the full redemption proceeds as a dividend in gross income that is subject to U.S. tax and such spouse retains no stock to which the basis of the re-

[1533] *See* Johnson, *Tales From the KPMG Skunk Works: The Basis-Shift or Defective-Redemption Shelter*, 108 Tax Notes 431 (2005). KPMG originally called the shelter the "Foreign Leveraged Investment Program" or FLIP, but then changed the name to "Offshore Portfolio Investment Strategy" or OPIS. OPIS added some complexity to the FLIP but did not change the underlying logic of the shelter. *Id.*

[1534] 2001-33 I.R.B. 129.

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deemed stock could attach. The IRS stated that it intended to disallow losses claimed (or to increase taxable income or gains) in these types of basis shifting transactions. According to the IRS, depending on the individual facts, the reasons for disallowance may include, but are not limited to, the following: (1) the redemption does not result in a dividend (and consequently there is no basis shift) because, viewing the transaction as a whole, the redemption results in a reduction of interest in the redeeming corporation to which §302(b) applies; (2) the basis shift is not a "proper adjustment" as contemplated by Reg. §1.302-2(c); and (3) there is no attribution of stock ownership or basis shift because the steps taken to achieve those results are transitory and serve no purpose other than tax avoidance. The IRS also stated that it may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under §6662, the return preparer penalty under §6694, the promoter penalty under §6700, and the aiding and abetting penalty under §6701. Finally, the IRS stated that transactions that are the same as, or substantially similar to, these basis shifting transactions are identified as "listed transactions" for purposes of Reg. §1.6011-4T(b)(2) and §301.6111-2T(b)(2).

In Announcement 2002-97,[1535] the IRS announced a settlement initiative for these types of basis shifting transactions. Pursuant to the settlement offer, taxpayers who participated in OPIS transactions would have to concede 80% of the claim basis shift and the deduction of all transaction costs other than certain deemed transaction costs. With respect to certain deemed transaction costs, taxpayers were required to concede 80% of the deemed transaction costs and were required to treat 20% of the deemed transaction costs as a capital loss. In addition, transactions that were disclosed pursuant to the disclosure initiative of Announcement 2002-2[1536] would not be subject to accuracy-related penalties.

In 2012, the Tax Court issued its first opinion on the OPIS transaction. In *Blum v. Commissioner*,[1537] the taxpayer paid KPMG at least $687,500 to enter into an OPIS transaction. The taxpayer in *Blum* founded Buy.com in 1997. In 1998, the taxpayer sold a minority interest in Buy.com for a total of $45 million, all of which constituted a capital gain. Pursuant to the OPIS transaction, the taxpayer paid approximately $1.5 million and claimed that the OPIS transaction yielded over $45 million in capital losses to offset his 1998 Buy.com capital gain.

In the Tax Court, the taxpayer relied on Reg. §1.302-2(c) *Ex.* 2, which involves a redemption of stock in a closely held corporation that does not qualify for sale or exchange treatment by virtue of the family attribution rules of §318(a)(1). In Reg. §1.302-2(c) *Ex.* 2, the stock basis of the redeemed shareholder is treated as transferred to the stock basis of the party whose relationship prevented the redeemed shareholder from offsetting the amount paid by the corporation in exchange for the stock with its basis; the attribution rules required that the redemption be treated as a dividend under §301 with no offset for stock basis.[1538] The taxpayers argued that the option attribution rules of §318(a)(4), and (a)(3)(C) affected the same result and so inflated the basis of the stock held by the taxpayer such that a later sale of the stock for a fair consideration generated large tax losses.

The Tax Court held that while KPMG painstakingly structured an elaborate transaction with extensive citations to complex federal tax provision, the OPIS transaction lacked economic substance. In holding that the transaction lacked economic substance, the Tax Court looked to the standard set by the Court of Appeals for the Tenth Circuit. According to the court, the Tenth Circuit applies a so-called unitary analysis in which it considers both the taxpayer's subjective business motivation and the objective economic substance of the transactions. The presence of some profit potential does not necessitate a finding that the transaction has economic substance. Instead, the Tenth Circuit requires that tax advantages be linked to actual losses. According to the Tax Court, the Tenth Circuit has further reasoned that "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance." Applying those standards, the Tax Court held that the taxpayer's OPIS transaction lacked economic substance. The court considered the following factors: (1) the OPIS transaction consisted of prearranged steps to generate a loss; (2) the taxpayer did not approach the transaction as an investor; (3) the loss had no economic reality; (4) the losses dwarfed any profit potential; and (5) the numbers proposed by taxpayer's expert did not add up. The Tenth Circuit later affirmed[1539] the Tax Court's decision, noting that the timing of the transaction relative to the sale of stock, the taxpayer's purpose in retaining KPMG, and the taxpayer's failure to investigate the economic prospects of the transaction were indicative that the subjective motivation was not to generate a profit from the transaction.

Shortly after the Tax Court's *Blum* decision, the court issued its second OPIS opinion in *Reddam v. Commissioner*.[1540] The taxpayer in *Reddam* had founded DiTech Corporation in 1995. In 1999, the taxpayer sold DiTech and recognized a $48.5 million capital gain. The taxpayer paid KPMG a minimum of $626,500 to implement the OPIS transaction on his behalf. The steps in Reddam were as follows: (1) taxpayer purchased Deutsche Bank stock; (2) taxpayer entered into a swap transaction with Clara LLC, a domestic limited liability company owned by a foreign person; (3) taxpayer purchased a call option from Clara LLC; (4) Cormorant, a Cayman Islands limited partnership, purchased Deutsche Bank stock with proceeds from a Deutsche loan; (5) Cormorant purchased options from and sold options to Deutsche Bank; (6) Deutsche Bank redeemed 919,931 shares from Cormorant; (7) taxpayer purchased 919,931 OTC call options from Deutsche Bank; (8) taxpayer settled the GP call option with Clara LLC; (9) taxpayer sold the European-style call options back to Deutsche Bank; and (10) the taxpayer sold his shares of Deutsche stock. As a result of the above transactions, T claimed a $50.2 million capital loss on an investment of approximately $6 million.

[1535] 2002-97 I.R.B. 757.

[1536] 2002-2 I.R.B. 304.

[1537] T.C. Memo 2012-16, aff'd, 737 F.3d 1303 (10th Cir. 2013).

[1538] This is sometimes referred to as the "mystery of the disappearing basis." *See* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 9.22[2] (7th ed. 2000).

[1539] 737 F.3d 1303 (10th Cir. 2013), aff'g T.C. Memo 2012-16.

[1540] T.C. Memo 2012-106, aff'd, 755 F.3d 1051 (9th Cir. 2014).

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As in the *Blum* case, the Tax Court in *Reddam* held that the OPIS transaction lacked economic substance. The Tax Court began its analysis by turning to the Ninth Circuit. The court noted that most courts have created the following two-pronged inquiry when dealing with economic substance: (1) whether the transaction had economic substance beyond tax benefits (objective prong); and (2) whether the taxpayer has shown a non-tax business purpose for entering the disputed transaction (subjective prong). However, the Ninth Circuit has rejected the notion of a "rigid two-step analysis" and, instead, applies an approach under which the subjective and objective prongs are elements of a single inquiry. According to the Tax Court, the Ninth Circuit considers the subjective and objective prongs merely "precise factors" to consider in an overall inquiry as to whether the transaction had "any practical economic effects" other than tax benefits. After analyzing the respective positions of both the taxpayer's expert and the IRS expert, the court stated that it was clear that the "pretax profit" potential of the transaction was so remote as to render disingenuous any suggestion that the transaction was economically viable. According to the court, it was unconvinced that the mere hint of future profitability, be it at a 10% or 25% likelihood, especially in the light of the underlying circumstances of the transaction, was "likely" to produce benefits aside from substantial capital losses. With respect to the subjective prong of the economic substance doctrine, the court stated that it was apparent that the taxpayer was engaged in a course of action with the principal and overriding purpose of reducing or eliminating tax on a significant capital gain. According to the court, the taxpayer knew little to nothing about the details of the OPIS transaction and the extent of his knowledge was limited to an understanding that the OPIS transaction was a "formula or a recipe" that would provide him with a substantial capital loss.

On appeal, the Ninth Circuit affirmed the Tax Court's decision in *Reddam* affirming the IRS's disallowance of a capital loss deduction because it lacked economic substance and was intended to create capital losses.

K. Structured Trust Advantaged Repackaged Securities (STARS) Transaction

The structured trust advantaged repackaged securities (STARS) transaction has been described as a type of "foreign tax credit generator." It was a complex structured transaction developed by Barclays Bank and KPMG and promoted to U.S. corporate taxpayers, primarily banks. STARS transactions included a below-market loan component, which required a U.K. counterparty (Barclays), and a foreign trust structure component. Four STARS cases have been tried and appealed, and decisions have been rendered in favor of the U.S. government in each decision.[1541]

A typical STARS trust structure and cash flow are illustrated in the Worksheets at the end of this Portfolio, and described in CCA 200826036. The cases discussed below also provide explanation of the STARS arrangement. In simplistic terms, the U.S. taxpayer created a trust, to which it contributed income-generating assets, in return for units in the trust. Barclays (a U.K. bank) contributed cash to the trust in return for a different class of units. The trustee of the trust was wholly owned by the U.S. taxpayer, but purposely made a U.K. resident, causing the trust's income to be subject to U.K. income taxation at a rate of 22%. The trust income was also subject to U.S. income taxation, offset by a foreign tax credit[1542] for the amount of U.K. income taxes paid.

Although 99% of the trust's income was nominally distributable to Barclays, Barclays was obligated to recontribute all of the distributed amounts back to the trust, in exchange for additional trust units. The U.S. taxpayer had the only material economic interest in the trust, and the arrangement had no real effect on the taxpayer's economic interests in its assets. However, circulating the income on the taxpayer's assets through the trust device resulted in a U.K. tax liability for which the U.S. taxpayer claimed foreign tax credits and also resulted in an offsetting deduction claimed by Barclays on its recontribution of the trust distributions. The trust distributed Barclays' share of income, after U.K. taxes, to a blocked account to ensure that the funds were immediately returned to the trust. After the U.S. taxpayer repurchased Barclays' units in the trust, it could access all of the accumulated trust income, net of U.K. taxes. Thus, the U.S. taxpayer bore the economic burden of the U.K. taxes paid by the trust.

Barclays' purchase of trust units was converted to a below-market secured loan from Barclays to the U.S. taxpayer through a forward sale agreement, a zero coupon swap, and a credit default swap. Under the forward sale agreement, the U.S. taxpayer bought back Barclays' trust units for an amount equal to the principal amount Barclays paid for the units, plus annually compounded interest, minus a fixed amount (Bx payment) based on the amount of U.K. taxes paid on the trust income. The Bx payment offset part of the loan interest so that the loan bore a below-market rate of interest.

Tracing the flow of $100 of trust income helps to illustrate how the STARS trust worked and why the IRS challenged it.[1543] For every $100 in income received by the trust, the U.S. taxpayer paid approximately $22 in U.K. taxes and claimed a $22 foreign tax credit in the United States. Barclays was also required to report the entire $100 as income for U.K. tax purposes — that is, under U.K. law, Barclays was taxed both on the $78 of income that had been "paid" to it by the trust (by means of circulating the $78 through the blocked account) and the $22 of income that had been paid as taxes to the United Kingdom. Barclays had to pay 30% in taxes on that $100 in trust income, but Barclays was also entitled to a $22 tax credit for the tax that the trust had already paid to the United Kingdom. As a practical matter, then, Barclays paid $8 in U.K. tax on each $100 of income produced by the trust. At this point, the STARS transaction is a wash for the U.S. taxpayer; it has paid $22 in taxes to the United Kingdom, but it has cut its U.S. tax bill by $22 by

[1541] *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016), cert. denied, No. 16-1130 (U.S. June 26, 2017); *Bank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 2015), cert. denied, No. 15-572 (U.S. Mar. 7, 2016); *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), cert. denied, No. 15-380 (U.S. Mar. 7, 2016); *Wells Fargo & Co. v. United States*, 260 F. Supp. 3d 1140, 2017 BL 173713 (D. Minn. 2017), *aff'd* No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020).

[1542] §901.

[1543] The following illustration is adapted from *Wells Fargo & Co. v. United States*, 143 F. Supp. 3d 827 (D. Minn. 2015). Other STARS opinions include similar illustrations.

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use of the foreign tax credit. Barclays is down the $8 in taxes that it paid to the United Kingdom. And the U.K. treasury is up $30 ($22 from the U.S. taxpayer and $8 from Barclays).

Barclays "reinvested" the $78 that was paid to it by the trust back into the trust in exchange for additional units. Because Barclays was spending $78 to purchase units that had no value to it, Barclays was able to deduct this $78 "loss" on its U.K. tax return. Given a 30% tax rate, Barclays achieved a tax savings of $23.40 on this $78 deduction. At this point, then, the STARS transaction is still a wash for the U.S. taxpayer; Barclays is now up $15.40 ($23.40 in tax savings minus $8 in tax payments); and the U.K. treasury is up $6.60 ($30 in taxes received from the U.S. taxpayer and Barclays minus $23.40 in tax savings for Barclays).

Barclays also made a monthly Bx payment to Wells Fargo in the amount of 47.5% of Barclays' $22 U.K. tax credit. Thus, for every $100 of trust income, the Bx payment would be $10.45 (i.e., 47.5% of $22). Barclays then took a deduction for the Bx payment on its U.K. tax return, resulting in an additional $3.14 in tax savings (i.e., 30% of $10.45). So Barclays ends up $8.09 in the black ($15.40 in initial tax savings minus the $10.45 Bx payment plus the additional $3.14 in tax savings).

In sum, the STARS transaction had the following impact: For every $100 in trust income, the U.S. Treasury lost $22, which represented the taxes that the U.S. taxpayer shifted from the United States to the United Kingdom; the U.S. taxpayer received the $10.45 Bx payment; Barclays received $8.09 in net tax savings; and the U.K. treasury held on to $3.46 of the original $30 in tax payments. Notably, the three "gains" add up to $22, which is the amount of revenue lost by the U.S. treasury.

1. Bank of N.Y. Mellon Corp. v. Commissioner

a. Tax Court

In 2013, in a case of first impression (*BNY I*), the Tax Court determined that the structured trust advantaged repackaged securities (STARS) transaction lacked economic substance.[1544] The IRS took the position that the STARS transaction lacked economic substance, and that the foreign tax credits, interest deductions, and other expenses attributable to STARS should be disallowed. In contrast, Bank of New York Mellon (BNY) argued that the STARS transaction had economic substance because BNY entered into the STARS transaction to obtain low-cost funding for its banking business and reasonably expected to earn a pre-tax profit from STARS.

Analyzing the STARS transaction under the economic substance doctrine, the Tax Court concluded that, although the STARS transaction was structured to meet the relevant requirements in the Code and the regulations for claiming the foreign tax credits, the transaction was in essence an "elaborate series of pre-arranged steps designed as a subterfuge for generating, monetizing and transferring the value of foreign tax credits among the STARS participants."

The Tax Court explained that the first step in the economic substance inquiry is to identify the transaction to be analyzed, and that the relevant transaction to be tested is the one that produces the disputed tax benefit, even if it is part of a larger set of transactions or steps. Agreeing with the IRS, the court decided that the appropriate analysis would focus on the trust structure, not the loan, for purposes of testing economic substance. The loan was not necessary for the trust structure to produce foreign tax credits.[1545]

First, the court determined that the trust structure lacked objective economic substance because it did not create any profits other than the foreign tax credits. BNY did not have a reasonable expectation that it would make a non-tax economic profit from using the trust structure. The trust structure did not increase the profitability of the trust assets in any way. To the contrary, it reduced their profitability by adding substantial transaction costs, e.g., professional service fees and foreign taxes incurred as result of using the STARS structure. Additionally, the activities or transactions that the trust structure was used to engage in did not provide a reasonable opportunity for economic profit. The trust structure's main activity was to circulate income between itself and Barclays. The circular cash flows or offsetting payments had no non-tax economic effect.

The court explained that economic benefits that would result independent of a transaction do not constitute a non-tax benefit for purposes of testing its economic substance. Benefits that are unrelated to the transaction cannot be what motivates a taxpayer to engage in the transaction and, therefore, are of no aid in determining whether the taxpayer would have engaged in the transaction absent the tax effects. In this case, BNY's control and management over the trust assets did not materially change as a result of their transfer to the trust structure, and the trust structure had no effect on the income stream generated by the trust assets. Therefore, the court concluded, the trust assets would have generated the same income regardless of being transferred to the trust, and income from the trust assets was not an incremental benefit of STARS.

Second, the court found that the trust structure lacked subjective economic substance. BNY claimed that it used the trust structure to obtain low-cost financing from Barclays. However, the trust structure lacked any reasonable relationship to the loan, and the loan was not "low cost." To the contrary, the court found, it was significantly overpriced and required BNY to incur substantially more transaction costs than similar financing available in the marketplace. BNY failed to establish a valid business purpose and its true motivation was tax avoidance.

Because the court in *BNY I* treated the loan as separate from the trust transactions, BNY filed a supplemental motion (*BNY II*) asking the court to consider whether interest paid on the loan was deductible.[1546] The court found that interest paid on the loan was properly deductible because BNY did not use the loan proceeds to finance, secure, or carry out the trust structure. Applying precedent from the Second Circuit, the Tax Court explained that an interest deduction is not allowed if the interest payment arises from a transaction that lacks economic substance. The loan was not necessary for the STARS structure to produce the disallowed foreign tax credits. Rather, the loan

[1544] *Bank of N.Y. Mellon Corp. v. Commissioner*, 140 T.C. 15 (2013), aff'd, 801 F.3d 104 (2d Cir. 2015), cert. denied, No. 15-572 (U.S. Mar. 7, 2016).

[1545] The court noted that even if the trust structure and the loan were analyzed as an integrated transaction, it still lacked economic substance.

[1546] *Bank of N.Y. Mellon Corp. v. Commissioner*, T.C. Memo 2013-225 aff'd, 801 F.3d 104 (2d Cir. 2015), cert. denied, No. 15-572 (U.S. Mar. 7, 2016).

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proceeds were available for BNY to use in its banking business throughout the STARS transaction. Accordingly, the loan served a purpose beyond the creation of tax benefits and should be respected for tax purposes.

b. Second Circuit

BNY's appeal of the Tax Court's decision was heard in tandem with AIG's interlocutory appeal of the questions whether foreign tax credit cases are susceptible to analysis under the economic substance doctrine and how foreign taxes are to be taken into account in the economic substance pretax profitability analysis.[1547] The Second Circuit held that the economic substance doctrine applies to the foreign tax credit regime generally and that both BNY's and AIG's cases were correctly decided. The court also held that foreign taxes are economic costs and should be deducted when calculating pretax profit for purposes of determining the objective economic substance of a transaction and that foreign tax credits should be excluded from the calculation. In addition, the Second Circuit agreed with the Tax Court that BNY's STARS transaction lacked economic substance and that loan interest was deductible because the loan had economic substance independent from STARS.

AIG argued that the economic substance doctrine cannot be applied to disallow foreign tax credits that comply with all statutory and regulatory requirements because the congressional purpose for enacting the foreign tax credit regime clearly is to prevent double taxation. The Second Circuit rejected this argument because the Supreme Court has long held that substance rather than form determines tax consequences. In addition, the court explained that the economic substance doctrine exists to provide courts a "second look" to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit and emphasized that the foreign tax credit is designed only for taxpayers engaged in purposive activity, not sham transactions built solely around tax arbitrage. The court cited the codified economic substance doctrine, which does not apply to the STARS cases, to support the idea that Congress recognized that a purely rule-based system cannot prescribe the correct outcome in every conceivable transaction and endorsed the two-prong economic substance test long-applied by the courts, including the Second Circuit.

Turning to the objective prong of the economic substance analysis, the court explained that the focus of the inquiry is whether the transaction offers a reasonable opportunity for economic profit, which is profit exclusive of tax benefits. The court indicated that this was the first time the Second Circuit was faced with the question how profit should be calculated when a transaction involves foreign tax credits — specifically, whether foreign taxes should be treated as costs when calculating pre-tax profit. If the answer is "yes," the court noted, a transaction will be less likely to appear profitable. The court explained that the purpose of calculating pre-tax profit is not to perform mere financial accounting, but to discern, as a matter of law, whether a transaction meaningfully alters a taxpayer's economic position other than with respect to tax consequences. Agreeing with the Tax Court and the Federal Circuit's *Salem* decision, and splitting with the Fifth and Eighth Circuits,[1548] the Second Circuit held that foreign taxes are economic costs that should be deducted when calculating pretax profit. The court also concluded that it is appropriate, in calculating pretax profit, for a court both to include the foreign taxes paid and to exclude the foreign tax credits claimed.

As to BNY's STARS transaction, the Second Circuit held that the Tax Court properly bifurcated the STARS structure and the loan because they were not interdependent and the purpose of the loan apparently was to create a valid business purpose for the STARS trust structure. Further, the court held that because it had economic substance independent of the STARS transaction, BNY could deduct the interest it paid on the loan.

2. Salem Fin., Inc. v. United States

a. Court of Federal Claims

Shortly after the Tax Court decided *Bank of N.Y. Mellon Corp. v. Commissioner*,[1549] discussed above, the Court of Federal Claims decided *Salem Fin., Inc. v. United States*,[1550] another case dealing with the economic substance of the structured trust advantaged repackaged securities (STARS) transaction. Salem Financial, Inc. is a subsidiary of BB&T Corporation, and the real parties in interest were BB&T and Barclays.

Like the Tax Court, the Court of Federal Claims concluded in *Salem I* that "[w]hile inarguably sophisticated and creative, the trust purely and simply is a sham transaction accomplishing nothing more than a redirection of cash flows that should have gone to the United States Treasury, but instead are shared among BB&T, Barclays, and the U.K. Treasury." Applying the same reasoning as the Tax Court, the Court of Federal Claims analyzed the economic substance of the trust structure separately from that of the loan. Also like the Tax Court, the Court of Federal Claims concluded that the trust structure lacked economic substance, a result that would not change in an analysis of the trust structure and the loan as an integrated transaction.

The Court of Federal Claims considered whether Barclays' $1.5 billion loan to BB&T at favorable interest rates caused the STARS transaction to have economic substance. Unlike the Tax Court's decision that the loan between Barclays and BNY served a purpose beyond the creation of tax benefits because BNY had access to the loan proceeds to use in its banking business throughout the STARS transaction,[1551] the Court of Federal Claims found that the loan between Barclays and BB&T lacked economic substance because it was not structured to make a profit. Instead, the court found, the loan was devised to provide BB&T with a "pretext for a purported business purpose for engaging in a sham transaction."

Significantly, the Court of Federal Claims characterized the Bx payment as an "in-substance rebate" to the U.S. taxpay-

[1547] *Bank of N.Y. Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 2015), cert. denied, No. 15-572 (U.S. Mar. 7, 2016). *See Am. Int'l Grp., Inc. v. United States*, No. 1:09-cv-01871-LLS (S.D.N.Y. Mar. 29, 2013).

[1548] *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), cert. denied, No. 15-380 (U.S. Mar. 7, 2016); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001).

[1549] 140 T.C. 15 (2013) (*BNY I*).

[1550] 112 Fed. Cl. 543 (2013) (*Salem I*).

[1551] *Bank of N.Y. Mellon Corp. v. Commissioner*, T.C. Memo 2013-225 (*BNY II*), discussed above.

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er of U.K. taxes paid. As discussed below, this characterization was rejected on appeal, but the issue is outlined here. Whereas the Tax Court decided that the Bx payment was a tax effect because it arose from and was calculated as a percentage of BNY's U.K. tax payments, the *Salem* court was persuaded by the government's argument that the Bx payment was a tax effect because it was "in substance" a rebate to BNY of the U.K. taxes, such that the U.S. STARS counterparty did not "in substance" pay any U.K. tax. The government's view in the STARS cases is that the Bx payment was "in effect" a rebate of U.K. taxes such that the U.S. counterparty "in effect" never paid those taxes and, therefore, allowing the foreign tax credit would not be in harmony with the credit's purpose. The court reasoned that:

> The rebates embodied in the Bx payments were directly proportional to the amount of U.K. taxes paid. The greater the amount of revenue produced by the ... Trust, the higher the U.K. taxes would be, and the higher the Bx payments would be to BB&T. STARS thus had the counterintuitive result that the greater the amount of foreign taxes paid by the taxpayer, the greater the amount of profit realized from the Bx rebate payments.

It is interesting that the court did not respond to BB&T's argument that it is not appropriate to substitute a judicial doctrine for a statutorily defined determination whether the facts of the case are abusive under the law. The IRS conceded that BB&T did not run afoul of the Code or regulations applicable to the foreign tax credits. Therefore, BB&T pointed to the legislative history of §901(i) and subsequent revisions to Reg. §1.901-2(e)(3)(ii) requiring that "substance and not form shall govern in determining whether a subsidy exists" as the authoritative statement of legislative and regulatory intent regarding what constitutes an "effective subsidy." Thus, both the regulations and the economic substance doctrine require a substantive analysis of the Bx payment to determine whether it was an effective subsidy. BB&T argued that "substance is substance" no matter the purpose for which it is analyzed; the substance of the Bx payment does not change depending on whether it is analyzed under the statute and regulations or under the economic substance doctrine. The taxpayers further argued that, because the government conceded that STARS does not violate the code or regulations, the government also effectively conceded that the Bx payments were not a rebate of U.K. taxes in substance or effect. Nowhere in the *Salem* decision appears a citation to §901(i), which forbids credit for foreign taxes that are used to provide a subsidy to the taxpayer, to Reg. §1.901-2(e), which defines when a foreign tax is refunded or rebated, or to Reg. §1.901-2(e)(3)(ii), which requires that "substance and not form shall govern in determining whether a subsidy exists."

The court found that the loan was used to camouflage what the court characterized as the monthly rebate, through the Bx payments, of BB&T's U.K. tax payments. The court decided that, absent the tax benefits, the cost of the loan was considerably higher than BB&T's normal cost of borrowing for similar loans, and had no non-tax business purpose and no possibility of pre-tax profit. Without the Bx payments, the court found that BB&T would not have entered into the STARS transaction. The loan transaction thus was substantially influenced by the payments from the sham trust, and lacked economic reality where the interest rate (after taking into account the Bx payment offsetting the nominal interest rate) was so low that for "nearly the first three years of the transaction, Barclays, the lender, made payments to BB&T, the borrower, exceeding by millions the interest payments due from BB&T to Barclays," an arrangement that, according to the court, would "raise the eyebrows of even an experienced financier." Further, the amount of the loan was unrelated to the amount of the Bx payments because a change in the loan amount did not have any effect on the amount of the Bx payments. The court concluded that the loan transaction lacked economic substance because it was so heavily driven by the monthly payments from the sham trust.

After the Tax Court's favorable ruling in *BNY II* permitting BNY to deduct interest on its STARS loan, BB&T filed a motion for reconsideration asking for a similar ruling.[1552] In denying BB&T's motion, the court noted that the Tax Court's decision was not controlling authority in the Court of Federal Claims, and what little persuasive value the *BNY II* decision might have had was undermined by the fact that the Court of Federal Claims had already considered and rejected the arguments advanced in BB&T's motion. Further, the findings of fact in the two cases were very different. *BNY II* relied on the Tax Court's finding in *BNY I* that the STARS loan was independent from the trust and that BNY was free to use the loan proceeds in its banking business. Unlike the Tax Court's findings, the Court of Federal Claims found in *Salem I* that the loan was necessary to the remainder of the STARS transaction and therefore the loan was not separate and distinct from the remainder of the transaction.

b. Federal Circuit

BB&T appealed the rulings of the Court of Federal Claims to the Federal Circuit, which affirmed the disallowance of the foreign tax credits but, following the Tax Court's *BNY II* opinion, permitted BB&T to claim deductions for interest paid on the loan.[1553] The Federal Circuit was the first appellate court to reach a decision in a STARS case.

The Federal Circuit held that economic substance is a prerequisite to the application of any Code provision allowing deductions, thus rejecting BB&T's argument that if, as the IRS conceded, the Bx payments were not, under the anti-abuse provisions in the applicable regulations, rebates of U.K. taxes paid, then they must also have "substance" for purposes of the economic substance doctrine. The court reasoned that separate analyses can and should be performed for the same transaction under the Code or regulations and under the economic substance doctrine. According to the court, "[t]he economic substance doctrine thus applies even to a transaction that is governed by a statute or regulation that itself contains a 'substance-over-form' provision." The court suggested that the dual analysis was necessary because the statutory or regulatory substance analysis depends on technical aspects of a transaction and does not answer the questions posed by the common law doctrine, which are: "whether the [STARS] Trust transactions lack economic reality, whether they lack a bona fide business purpose, and whether they are not the kinds of transactions on which

[1552] *Salem Fin., Inc. v. United States*, 119 Fed. Cl. 84 (2014) (*Salem II*).

[1553] *Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), cert. denied, No. 15-380 (U.S. Mar. 7, 2016).

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Congress intended to confer the benefit of the foreign tax credit provision."

In considering the objective economic reality prong of the economic substance test, the court decided that the Bx payment should be accounted for as income to BB&T in the pre-tax profitability analysis, rather than as a rebate of U.K. taxes. BB&T realized an immediate economic benefit by receiving the Bx payments, which were made in consideration of BB&T's services rendered under the STARS transaction. Furthermore, Barclays was willing to make the payment to BB&T because BB&T's participation in the STARS transaction enabled Barclays to realize substantial tax benefits under U.K. law, and it was not clear to the court that the Bx payments were derived, as the government contended, by cycling BB&T's U.K. tax payments through the U.K. government and Barclays. Finally, the court could find no authority for treating private payments as tax effects rather than income simply because the amount of the payments was calculated based on a tax-based formula.

Next, the court addressed the government's contention that if the Bx payments were income to BB&T, then that income must be netted against the amount of U.K. taxes paid by the STARS trust. The result of this netting would be that, absent the foreign tax credit, the STARS transaction would lack profit potential. After acknowledging that the Fifth and Eighth Circuits[1554] have held that foreign tax credits must be included in the pre-tax profitability analysis ("[t]o be consistent, the analysis should either count all tax law effects [both foreign tax credits and foreign tax expenses] or not count any of them"), the Federal Circuit court reasoned that the fact that a transaction produced a net gain to the taxpayer after taking both the foreign taxes and the foreign tax credit into account says nothing about the economic reality of the transactions, because all tax shelter transactions produce a gain for the taxpayer after the tax effects are taken into account. The *Salem* court agreed with the government that profitability must be analyzed in the absence of tax benefits (i.e., without the benefit of foreign tax credit). But, the court was careful to point out that absence of pretax profitability alone was not sufficient to conclude that a transaction lacked economic substance. "Nonetheless," the court stated,

> if a taxpayer has incurred a large foreign tax expense that would render the transaction unprofitable absent the foreign tax credit, that situation demands careful review of the transaction. In particular, it requires an inquiry into whether the transaction meaningfully alters the taxpayer's economic position (other than with regard to the tax consequences) and whether the transaction has a bona fide business purpose.

Continuing its economic substance analysis, the Federal Circuit court noted that the complex circular cash flows had no economic effect aside from their intended tax consequences. Although the Federal Circuit disagreed with the Court of Federal Claims' characterization of the Bx payment as a rebate of tax, the Federal Circuit did agree that the STARS Trust transaction was "… a contrived transaction performing no economic or business function other than to generate tax benefits." The court went on to explain that "… the STARS Trust transaction was simply a money machine," and that "… allowing foreign tax credit for such an arrangement would be inconsistent with the purposes of the foreign credit statute."

The court was impressed by the fact that by subjecting the STARS trust income to U.K. taxes, BB&T obtained a post-foreign tax-credit "profit" free of economic risk. The court explained that the "artificiality of the transaction is shown by its unlimited capacity to generate gains, without any additional exposure or commitment of resources."

Turning next to the question whether there was any legitimate business purpose for the STARS trust, the court agreed with the trial court's finding that the STARS trust had no non-tax business purpose and that its sole function was to "self-inflict" US-sourced BB&T income to U.K. taxation in order to reap U.S. and U.K. tax benefits. It is important to note that BB&T abandoned the argument it made at trial that the purpose of the STARS transaction was to obtain financing.[1555] Instead, BB&T argued that the legitimate business purposes of the transaction were to earn a profit and to enable Barclays to claim U.K. tax benefits. The court rejected Salem's first business purpose, reasoning that the Bx payment, while an economic benefit, "[did] not represent profit from any business activity." The court reasoned that if producing an economic benefit was an acceptable business purpose, then the business purpose test would effectively be eliminated, because taxpayers almost always engage in a transaction for the prospect of monetary gain. Thus, the court distinguished between economic gain and profit from a business activity — the latter indicates a legitimate business purpose, while the former does not. As for BB&T's second asserted business purpose, it cited *N. Ind. Pub. Serv. Co. v. Commissioner*[1556] for the proposition that "accommodating a counterparty's tax position is a legitimate business purpose." The court distinguished the STARS transactions from the transactions in *N. Ind. Pub. Serv. Co.* by pointing out that in *N. Ind. Pub. Serv. Co.*, the avoidance of tax was only one of the taxpayer's motives, and the taxpayer had other legitimate business activities as well. The court explained that *N. Ind. Pub. Serv. Co.* stands for the idea that a transaction should not be disregarded as an economic sham simply because tax avoidance was one of the motives for creating or structuring the transaction. Here, the Federal Circuit found that BB&T had no other business purpose than tax avoidance, and therefore *N. Ind. Pub. Serv. Co.* did not apply.

Unlike the STARS trust, the court concluded that the loan satisfied the economic substance test. While the government asserted that the loan should be viewed as lacking economic substance because it provided for a higher-than-market interest rate, the court found that to be insufficient to establish a sham, stating that the relevant inquiry is "whether there was something of substance to be realized by the taxpayer from the loan transaction, other than tax deductions." The court found that the loan provided BB&T with "unrestricted access to $1.5

[1554] *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001).

[1555] Below-market financing was accepted as a legitimate business purpose for STARS in *Santander Holdings USA, Inc. v. United States*, 144 F. Supp. 3d 239 (D. Mass. 2015), rev'd, 844 F.3d 15 (1st Cir. 2016), cert. denied, No. 16-1130 (U.S. June 26, 2017), discussed below.

[1556] 115 F.3d 506 (7th Cir. 1997).

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billion in loan proceeds" and "had real economic utility to BB&T." In addition, "[d]espite the [l]oan's higher-than-market interest rate, it has not been shown that the transaction would result in an economic loss 'regardless of what investment [BB&T] planned to use the loan proceeds for.'"[1557] As a result, the Federal Circuit reversed the Court of Federal Claims on this issue and held that BB&T was permitted to claim interest deductions with respect to the loan.

3. Santander Holdings USA, Inc. v. United States

a. District of Massachusetts

In a decision that was reversed on appeal, the U.S. District Court for the District of Massachusetts found that the structured trust advantaged repackaged securities (STARS) transaction has economic substance.[1558]

The taxpayer in *Santander* (Sovereign) filed a motion for partial summary judgment and then a motion for summary judgment. First, Sovereign[1559] moved for partial summary judgment on what the court described as the "linchpin issue" — whether the Bx payment should be accounted for as revenue to Sovereign in assessing whether Sovereign had a reasonable prospect of profit in the transaction. The government argued that the payment should be excluded from a calculation of Sovereign's pre-tax profit as a "tax effect" because it was an "effective rebate" of U.K. taxes paid by Sovereign. The existence or not of a reasonable prospect of profit is critical in determining whether the transaction had objective economic substance. If the payment is counted as pre-tax revenue, the court indicated, it is objectively clear that the transaction has economic substance for Sovereign.[1560]

The district court took a markedly different analytical approach to the STARS transaction than did the Tax Court and the Court of Federal Claims. Explaining why summary judgment was appropriate, the court stated that

> [t]here is no material factual issue about how the credits and debits worked their labyrinthine way through the Goldbergian apparatus. The question is, [s]hould the Barclays payment be treated, as a matter of law, as if it were a rebate from the United Kingdom to Sovereign? That is a legal question, to be answered by judges, not economists.

Citing the *BNY I* and *Salem I* cases discussed above, the court pointed out that those courts did not discuss this issue. Instead,

> [t]hose cases appear to deal with the question whether the Barclays payment was 'in substance' a 'tax effect' as a matter of fact, rather than as a matter of law, as I conclude is proper. In other words, they accept the testimony of the government's experts and make a factual finding that the Barclays payment was an effective U.K. tax rebate and consequently a U.S. tax effect. Notably, they do not address the legal question whether a private party payment between Barclays and the relevant bank can properly be classified as a tax effect because it is so much like one in substance, a question that [cited precedents] answer in the negative. (Citations omitted.)

There was no dispute that Sovereign incurred and paid U.K. taxes on the trust income, reported the income on its U.S. tax returns, and claimed a correctly computed foreign tax credit. The government's position was that Sovereign did not "in substance" pay the U.K. taxes claimed because the Barclays payment was "in substance" a rebate by the U.K. government of one-half of Sovereign's U.K. taxes. The theory was that Barclays was able to make the monthly Bx payments only because of the tax credits it had received from the United Kingdom.

Addressing the government's contention that the Bx payments were in effect rebates from the U.K. treasury, the *Santander* court bluntly rejected the notion, indicating that there are no precedents, and no statutory or regulatory provisions, that would allow a payment from a private party to be recharacterized as a payment from a taxing authority. On the contrary, the court reasoned that the terms "taxes" and "tax credits" are properly understood to refer to transactions between a taxpayer and a taxing authority, not transactions between private parties, even if the effect is to lessen for a taxpayer the economic burden of having paid the tax. Amounts paid between private parties pursuant to private contracts are not and cannot be federal income taxes, the court explained.

The Code and regulations contain explicit provisions addressing when a foreign tax may be considered rebated by the taxing authority and when a taxpayer may be considered to have received a subsidy from a foreign source to pay its foreign taxes. Citing Reg. §1.901-2(e)(3), the court emphasized the regulatory language that "[s]ubstance and not form shall govern in determining whether a subsidy exists." Pointing out that the government declined, in pretrial discovery, to argue that the Barclays payment was a subsidy under the Code or regulations, the court indicated that "the government presses its argument that the Barclays payment was 'in substance' a rebate from the U.K. But the government can point to no governing or precedential legal authority that supports treating the private payment between Barclays and Sovereign as a payment from the U.K. treasury, because there is none."

It is a "hoary principle dating to the earliest days of the income tax," the court explained, that taxes paid on behalf of a taxpayer are counted as income to the taxpayer. The court explained that this principle is also reflected in the regulations. Reg. §1.901-2(f) provides that the person by whom tax is considered paid for purposes of the foreign tax credit is the person on whom foreign law imposes legal liability for the tax, even if another person remits the tax. The tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability.

The district court also addressed the argument that had been accepted in *BNY I* and *Salem I* and advanced again in

[1557] 115 F.3d 506 (7th Cir. 1997) (citing *Kerman v. Commissioner*, 713 F.3d 849, 865 (6th Cir. 2013)).

[1558] *Santander Holdings USA, Inc. v. United States*, 144 F. Supp. 3d 239 (D. Mass. 2015), rev'd, 844 F.3d 15 (1st Cir. 2016), cert. denied, No. 16-1130 (U.S. June 26, 2017); 977 F. Supp.2d 46 (D. Mass. 2013).

[1559] Santander Holdings USA, Inc. was formerly known as Sovereign Bancorp, Inc., which is how the court refers to the taxpayer in the opinion.

[1560] The First Circuit declined to address this issue, because whether the Bx payments were revenue or not, they were earned by paying twice their value in U.K. tax, making the trust transaction profitless. *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016), cert. denied, No. 16-1130 (U.S. June 26, 2017).

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Santander that the entire STARS transaction lacked economic substance:

> Under this broad view, the whole STARS transaction was concocted to manufacture a bogus foreign tax credit for Sovereign. There was no legitimate business purpose or economic substance to the transaction, the argument goes, except to create the conditions under which Sovereign could claim the foreign tax credit on its U.S. tax returns. The courts in the other cases apparently were persuaded to that position, but I am not. In part the argument is foreclosed by what has just been explained. If the Barclays payment is included in the calculation of pretax profitability, then there was a reasonable prospect of profit as to the trust transaction, giving it economic substance. But in any event, unless the 'effective rebate' theory is credited, Sovereign's payment of the U.K. tax and claiming of the U.S. foreign tax credit did not produce an improper tax benefit; rather, it was simply a wash. Even if the Barclays payment was intended to be and was the assumption of part of Sovereign's U.K. tax burden (which Sovereign concedes for the purposes of this motion), Sovereign is nonetheless treated as having paid the full U.K. tax for purposes of the foreign tax credit. [citations omitted] It was thus entitled to claim the foreign tax credit on its U.S. returns. It is true that the United Kingdom received an amount in taxes from Sovereign that but for the transaction would have gone to the U.S. Treasury, but that transfer produced no advantage to Sovereign. It was still out the same amount of tax, regardless of which country it was paid to.

The district court cast the STARS transaction not as a mere foreign tax credit generator, but as a financing structure designed to give Barclays substantial benefits under U.K. tax laws, in exchange for which Barclays lent funds to U.S. banks at a lower cost than otherwise might be available to them. The banks could re-lend the money in their normal banking operations, using the lower cost either to obtain a competitive advantage or to increase their marginal return on lending or both.

The court acknowledged that the STARS transaction "included a number of contrived structures and steps that, each viewed in isolation, would make little or no sense." The court pointed out as an example that Barclays had an ownership interest in the trust and, as a result, received monthly distributions from the trust, which, under the terms of the transaction, it was required immediately to recontribute to the trust. Standing in isolation, this circular movement of distributions would make no sense, the court said, but in the context of the entire transaction, the court recognized it was crucial to Barclays' obtaining favorable tax treatment under U.K. law, which gave it the ability to lower its effective lending rate to a U.S. bank. The result of the STARS transaction for Barclays was a net tax gain, which it was able to use to reduce other U.K. tax liabilities that it owed.

The court described the loan as "highly structured in an idiosyncratic way," but noted it was consistently treated by Sovereign for accounting and regulatory purposes as a secured loan, which was acceptable to regulating agencies, including the Securities and Exchange Commission and the Office of Thrift Supervision. The Bx payment was actually a monthly credit to Sovereign figured into its interest costs, the court explained.

Following the success of its first motion on the issue whether the Bx payment should be counted as revenue to Sovereign, Sovereign filed a second motion, this time for summary judgment. In response, the court concluded the loan was legitimate and Sovereign was entitled to deduct the interest expenses for the loan, and that the STARS transaction had economic substance and Sovereign was entitled to the foreign tax credits.[1561] First, the district court agreed with the Second and Federal Circuit courts and the Tax Court that the undisputed fact that Sovereign borrowed more than a billion dollars from Barclays to use in its banking business was, by itself, sufficient to reject the government's contention that the loan lacked economic substance, even when the loan was analyzed separate from the trust transaction. The court noted that STARS originally was marketed to non-bank businesses and lacked a loan component. Only after the loan was added did banks become interested in STARS, and "it is an obvious and fair conclusion that it was the economic value of the loan that attracted their attention." That the pre-Bx interest rate was above market was not sufficient to conclude that the loan lacked any economic substance.

Next, the district court addressed how the Bx payments should be factored into the pre-tax profit analysis. In its first opinion, discussed above, the court concluded that the Bx payment should be counted as revenue to determine whether there was a reasonable profit potential. In adjudicating Sovereign's second motion, the court explicitly rejected the government's contention that the taxes paid to the United Kingdom should be counted as an economic cost of earning the Bx payment (thus reducing the profitability of the transaction). The court explained that it is inaccurate to say that Sovereign "paid for" the Bx payment by paying taxes to the United Kingdom. The assets contributed to the trust were earning income and Sovereign was accruing tax liability on that income before STARS, and it is undisputed that neither condition changed upon contribution of the assets. From a tax perspective, STARS was a wash; Sovereign's global tax liability remained the same; all that changed was that some of the tax was paid to the United Kingdom, instead of the U.S. treasury. The U.K. income tax was not an incremental cost of the STARS transaction. The court acknowledged that payment of tax to the United Kingdom was a condition to receiving the Bx payment, but the requirement was not economic — it was jurisdictional. The only economic costs of establishing that jurisdictional requirement were the costs to negotiate the STARS transaction. Even if the U.K. taxes should be treated as an expense in a profitability analysis, the court indicated, then it also would be necessary to consider the effect of the offsetting foreign tax credit. To be consistent, the profitability analysis should either count all tax effects or none of them. As to the nature of the Bx payment, the court reiterated its earlier opinion that the Bx payment was not a rebate of U.K. taxes and held that the Bx payment was not a tax effect to be ignored in the pre-tax profitability analysis.

The *Santander* court departed significantly from the other courts that have considered the economic substance of the

[1561] *Santander Holdings USA, Inc. v. United States*, 144 F. Supp. 3d 239 (D. Mass. 2015).

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STARS transaction. The court explained that the taxpayer had already disregarded the STARS trust for U.S. income tax purposes, so that all the trust's income and expenses were treated as being owned directly by Sovereign. Thus, the step transaction and conduit doctrines do not apply to disregard the trust. Nor do they apply to disregard the actual, economically significant, payment of U.K. taxes. Perhaps most significantly, the *Santander* court noted that it is inappropriate to apply the U.S. judicial economic substance doctrine to examine the computation of Barclays' U.K. tax liability. The STARS transaction was designed to affect Barclays' tax liability, not Sovereign's, it was conceived of by Barclays as a way for Barclays to reduce its U.K. tax liability — it was not developed to help U.S. taxpayers to obtain U.S. tax benefits — they simply looked to the foreign tax credit to maintain tax neutrality. The parties to STARS were unrelated and dealt with each other at arm's length. Barclays was looking for U.K. tax benefits and Sovereign was looking for low-cost financing. Subjecting some of its income to U.K. tax, the court reasoned, was "Sovereign's quid for Barclay's quo" and "[b]eing compensated for services rendered seems like 'meaningful economic activity'". Finally, the court noted, while it may be true that the STARS trust was created solely to produce tax benefits for Barclays, that was not true for Sovereign. STARS brought the Bx payment, a substantial economic benefit.

Finally, the *Santander* court opined that it is possible for an anti-abuse doctrine to itself be abused, and suggested that the *Salem*, *BNY*, and *Wells Fargo* cases are illustrative of such abuse. "What seems to bother the government," the court wrote, "is not so much that Sovereign does not *qualify* for foreign tax credits as that it does not *deserve* them. It is almost as if the government thinks that, under a sort of aiding and abetting theory, Sovereign should be punished by taking away its credit for helping Barclays manipulate *its* benefits under the U.K. tax laws."

b. First Circuit

The First Circuit reversed the district court, holding that the STARS trust transaction had no objective non-tax economic benefit and that Congress did not intend the foreign tax credit regime to cover transactions that do not change the participant's economic position other than with regard to taxation. Further, the court found that the trust transactions' sole function was to create exposure to U.K. taxation for the purpose of generating U.S. foreign tax credits.[1562] The First Circuit substantially agreed with and relied on the Federal Circuit's *Salem Fin., Inc. v. United States*[1563] opinion to support its own conclusions. The parties agreed, for purposes of the appeal, that the STARS trust should be analyzed separately from the loan transaction, and the government did not challenge the economic substance of the loan transaction standing alone or that Sovereign could claim interest-expense deductions.

The court held that the STARS trust transaction lacked economic substance no matter whether the Bx payments were counted as income or as a rebate of U.K. taxes, and so it did not address the proper character of the Bx payments. Instead, the court found that the STARS trust transaction had no profit potential without considering the foreign tax credits, was structured solely for tax-avoidance purposes and lacked a bona-fide business purpose. Most importantly, the court concluded that the STARS trust transaction was profitless because the Bx payment was obtained by paying twice the value of the Bx payments in U.K. taxes and not the type of transaction Congress intended the foreign tax credit to promote.

The court reasoned that the foreign taxes should be considered as transaction expenses because exposure to U.K. taxation was the "necessary and sufficient condition of the Bx payment." The U.K. taxes were the cost incurred to obtain the profit generated by the STARS trust transaction. The court noted that this conclusion does not contradict the Supreme Court's decision in *Old Colony Trust Co. v. Commissioner*[1564] that tax paid on behalf of a taxpayer is income to that taxpayer, because that case did not involve foreign taxes and "says nothing about whether foreign tax liability may ever be considered an expense."

4. Wells Fargo & Co. v. United States

The fourth structured trust advantaged repackaged securities (STARS) case is *Wells Fargo & Co. v. United States*. The case was tried to a jury, which found that the STARS trust lacked both business purpose and pre-tax profit potential and that the loan should be analyzed separately from the trust. The jury found that the loan had a possibility of pre-tax profit but was entered into solely for tax purposes.[1565]

The *Wells Fargo* court addressed many of the same issues decided by the other courts, but there were two notable differences. First, Wells Fargo moved for partial summary judgment that the Bx payment should be considered pretax income rather than a tax benefit, in part because the Bx payment reflected compensation for services provided (i.e., participating in STARS).[1566] As in other STARS cases, the taxpayer cited the Eighth Circuit's *IES Indus., Inc. v. United States*[1567] opinion in support of that proposition. However, the district court found that *IES* "has little to say about the proper characterization of the Bx payment." The court indicated that the government was not arguing that any tax payment made by a third party on Wells Fargo's behalf should not be considered income to Wells Fargo. Instead, the court said, the government was arguing that "a sum of money that was indisputably a tax benefit in Barclays' hands should also be considered a tax benefit when Barclays shares it [via the Bx payment] with Wells Fargo." Said another way, the government was arguing that the passage, via the Bx payment, of the U.K. tax benefit through Barclays' hands and into Wells Fargo's hands does not change its character as a tax benefit. The court found that to be a different issue than the one addressed by *IES*.

Second, in discussing whether the STARS trust and loan should be analyzed as a single transaction or as two separate

[1562] *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016), cert. denied, No. 16-1130 (U.S. June 26, 2017).

[1563] 786 F.3d 932 (Fed. Cir. 2015), cert. denied, No. 15-380 (U.S. Mar. 7, 2016).

[1564] 279 U.S. 716 (1929).

[1565] 260 F. Supp. 3d 1140 (D. Minn. 2017), *aff'd*, No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020).

[1566] *Wells Fargo & Co. v. United States*, 143 F. Supp. 3d 827 (D. Minn. 2015).

[1567] 253 F.3d 350 (8th Cir. 2001).

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transactions, the court observed that even if a unitary analysis is undertaken, and even if a jury found that STARS satisfied the objective prong of the economic substance analysis (i.e., had economic substance), the jury still might find that the transaction failed the second, subjective, prong because it lacked a business purpose. Citing *WFC Holdings Corp. v. United States*,[1568] the district court pointed out that the Eighth Circuit has never definitively resolved the question whether a transaction that satisfies one prong, but not both prongs, of the economic substance analysis is a sham. Thus, the district court indicated, it would submit to the jury both prongs of the analysis and the jury would be permitted to consider, under the business purpose test, evidence that there were much less expensive sources of funding available.

After the jury returned its findings, there were three issues remaining. First was a question of penalties, which is discussed in 634 T.M., *Civil Tax Penalties*. Second was the question whether the loan should be disregarded as a sham where the jury found it had objective economic substance but the taxpayer lacked a subjective non-tax business purpose.[1569] Third was the question whether Wells Fargo could deduct the foreign taxes it actually paid, even though it had been denied foreign tax credits for those taxes.[1570]

The district court concluded that the Eighth Circuit is likely to treat the objective and subjective components of the sham transaction test as two factors in a single flexible analysis. The government did not point to any case in which a transaction that had economic effect was disregarded simply because the taxpayer lacked a non-tax objective and the district court noted that such a rule would make it more difficult to engage in legitimate tax planning[1571] and would lead to the absurd result of identical transactions being treated differently merely because the taxpayers had different motivations.

Applying this flexible analysis, the district court held that the loan was not a sham and that Wells Fargo could deduct the interest expenses associated with it. The court also noted that the fact that Wells Fargo would not have entered into the loan transaction but for the opportunity to gain unrelated tax benefits does not change the fact, found by the jury, that the loan was a real transaction with substantial non-tax economic consequences. Further, the court reasoned that although Wells Fargo's motivation for entering into the loan was not to borrow money but to disguise the sham nature of the STARS trust, the loan was not integral to the trust structure and did not play a role in generating the abusive foreign tax credits.

The question whether Wells Fargo could deduct the foreign taxes it paid was raised too late and was deemed waived.[1572] Nevertheless, the court analyzed the question and concluded that Wells Fargo was not entitled to the deduction in any event. Unlike the interest expenses that were attributable to a separable, economically substantive element of the larger STARS transaction, the tax payments arose from the sham trust that was created specifically in order to create the obligation to pay the tax. The purpose of the sham transaction doctrine is to disallow benefits to which a taxpayer otherwise would be allowed, the court noted, and to permit a deduction after having denied a credit would be contrary to that purpose.

On appeal, the Eight Circuit concluded that:

- Outside of its tax benefits, Wells Fargo's STARS trust transaction was essentially comprised of economically meaningless, and circular, cash flows;
- There was virtually no economic risk, apart from tax risk, in the transaction;
- The transaction's trust component had no real potential for profit outside of its tax implications; and
- Wells Fargo had no valid business purpose for entering into the transaction.[1573]

The Eight Circuit affirmed the district court's conclusion that the trust component of the STARS transaction was a sham transaction that needed to be disregarded for tax purposes, determined that Wells Fargo could not deduct the foreign taxes it paid in connection with the STARS transaction, and determined that Wells Fargo was liable for a negligence penalty for claiming foreign tax credits.[1574]

L. Son-of-BOSS Cases

So-called "son-of-BOSS" transactions involve the artificial creation of tax basis in a partnership by contributing high-basis property that correspondingly increases partnership basis along with an economically offsetting position that does not give rise to a corresponding basis reduction.[1575] While the facts of such transactions vary, a typical fact pattern involved the contribution of a high-basis fixed position and an offsetting contingent position, with the taxpayer claiming that the contingent position was not a liability that reduced partnership basis, generating a loss upon the liquidation of the partnership.[1576] Son-of-BOSS transactions were marketed in the late 1990s to early 2000s, primarily to wealthy individuals. According to the IRS, more than 1,800 people participated in Son-of-BOSS transactions.[1577]

In Notice 2000-44[1578] the IRS described three son-of-BOSS transactions and concluded that the resulting losses "do not

[1568] 728 F.3d 736 (8th Cir. 2013).

[1569] *Wells Fargo & Co. v. United States*, 260 F. Supp. 3d 1140 (D. Minn. May 24, 2017), *aff'd*, No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020).

[1570] *Wells Fargo & Co. v. United States*, No. 09-cv-02764 (PJS/TNL), 2017 BL 326553 (D. Minn. Sept. 15, 2017), *aff'd*, No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020).

[1571] The district court cited *Gregory v. Helvering*, 293 U.S. 465 (1935) for the proposition that taxpayers have a legal right to decrease or eliminate their tax burden through legitimate means.

[1572] *Wells Fargo & Co. v. United States*, No. 09-cv-02764 (PJS/TNL), 2017 BL 326553 (D. Minn. Sept. 15, 2017), *aff'd*, No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020).

[1573] *Wells Fargo & Co. v. United States*, No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020), citing *Wells Fargo & Co. v. United States*, 641 F.3d 1319, 1330 (Fed. Cir. 2011) (purely circular transactions that elevate form over substance are characteristic of abusive tax shelters).

[1574] *Wells Fargo & Co. v. United States*, No. 17-3578, 2020 BL 152882 (8th Cir. Apr. 24, 2020).

[1575] "BOSS" is an acronym for "Bond and Option Sales Strategy," an earlier strategy that son-of-BOSS transactions were said to resemble. *Stobie Creek Invs., LLC v. United States*, 608 F.3d 1366, 1368 n.1 (Fed. Cir. 2010).

[1576] The IRS has since issued regulations concerning contingent liabilities that effectively prevent this tax planning from a technical perspective. Reg. §1.752-1(a)(4), §1.752-6 and §1.752-7. See 714 T.M., *Partnerships — Allocation of Liabilities; Basis Rules*.

[1577] IRS News Release 2005-37 (Mar. 24, 2005).

[1578] 2000-2 C.B. 255.

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represent bona fide losses reflecting actual economic consequences as required for purposes of section 165." Courts that have considered son-of-BOSS transactions have generally agreed with this conclusion and have disallowed the tax benefits claimed by the taxpayers, often on the grounds that the transactions lacked economic substance. Key decisions by the Tax Court, the Court of Federal Claims, and a U.S. Court of Appeals are discussed below.[1579]

1. Sala v. United States

In *Sala v. United States*,[1580] the taxpayer entered into a transaction involving offsetting long and short options. The taxpayer had contributed the options to a partnership and claimed that only the long options should be taken into account in establishing basis in the partnership because the short options were contingent liabilities. The district court initially allowed the taxpayer to claim the tax benefits from the transaction, but the Tenth Circuit reversed the district court and held that the transaction lacked objective economic substance. The court disallowed losses arising from the higher basis that the taxpayer claimed on liquidation of the partnership. According to the appeals court, the expected tax benefit of nearly $24 million exceeded the potential profit of $500,000 over the course of one year. Citing *Rogers v. United States*[1581] and *Keeler v. Commissioner*,[1582] the court held that the existence of some potential profit is 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 appeals court rejected the district court's findings to the extent that they were based on the consideration of the option program as a whole, holding that only the loss-generating phase is relevant to the economic substance analysis. (*Sala* is discussed in greater detail in IV.G., above.)

2. Jade Trading, LLC v. United States

Jade Trading, LLC v. United States,[1583] like *Sala*, involved the taxpayer entering into economically offsetting positions in a currency option spread transaction. After entering into the option spread, the taxpayer contributed it to a partnership, which subsequently liquidated the taxpayer's interest. The taxpayer claimed a loss of almost $15 million on the ground that the short option position was not a liability for purposes of §752. The U.S. Court of Federal Claims held that the transaction was an economic sham and should be disregarded for lacking economic substance, concluding that the options could not be treated as separate transactions because they were "inextricably linked." Had the positions been legally distinct, the court reasoned that the counterparty would have required payment of the full face amount of the $15 million premium for the long option and would have required margin collateral of at least $8 million for the short option; instead, the premiums were netted and the actual payment for the positions was $150,000. The holding of the U.S. Court of Federal Claims that the transactions lacked economic substance was affirmed by the U.S. Court of Appeals for the Federal Circuit.

3. Markell Co. v. Commissioner

Markell Co. v. Commissioner[1584] involved a variation on the son-of-BOSS transaction, with a corporation as a partner in the partnership. A corporation contributed short and long options to a limited liability company that the taxpayer claimed was a partnership for U.S. federal tax purposes. The short option was not taken into account in determining the corporation's basis in the partnership, resulting in a built-in loss in the corporation's interest in the partnership. The corporation resigned from the partnership, taking a transferred basis in the securities distributed to it in liquidation of its interest, and subsequently sold those assets at a loss. The Tax Court denied the taxpayer the loss on the basis that the limited liability company was not, in fact, a partnership. The court found that scrupulous adherence to the formal requirements to make the entity look like a partnership was insufficient to overcome the absence of any objective indication of mutual combination for the present conduct of an ongoing enterprise other than tax avoidance. One factor in the court's finding that the alleged partnership lacked economic substance was an adverse inference drawn from James Haber's[1585] invocation of his Fifth Amendment right to remain silent. The court noted that the Fifth Amendment permits an adverse inference from its invocation during a civil trial, and that the relationship between Haber and the parties to the suit was such that an adverse inference was appropriate.

4. CNT Investors, LLC v. Commissioner

In *CNT Investors, LLC v. Commissioner*,[1586] individuals (through an S corporation) owned real estate with a substantial built-in gain. The individuals entered into a son-of-BOSS transaction by contributing the real estate to a partnership, as well as cash and obligations resulting from the short sales of T-notes. The individuals claimed that the cash increased their outside basis in the partnership and that this partnership basis was not reduced by the contributed obligations on the short sale. The partnership used the cash to purchase T-notes of a similar principal amount, and entered into a repo transaction on the T-notes to eliminate the risk of loss from the short sale. The partnership closed the repo transaction and the short sale positions, and the partnership was then terminated. Upon the termination of the partnership, the individuals claimed tax basis in the real estate

[1579] Among other well-known Son-of-BOSS cases are *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp.2d 885 (E.D. Tex. 2007), aff'd, 568 F.3d 537 (5th Cir. 2009), and *Stobie Creek Invs. v. United States*, 82 Fed. Cl. 636 (2008), aff'd, 608 F.3d 1366 (Fed. Cir. 2010). *See* Jackel & Crnkovich, *Son-of-BOSS Revisited*, 123 Tax Notes 1481 (June 22, 2009) (listing and discussing son-of-BOSS cases up to the date of the article).

[1580] 613 F.3d 1249 (10th Cir. 2010), rev'g 552 F. Supp.2d 1167 (D. Colo. 2008), reh'g en banc denied and opinion amended, 106 AFTR2d 5488 (10th Cir. 2010) (adding footnote to opinion), cert. denied, 132 S. Ct. 91 (2011). *See also Fid. Int'l Currency Advisor A Fund, LLC v. United States*, 747 F. Supp.2d 49 (D. Mass. 2010), aff'd, 661 F.3d 667 (1st Cir. 2011) (foreign currency option transactions had no economic substance).

[1581] 281 F.3d 1108 (10th Cir. 2002).

[1582] 243 F.3d 1212 (10th Cir. 2001).

[1583] 80 Fed. Cl. 11, 50–51 (2007), aff'd in part, *vacated in part and remanded*, 598 F.3d 1372 (Fed. Cir. 2010) (son-of-BOSS transaction lacked economic substance; U.S. Court of Federal Claims lacked jurisdiction to apply penalties because it relied solely on outside basis in applying penalties).

[1584] T.C. Memo 2014-86. *Accord AD Inv. 2000 Fund LLC v. Commissioner*, T.C. Memo 2015-223, supp. op., T.C. Memo 2016-226.

[1585] Haber was not a party to the suit, but had nearly unfettered authority over, and placed himself in managerial positions in, every entity necessary for the transaction to work.

[1586] 144 T.C. 161 (2015).

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based on their stepped-up outside basis in the partnership. The court applied the step transaction doctrine to the transactions, and held that the real estate should be treated as distributed by the S corporation to the shareholders, resulting in the recognition of gain under §311(b).

5. BCP Trading & Invs., LLC v. Commissioner

A variant of the son-of-BOSS transaction is the contingent deferred swap (CDS), in which a taxpayer contributes nearly offsetting European-style foreign currency long and short digital options to a partnership and does not reduce its basis in the partnership interest by the contingent liabilities represented by the short options. Upon expiration of the contingency period for the assets and liabilities, the taxpayer disposes of its partnership interest and receives a distribution of foreign currency with a basis equal to the original basis in the partnership. The currency is then sold at fair market value, generating a loss. In *BCP Trading & Invs., LLC v. Commissioner*, the court analyzed the factors set forth in *Luna v. Commissioner*[1587] to find "scrupulous adherence to the formal requirements of making BCP look like a partnership, but a complete absence in its operating agreement and actual operations of any objective indication of a mutual combination for the present conduct of an ongoing enterprise." Having disregarded the partnership, the court treated the partnership's activities as having been engaged in directly by the partners. Thus, the partners' basis in the option contracts and their basis in the foreign currency was their purchase price and each partner recognized modest gains or losses.[1588]

[1587] 42 T.C. 1067 (1964).

[1588] *See* T.C. Memo 2017-151, *aff'd* No. 19-1068, 2021 BL 102952 (D.C. Cir. Mar. 23, 2021) (Tax Court correctly applied *Luna* factors to determine whether parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise, and correctly determined that taxpayer failed *Luna* analysis).

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