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The Economic Substance Doctrine:
2005-2007 Government Court Victories and Current Legislative Proposals for Codification

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I. Government Trial Court Victories.

A. ***Long Term Capital Holdings v. United States,*** **330 F. Supp. 2d 122 (D. Conn. 2004);** ***aff'd*****, 2005 U.S. App. LEXIS 20988 (2d Cir. 2005).**

1. Facts.

   a. Onslow Trading and Commercial LLC ("OTC"), an entity incorporated under the laws of the Turks and Caicos Islands and resident in the United Kingdom, entered into a series of nine cross-border lease-stripping transactions. OTC exchanged the resulting leases, subleases, and bank accounts for preferred stock. The preferred stock had a market value of $4 million and a claimed basis of $400 million.

   b. OTC contributed to Long-Term Capital Portfolio ("Portfolio") the preferred stock from the lease-stripping transactions in exchange for a Portfolio partnership interest. OTC sold its interest in the partnership to another partner of Portfolio, Long-Term Capital Management L.P. ("LTCM").

   c. Portfolio sold the preferred stock, which had a basis of 100 times its fair market value.

2. Government's position.

   a. The transactions (transfer of Portfolio stock by OTC to Portfolio and LTCM's investment in Portfolio) lacked a non-tax business purpose and economic substance.

   b. Based on all of the costs associated with the transaction, LTCM did not have the potential to make a profit.

   c. There was no real economic explanation for the transaction apart from the tax benefits.

3. Taxpayer's position.

   a. LTCM entered into the transaction with an expectation of making a substantial pre-tax profit from the management and incentive fees. This established both a subjective business purpose and objective economic substance.

   b. The transaction also increased the LTCM principals' investments in Portfolio, which is another non-tax business purpose.

   c. Objective economic substance was present because the transaction caused a change in the economic positions and rights of the parties.

4. District Court opinion.

   a. Like *TIFD III-E* (*Castle Harbour, infra*), this case was tried in the United States District Court for the District of Connecticut. However, each case was heard and decided by a different judge.

   b. In holding that the transaction lacked economic substance, the court applied the following test for economic substance: An inquiry into economic substance requires an analysis of both business purpose and the transaction's objective economic substance. A finding of either a lack of business purpose or an absence of economic substance can be sufficient to conclude that a transaction is a sham.

   c. A transaction has economic substance if it offers a reasonable opportunity for economic profit exclusive of tax benefits. The court weighed the transactional costs and fees in determining whether there was a reasonable expectation of return. The costs and fees included legal fees for opinions, bonuses, loan costs, and option costs. Significantly, the court held irrelevant whether the transaction caused a change in the parties' economic positions and whether the transaction changed the beneficial and economic

rights of the parties. The court concluded that, based on the costs of the transaction (the transfer of preferred stock by OTC to Portfolio), there was no realistic or reasonable expectation that it would make a non-tax based profit from the transaction.

d. The transaction also did not have a non-tax business purpose. The absence of s reasonable probability of making a profit demonstrated that tax avoidance motivated the transaction.

e. "[T]he OTC 'investment' was a one-time purchase of a tax product by Long Term and different in almost every way from Long Term's core investment business. The OTC transaction was not a mere change in the manner in which a profit making business is administered but, in Scholes' words, a 'unique' transaction, different in kind not just degree from the usual transaction cost investments of which Long Term's core business was comprised. In sum, the present case is akin to the ones United Parcel took pains to distinguish, 'tax-shelter transactions ... by a business ... that would not have occurred, *in any form*, but for tax-avoidance reasons.'" (quoting *United Parcel Service v. Commissioner*, 254 F.3d 1014, 1020 (11th Cir. 2001)).

5. Court of Appeals Opinion: The opinion did not consider economic substance. Rather, the Court of Appeals addressed the step transaction doctrine and penalty issues.

B. *CMA Consolidated, Inc. v. Commissioner*, T.C. Memo. 2005-16.

1. Facts.

a. CMA Consolidated, Inc. ("CMA") was a closely held California corporation in the business of leasing and structuring the financing of equipment.

b. CMA, as part of its business, regularly entered into a series of transactions with several entities to bifurcate and reallocate rental income and related rental expenses. The majority of the rental income was stripped out and allocated to a tax-indifferent party.

c. In the first lease strip transaction, another party paid $2.9 million for $13.8 million in deductions. A second lease strip transaction was required to reap all of the tax benefits. The first lease strip transaction was not before the Tax Court.

d. Between the first and second lease stripping transactions, the IRS issued Notice 95-53, in which the IRS warned that it would challenge and disallow tax benefits claimed in certain lease strip transactions.

e. In order to take advantage of the tax benefits from the first lease strip transaction, CMA entered into the second lease strip transaction (the "transaction") approximately 9 months after the first lease strip transaction. CMA contended that it "was forced to become involved in the second lease strip deal because of the IRS's October 30, 1995, issuance of Notice 95-53…." CMA paid $40,000 for $4.2 million in deductions.

2. Government's position.

a. The form of the transaction should be disregarded because the transaction lacked economic substance.

b. "[M]odest or inconsequential profits relative to petitioner's [CMA's] claimed substantial potential tax benefits are insufficient to imbue an otherwise questionable second lease strip deal with economic substance."

3. Taxpayer's position.

a. The transaction had economic substance. The form of the transaction should be respected.

b. CMA was in the business of structuring lease transactions. The two lease strip transactions at issue "did not differ from and were typical of contemporaneous lease strip deals."

c. CMA was generally motivated to seek a pretax economic profit.

4. Tax Court opinion.

a. The Tax Court applied a facts and circumstances test, with no single factor being determinative. In applying the facts and circumstances test, the court inquired into the taxpayer's subjective reasons for entering into the transaction and whether there was the potential to make a profit on the transaction. Citing *Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990), the court stated that "the two tests [subjective business purpose and objective economic substance] have much in common and are not necessarily discrete prongs of a 'rigid two-step analysis.'"

b. The taxpayer lacked a non-tax business purpose. The transaction was designed to provide substantial tax benefits for the taxpayer. "Petitioner has not shown any credible business purpose for its involvement in the second lease strip deal other than its intent to claim $4.2 million in tax benefits."

c. There was little or no potential for profit. Aside from the potential tax benefits, the second lease strip deal "lacked any demonstrable objective, practical, economic profit potential."

d. Applying the facts and circumstances test, the court did not respect the transaction because it lacked both a non-tax business purpose and economic substance. "The lease strip deals we consider in this case are mere tax-avoidance devices or subterfuges mimicking a leasing transaction. The obvious purpose was to obtain unwarranted and substantial tax benefits."

C. ***BB&T Corp. v. United States*, 99 A.F.T.R.2d (RIA) 2007-376 (Jan. 4, 2007).**

1. Facts.

a. Sodra, a Swedish company, owned certain equipment. BB&T obtained a lease (the "Head Lease") for an undivided interest in the equipment for a period of 36 years. As part of the same transaction, BB&T subleased the equipment back to Sodra for a term of 15.5 years. Under the terms of the Head Lease, BB&T was required to make (i) a payment of $86.2 million due at closing and allocated to the first five years and (ii) a payment of $557.8 million due in 2038 and allocated to the last 31.5 years of the Head Lease.

b. BB&T made the $86.2 million payment using approximately $18.2 million in its own cash and $68.0 million from a non-recourse loan issued by a bank ("HBU"), a subsidiary of another bank ("ABN").

c. Also at closing, Sodra made a $68.0 million payment to ABN under an agreement (the "Debt PUA") pursuant to which ABN would make payments to BB&T on Sodra's behalf, and another $12.0 million to Fleet National Bank ("Fleet") for Fleet to purchase government securities.

d. The amount of Sodra's annual rent payments to BB&T under the sub-lease equaled the amount of BB&T's scheduled debt payments to HBU on the nonrecourse loan. Moreover, Sodra's annual rent payments equal the scheduled payments pursuant to the Debt PUA, which obligates ABN to pay Sodra's rent directly to HBU.

e. Sodra had an option to purchase the equipment at the end of the sub-lease term.

f. BB&T included in income rent from Sodra of $3.4 million. It also deducted $9.9 million in rent and $2.8 million in interest.

2. Government's position.

a. BB&T did not acquire a leasehold interest in the equipment because Sodra continued to use it as before and never conveyed a real leasehold interest.

b. The court should collapse the Head Lease and sub-lease because they create offsetting obligations.

c. The "true substance" of the transaction was "BB&T's payment of transaction costs and its investment in the government securities" purchased by Fleet.

3. Taxpayer's position.

a. Sodra's use of the equipment was altered as a result of the transaction, and Sodra assumed new obligations with respect to maintaining and operating the equipment.

b. BB&T acquired a leasehold interest because if Sodra did not exercise its purchase option, BB&T would own the equipment outright.

4. District Court opinion.

a. The combined effect of the Head Lease and the sub-lease is that BB&T did not have a right to possess the equipment. The rights transferred and re-transferred were identical, such that in substance Sodra's use and possession of the equipment was unaltered.

b. Although in form Sodra was required to make rent payments to BB&T, those payments were in fact made by the Debt PUA, were funded in full by BB&T's initial Head Lease payment, and did not require Sodra to invest any of its own funds.

c. Sodra's option to purchase the equipment was fully funded by the payments it had already made to the Debt PUA and to purchase government securities. "BB&T bore no real risk of loss of its initial investment in the Transaction."

d. In relying on the transaction documents to support its position, BB&T "elevates form over substance." In substance, BB&T would not be required to expend any additional funds even if Sodra did not exercise its purchase option. When the substance is considered, "BB&T acquired only a future interest in the right to use and possess the Equipment."

e. With respect to the interest deductions, the court repeatedly emphasized that while the loan documents represent the form selected by the parties, the substance of the "loan" did not require BB&T to pay any money to HBU. After the closing, BB&T was not required to make any additional payments on the loan and therefore the purported interest expense "cannot be what Congress intended to allow as an income tax deduction." The court stated that the debt service payments were in substance made from the proceeds of the loan itself.

D. *Tribune Co. v. Commissioner*, 125 T.C. 110 (2005).

1. Facts.

a. Times Mirror wholly owned an investment subsidiary, TMD. TMD in turn owned a legal publishing business, Bender, which Times Mirror wished to transfer to Reed, an unrelated party. Therefore, Times Mirror structured a transaction to qualify as a tax-free reorganization under either section 368(a)(2)(E) or section 368(a)(1)(B).

b. Reed formed two subsidiaries, MergerSub and MB Parent. Two Reed affiliates contributed $775 million to MergerSub in exchange for voting common stock and voting preferred stock and then transferred the preferred stock to MB Parent in exchange for voting preferred stock of MB Parent. Simultaneously, MergerSub borrowed $600 million from another Reed affiliate and transferred all its cash ($1.375 billion) to MB Parent in exchange for MB Parent common stock (which had 20% of the voting power). Following these transactions, the Reed affiliates owned the common stock of MergerSub, while MB Parent owned

the preferred stock, and MergerSub owned the common stock of MB Parent, while the Reed affiliates owned MB Parent preferred stock.

c. MergerSub then merged into Bender (the target), and the MergerSub stock was converted into target stock of the same class. The common stock of MB Parent held by MergerSub was transferred to TMD (the taxpayer) in exchange for its common stock in Bender. After this transaction, (1) MergerSub's liability of $600 million was a liability of the target, (2) the taxpayer held the voting common stock of MB Parent (20 percent of the vote), while the Reed affiliates held voting preferred stock (80 percent of the vote) and participating preferred stock of MB Parent, (3) the Reed affiliates held the target's common stock (20 percent of the vote), while MB Parent held the target's voting preferred stock (80 percent of the vote) and participating preferred stock, (4) the Reed affiliates effectively controlled the target through their direct ownership of the target's common stock and voting control (80 percent) of MB Parent, which owned the remainder of the target's stock, and (5) the assets of MB Parent consisted of target stock and cash of $1.375 billion.

d. The parties also created a limited liability company (LLC), designating the taxpayer as manager of the LLC. MB Parent transferred all of its cash ($1.375 billion) to the LLC, which used the cash to repay short-term debt and purchase stock in the taxpayer.

2. Government's position.

   a. The transaction does not qualify as a tax-free reorganization because (i) TMD did not receive an amount of voting stock constituting control of MB Parent (and thus the transaction did not qualify under section 368(a)(2)(E)) and (ii) TMD did not exchange its Bender stock solely for voting stock (and thus the transaction did not qualify under section 368(a)(1)(B)).

   b. The government did not deny that there was a business purpose to the transaction. Nevertheless, the transaction was designed to segregate and seal off Times Mirror's interest in the cash and Reed's interest in Bender, such that "[t]he substance of the Bender Transaction is a swap. [Times Mirror] gave up Bender for the right to control and distribute to itself at will $1.375 billion of cash. Reed gave up $1.375 billion of cash for ownership and control of Bender."

   c. The government also argued that the court should adopt a broad approach and apply the "spirit" of the reorganization provisions, citing *Gregory v. Helvering* and *Minnesota Tea Co. v. Helvering*.

3. Taxpayer's position.

   a. The merger of MergerSub into the target was a reverse triangular merger, or alternatively the transaction qualifies as a reorganization under section 368(a)(1)(B).

   b. Times Mirror's control over the cash in the LLC was not part of the consideration received.

   c. The taxpayer cited *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), as demonstrating the limitations of substance over form arguments to recast a transaction that complies with the formal requirements of the statute.

4. Tax Court opinion.

   a. The court stated that the taxpayer could not point to any provision in the transaction documentation that restricts Times Mirror's use of the cash in the LLC.

   b. The cash in the LLC was consideration as part of the transaction because "from the standpoint of Times Mirror, control of the funds was the most important asset received." The documents confirm that only Times Mirror had a continuing economic interest in the cash, and only Reed had a continuing economic interest in Bender.

c. The court declined to accept the government's position that the "spirit" of the reorganization provisions should control. Rather, the court stated that its "understanding of the Bender transaction gives full effect to all of the contractual terms other than the labels assigned." The court distinguished *Esmark* by pointing out that in this case, there was no uncontrolled participation by persons who were not parties to the contractual arrangement, such as the public shareholders in *Esmark*.

E. *Klamath Strategic Investment Fund LLC v. United States*, 99 AFTR 2d 2007-850, 2007 U.S. Dist. LEXIS 6939, (E.D. Tex. 01/31/2007).

1. Facts.

a. This case involves a son-of-BOSS transaction to create excess basis in a partnership interest.

b. Two LLCs taxed as partnerships took out independent loans requiring interest payments and a balloon payment of principal at the end of the term. The LLCs received loan premiums for agreeing to pay above-market interest, bringing the total amount received to $66.7 million.

c. The LLCs contributed the loan proceeds and premiums into separate partnerships in exchange for 90 percent partnership interests, and the partnerships assumed the LLCs' credit responsibilities. The partnerships then exchanged the above-market fixed rate for a floating rate. The partnerships were purportedly formed to invest in US dollar and foreign currency securities, but the LLCs withdrew from the partnerships after 60 days and liquidated the partnerships, claiming losses on the sale of the foreign currency to which their excess basis in their partnership interests had attached.

d. The tax benefit hinges on the loan premium being characterized as a contingent liability that is not counted as a liability under section 752. Such a characterization would result in a discrepancy between inside and outside basis—the partnership's inside basis included both the loan proceeds and the loan premium, while the partners' outside bases did not include the loan premium because it was contingent. When the partnership is liquidated, the cash received by the partners would reduce their bases, and the remaining property received (foreign currency, e.g.) would have a large basis. The partners could then sell the foreign currency and generate a large loss equal to the loan premium.

2. District Court opinion - July 2006 - 440 F. Supp. 2d 608.

a. On summary judgment, the district court held that the loan premiums were not liabilities under section 752.

b. The district court also held that it was an abuse of discretion to apply the new section 752 regulations retroactively to transactions entered into before the IRS announced its position on loan premiums in Notice 2000-44, 2000-2 C.B. 255.

c. The court did not decide whether the son-of-BOSS transactions at issue lacked economic substance.

3. District Court opinion - January 2007.

a. The court relied on *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) as Fifth Circuit precedent for applying the economic substance doctrine. The court stated that, under *Compaq*, the court must consider both economic substance, i.e., whether a reasonable possibility of profit exists, and business purpose. However, under *Compaq*, it is unclear whether a transaction must be invalidated if it lacks only one of these.

b. Following *Coltec*, the court stated that "the transaction to be analyzed is the particular transaction that gives rise to the tax benefit, and not collateral transactions which do not produce the benefit. Accordingly, the court focused on the loan agreements – "the transactions that provide the cornerstone of the tax benefits."

c. The court found that the loan agreements lacked economic substance because they were entered into with additional understandings and agreements concerning the expected duration of the loans. The court found that the parties intended from the outset to liquidate the partnerships and claim the tax losses. The court was also persuaded by the fact that the fee arrangement for the investment was structured as a percentage of the tax losses generated.

d. The court also found that "the only reason for the loans … was to generate tax losses," and, accordingly, there was no non-tax business purpose for the loans.

e. The court refused to uphold the IRS's imposition of penalties. The court held that the gross and substantial valuation statement penalty could not apply because, under Fifth Circuit precedent, those penalties do not apply where the IRS totally disregards a transaction as lacking economic substance.

f. Significantly, the court also refused to uphold the IRS's imposition of the substantial understatement penalty and the negligence penalty.

(i) Substantial understatement penalty. The court assumed that the transactions were tax shelters within the meaning of section 6662(d)(2)(C)(iii), and, accordingly, that to avoid the penalty, the taxpayer had to show substantial authority <u>and</u> that the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment. Based upon the opinion of outside counsel and the taxpayers reliance on outside counsel, the court held that both of these tests were satisfied.

(ii) Negligence penalty. The court found that the taxpayers qualified for the reasonable cause and good faith exception to the negligence penalty because the taxpayers sought the advice of outside counsel who were familiar with the transactions, provided counsel with all of the relevant facts, and then had their accountants review the opinion of their counsel.

II. Government Appellate Court Victories (taxpayer victories overturned on appeal)

A. ***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).**

1. Facts.

a. Black & Decker ("B&D") sold three businesses in 1998, thereby generating significant capital gains.

b. In 1998, B&D transferred $561 million in cash to a newly formed subsidiary, Black & Decker Healthcare Management, Inc. ("BDHMI"), along with $560 million of contingent health care liabilities in exchange for BDHMI stock (the "BDHMI transaction"). B&D believed that it had a basis of $561 million in the BDHMI stock.

c. In 1998, B&D sold its BDHMI stock to an independent third party for $1 million. B&D claimed a $560 million loss from the sale.

d. The BDHMI transaction is the same or substantially similar to the contingent liability transaction described in Notice 2001-17.

2. Government's position: The BDHMI transaction was a tax avoidance vehicle that should be disregarded for tax purposes.[1]

3. Taxpayer's position.

[1] The loss was also challenged on other grounds that are not addressed in this outline. This outline is limited to the economic substance aspect of the cases reviewed.

a. The transaction should be respected because it had economic substance.

b. B&D conceded that it did not have a non-tax business purpose for the transaction and that tax avoidance was its sole motivation.

4. District Court opinion.

a. The court held that the BDHMI transaction had economic substance. The court applied the test in *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985) to determine whether the transaction was a sham. Under that test, a transaction is treated as a sham where "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."

b. Economic substance examines the objective reasonableness of the transaction to determine whether it contained economic substance aside from tax benefits. "A corporation and its transactions are objectively reasonable, despite any tax avoidance motive, so long as the corporation engages in bona fide economically-based business transactions."

c. The court held that the BDHMI transaction satisfied the second prong of the *Rice's Toyota World* test for the following reasons: BDHMI (1) "assumed the responsibility for the management, servicing, and administration of plaintiff's employee and retiree health plans; (2) has considered and proposed numerous healthcare cost containment strategies since its inception in 1998, many of which have been implemented by B&D; and (3) has always maintained salaried employees. 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. Pl.'s Ex. 17 (Mark Hirschey Depo. at 414). The 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." (Footnotes omitted).

d. "The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes."

5. Court of Appeals opinion.

a. The court held that the District Court misapplied the objective prong of the *Rice's Toyota* test. As discussed in *Rice's Toyota* and *Hines v. United States*, 921 F.2d 736 (4th Cir. 1990), the second prong of the *Rice's Toyota* test requires an objective analysis of whether a reasonable possibility of profit from the transaction existed apart from the tax benefits.

b. In analyzing the objective prong of the test, the District Court incorrectly relied on the fact that BDHMI maintained salaried employees and paid health care claims as they came due with BDHMI assets.

c. The IRS offered four experts who created a triable issue on the taxpayer's reasonable profit expectations. The four experts opined in their reports that the "only economically substantial value to Taxpayer in transferring its contingent liability to BDHMI was in tax savings." The District Court did not cite any of these opinions or otherwise evaluate them.

d. The court reversed and remanded for trial to resolve whether both prongs of the *Rice's Toyota* test were satisfied. The court indicated that the taxpayer must present objective evidence to demonstrate that the activity was engaged in for profit.

B. *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004)); *rev'd*, 454 F.3d 1340 (Fed. Cir. 2006).

1. Facts.

a. Coltec Industries, Inc. ("Coltec") brought this refund case in the United States Court of Federal Claims.

b. This is another contingent liability transaction case. The transactions also are the same or substantially similar to the transaction described in Notice 2001-17.

c. In 1996, Coltec sold Holly Automotive to Borg-Warner Automotive, Inc. for $283 million. Coltec recognized a significant gain from the sale.

d. Coltec was the parent of Garlock, Inc. ("Garlock") and Anchor Packing. Garlock and Anchor Packing manufactured gaskets and packing material that contained asbestos.

e. In 1996, Coltec established a case management subsidiary, the Garrison Litigation Management Group ("Garrison"), to handle the rising costs from asbestos litigation and settlements. Garlock capitalized Garrison with a $375 million note, all of the outstanding stock of Anchor, any future asbestos insurance recoveries, furniture, fixtures, equipment, and the data from the asbestos litigation department. In exchange, Garrison issued stock to Garlock, and Garrison assumed $371.2 million of Garlock's and Anchor's contingent asbestos liabilities. As a result of the transaction, Garlock claimed a tax basis of $379 million in its Garrison stock.

f. Coltec stated that one of its non-tax business reasons for forming Garrison was to make the Coltec group attractive for an acquisition.

g. In 1996, Garlock sold part of its Garrison stock to third party banks for $500,000. As part of the sale, Coltec agreed to indemnify the banks for any asbestos claims that may arise in the future. Garlock claimed a loss of $83 million from the sale.

h. In October 1998, Coltec sold 3% of its Garrison stock to four law firms that were involved in the legal defense of asbestos claims. This sale was not at issue before the court.

i. In 1999, the B.F. Goodrich Corporation acquired the Coltec group.

2. Government's position.

   a. The transactions (the formation of Garrison and sale of stock) lacked business purpose because "they were the product of a tax avoidance strategy conceived by [Arthur] Andersen and Coltec's tax department to shelter the capital gain from the sale of Holley [Automotive]."

   b. The sale of Garrison stock lacked economic substance because Garlock transferred only bare legal title and not full ownership in the Garrison stock.

3. Coltec's position.

   a. The sale of Garrison stock to the banks had economic substance. The sale of Garrison stock to the banks did not require a separate non-tax business purpose for the loss to be deductible by Garlock. The transaction had economic substance because the tax loss from the sale of the stock resulted from a real economic loss suffered in its historic business.

   b. The Garrison transactions (the formation of Garrison and stock sale) were not shams. The Garrison transactions "permanently changed the parties' economic positions, legal relations, and non-tax business interests, and created genuine, enforceable obligations to the third-party Banks."

   c. The Garrison transaction (the formation of Garrison) "was not transitory and had a legitimate business purpose, *i.e.,* to isolate and further insulate the asbestos litigation activities from Coltec's core business and to streamline and better manage asbestos litigation activities and facilitate settlements."

4. Court of Claims opinion.

a. The court held that the transactions (the formation of Garrison and stock sale) had economic substance and were not shams. The court said that a transaction will be respected where a taxpayer can demonstrate either business purpose or economic substance.

b. Coltec demonstrated a non-tax business purpose under section 357(b) of the Code: 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 level of comfort to purchase all of the Coltec Group in 1999." The court held that Coltec's business purpose under section 357(b) satisfied the subjective prong of the economic substance test.

c. The court refused to apply the economic substance doctrine: "[W]here a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers."

5. Court of Appeals opinion.

a. The court first turned to "the arguments based on the literal language of the Code provisions."

(i) The court disagreed with the lower court's holding that contingent liabilities are not liabilities for purposes of section 358(d).

(ii) However, the Court held that the exception in section 358(d)(2) for "liabilities excluded under section 357(c)(3)" was applicable because the liabilities "would give rise to a deduction."

(iii) Finally, the Court adopted the taxpayer's interpretation of the anti-abuse in section 357(b)(1): the anti-abuse rule only applies when the liability in issue "is actually excluded from gain recognition under section 357(c)(1) by operation of section 357(c)(3).

b. Next, the court turned to the economic substance doctrine.

(i) First, the court rejected the lower court's holding that the economic substance doctrine violates separation of powers and is unconstitutional.

(ii) Second, the court cast the economic substance doctrine as a tool of statutory interpretation: "From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal term of the statute can undermine the ultimate purpose of the statute."

(iii) Third, the court enumerated five general principles to be used in applying the economic substance doctrine: (1) taxpayers may decrease or avoid taxes by lawful means, but not from transactions that lack economic reality; (2) when the taxpayer claims a deduction, the taxpayer bears the burden of proving that a transaction has economic substance; (3) the economic substance of the transaction must be viewed objectively, not subjectively; (4) the transaction (or step) to be analyzed is the one that gave rise to the claimed tax benefit, not the overall transaction; and (5) arrangements with subsidiaries that do not affect the economic interests of independent third parties deserve close scrutiny.

(iv) Fourth the court applies the economic substance doctrine to the facts of the case. The court rejected the proffered non-business purposes of the transaction. The court held that the creation of the special purpose subsidiary to manage the liabilities could not provide a business purpose for the exchange of the liabilities *for a note* – the very transaction that created the high basis in the subsidiary's stock and, therefore, caused the claimed tax benefits. The court also rejected the taxpayer's claim that the creation of the subsidiary would add a barrier to veil-piercing claims because, viewed objectively (not subjectively) "there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary."

C. ***The Dow Chemical Co. v. United States,* 250 F. Supp. 2d 748 (E.D. Mich. 2003), *rev'd*, 435 F.3d 594 (6th Cir. 2006).**

1. Facts

    a. Dow purchased corporate-owned life insurance (COLI) policies on employees from Great West Life Assurance Company (Great West) in 1988 and Metropolitan Life Insurance Company (MetLife) in 1991.

    b. Dow borrowed money from the insurers using the cash values of the policies as collateral. The loans were the principal source of funding during the first, second, third, eighth and ninth years of the Great West plan and during the first three years of the MetLife plan.

    c. Dow made withdrawals from the cash values of the policies that were not already used as collateral for a policy loan. Dow ultimately paid between 10% and 16% of the premiums from its own cash. The remaining funds for the premiums came from the policy loans and withdrawals.

    d. Both plans were projected to generate significant negative pre-tax cash flow for numerous years before generating a positive cash flow. In order to generate a positive cash flow, Dow would have to make a significant cash contribution in a later year. Both plans did not have a significant amount of inside build-up in the short term.

    e. For tax years 1988 through 1991, Dow claimed deductions for interest paid on the loans used to pay the COLI premiums and for various fees related to the policies. The IRS disallowed the deductions.

2. Government's Position.

    a. The COLI transactions lacked economic substance because there were no practical economic effects except to create income tax deductions.

    b. The transactions were shams in fact because of the use of simultaneous netting transactions to pay premiums on policies.

3. Taxpayer's Position.

    a. Dow entered the transaction for purposes of funding its employee benefit plans.

    b. The transactions had economic substance.

4. District Court opinion.

    a. Unlike the other COLI cases, Dow would realize the benefits of the inside build-up of the policies. The pre-purchase projections showed a non-tax positive cash flow in future years. The capping of the policy loans at $50,000, along with the fact that Dow withdrew cash only to basis, indicate that Dow intended to produce a positive cash flow in the future. Dow had the potential to realize substantial economic gain from the tax-free inside build-up.

    b. Unlike the other COLI cases, Dow's COLI plans transferred mortality risk to the insurers and were not mortality neutral. In contrast to the other COLI cases, the Dow COLI plans did not contain retroactive adjustments that eliminated mortality risks. Dow had the potential to realize substantial mortality gains.

    c. Thus, for these reasons, Dow's COLI plans had economic substance.

5. Court of Appeals opinion

a. The Court of Appeals reversed the trial court. First, as a procedural matter, the court held that the proper standard of review for the district court's finding of facts is clear error. However, the proper standard of review for the district court's holding on economic substance is *de novo*.

b. The court looked to the other COLI cases and noted that the following factors are important in assessing whether a COLI transaction has economic substance: (i) projected pre-tax cash flows, (ii) mortality gains to the beneficiary, who does not pay tax on proceeds, and (iii) interest-free build-up.

c. The district court found that the two plans would generate negative pre-tax cash flows for several years. Unlike the other COLI cases, Dow planned to inject large amounts of cash into the plan at a later time. Citing *Knetsch v. United States*, 364 U.S. 361 (1960), the Court of Appeals held that a court "may consider future profits contingent on some future taxpayer action, but only when the action is consistent with the taxpayer's actual conduct. Courts should be skeptical, however, when the asserted future profits hinge on future taxpayer actions that seriously depart from past conduct, especially where such departure involves the expenditure of large sums of money." Thus, the trial court erred and should not have considered the future positive cash flows.

d. Similarly, the trial court erred by considering the prospect of large cash investments with respect to the inside build-up.

e. The court held that the potential to benefit from mortality gains on the COLI was sufficiently similar to the other COLI cases and indicated the lack of economic substance.

f. Thus, the Dow COLI plans did not generate any non-tax benefits and lacked economic substance. The court did not address Dow's business purpose in light of the holding on economic substance.

g. The dissent attacked the majority's reliance on *Knetsch*. *Knetsch* did not hold that future cash infusions are irrelevant to the economic substance inquiry. The dissent further stated that the trial court's findings of fact were not clearly erroneous in two central areas – mortality payments and inside build-up. Based on these facts, the transactions had economic substance.

6. Taxpayer's Position in its Petition for a Writ of Certiorari.

a. The Court of Appeal's *de novo* standard of review is in conflict with most courts. The majority of courts use a clearly erroneous standard when considering the economic substance doctrine.

b. The Court of Appeals improperly excluded evidence of future cash infusions and incorrectly applied *Knetsch*. Future investments affecting profitability must be taken into account unless the taxpayer has no intention of making them.

D. *TIFD III-E INC. v. United States (Castle Harbour),* 342 F. Supp. 2d 94 (D. Conn. 2004); *rev'd*, 459 F.3d 220 (2d Cir. 2006).

1. Facts.

a. General Electric Capital Corporation ("GECC") is in the business of commercial aircraft leasing. GECC sought to raise capital and to spread the risk of its commercial aircraft leasing business.

b. GECC's subsidiaries established Castle Harbour, a limited liability company that elected to be treated as a partnership for federal income tax purposes. GECC subsidiaries contributed the following assets to Castle Harbour: $530 million worth of fully depreciated aircraft subject to $258 million of non-recourse debt, $22 million of rents receivable, $296 million of cash, and all stock of a GECC subsidiary with no value.

c. Two Dutch banks not taxable in the United States invested $117.5 million in Castle Harbour. The Dutch banks were allocated 98 percent of the book and tax income.

d. The book income was reduced by depreciation with respect to the aircraft. The tax income did not reflect depreciation because the aircraft were fully depreciated for tax purposes. The depreciation for book purposes was approximately 70 percent of the rental income. Since the Dutch banks did not pay U.S. tax, GECC was able to shift significant taxable income while shifting little book income.

e. "Put another way, by allocating income less depreciation to tax-neutral parties, GECC was able to 're-depreciate' the assets for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them but actually received only the income in excess of book depreciation. Thus, the full amount of book depreciation was available, pre-tax, to Castle Harbour to use."

f. GECC and its subsidiaries were able to shift $310 million in income to the banks and save approximately $62 million of tax.

2. Government's position.

   a. Castle Harbour was formed with no non-tax purpose and therefore was a sham that should not be respected.

   b. The government asserted that business purpose and economic effect of the transaction are factors for identifying a sham, and neither factor alone is dispositive of the issue.

   c. At trial and on appeal, the government argued that the District Court applied the wrong legal test. The government asserted that the Dutch banks' interests were not bona fide equity partnership interests. The court should have applied the test for partnerships set forth in *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

3. Taxpayer's position.

   a. Castle Harbour was not a sham. Castle Harbour had a non-tax business purpose. Castle Harbour was formed to raise capital and to demonstrate to investors, rating agencies, and senior management, that it could raise capital on its fleet of aircraft.

   b. The taxpayer argued that the court should respect the entity if the court finds either a subjective business purpose or objective economic effect, and Castle Harbour had both a business purpose and economic effect.

4. District Court opinion.

   a. The court did not address which test to apply for economic substance because it found that the transaction had both a non-tax economic effect and a non-tax business motivation.

   b. The court found that the formation of the partnership had economic effect because the foreign partners gave up $117 million that was used by Castle Harbour's subsidiary to purchase aircraft or to retire GECC debt. In return, the foreign partners received part of Castle Harbour's operating income. Also, the transaction had some upside potential with some guarantee against loss.

   c. The court also found that GECC had a non-tax business purpose. GECC entered into the transaction to raise capital and demonstrate its ability to do so.

   d. In distinguishing this case from *Boca Investerings Partnership v. United States*, 314 F.3d 625 (D.C. Cir. 2003), and *ASA Investerings Partnership v. United States*, 201 F.3d 505 (D.C. Cir. 2000), the court concluded that "there was a 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…In that case [*ASA Investerings*] the court was principally concerned that (1) the outside 'investors' appeared to have absolutely no stake in the partnership and (2) there seemed to be no reason to form a separate entity to engage in the underlying transactions, other than to avoid taxes. Neither situation is present here."

(i) The foreign partners had a real stake in the transaction because their return was tied directly to the performance of the aircraft leasing business.

(ii) The foreign partners limited their downside but not their upside. They had a real interest in the performance of the partnership and were not indifferent to Castle Harbour's activities.

(iii) "[T]he creation of a partnership was one – even if not the only – legitimate way of achieving the non-tax purpose of raising capital against some of GECC's Stage II aircraft. That is all the economic substance test requires."

5. Court of Appeals opinion.

a. The Court of Appeals held that the District Court applied the wrong legal standard. The District Court should not have applied the sham transaction test to the exclusion of the *Culbertson* test. The *Culbertson* test states that a partnership will be respected where "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." *Culbertson*, 337 U.S. at 742.

b. Applying *Culbertston,* the court held that the Dutch banks' interests were in the nature of a secured lender's interests. The banks were insulated against poor performance and had a limited, guaranteed profit. Thus, the banks had no stake in the failure or success of the partnership.

III. Pending Decision

A. Jade Trading LLC v. United States (Fed. Cl.)

1. Facts.

a. This is the first son-of-BOSS case to go to trial.

b. Three brothers formed three separate LLCs. Each of the LLCs purchased a foreign currency call option from AIG International for about $15 million. At the same time, each LLC sold to AIG International a foreign currency call option with roughly offsetting terms.

c. The LLCs then contributed both the purchased and sold call options to Jade Trading LLC, an existing partnership. Each of the LLCs claimed a basis in their partnership interests of $15 million, the cost of each option.

d. Approximately three months after contributing the options to Jade Trading LLC, the LLCs withdrew from the partnership. When the LLCs later sold the distributed property, they generated large tax losses, which the brothers deducted on their returns.

2. Pending decision.

a. Because of overlapping issues with respect to the economic substance doctrine, the Court of Federal Claims judge decided to stay the *Jade Trading LLC* action pending a decision from the Federal Circuit in the *Coltec Industries* case. The Federal Circuit issued the *Coltec Industries* opinion in July 2006, and a decision in *Jade Trading LLC* is pending.

IV. Codification of the Economic Substance Doctrine.

A. History of Codification

1. Since 2002, numerous bills have been introduced in Congress for the purpose of codifying the economic substance doctrine. *See,* e.g., S. 1565, The Tax Shelter and Tax Haven Reform Act of 2005. The idea has been more popular in the Senate than in the House and is a potential revenue raiser. The principal purpose of these proposals is to clarify that a transaction has economic substance only if it satisfies both prongs of a two-part test: (1) the transaction has economic substance, *i.e.*, it results in a meaningful change in the taxpayer's position apart from taxes, **and** (2) there is a non-tax business purpose for the transaction. The various Federal Circuit Courts of Appeals have applied the economic substance doctrine in different ways. *Compare Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993) (requiring satisfaction of both prongs); *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985) (requiring satisfaction of either prong); and *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995) (each prong is merely a factor to consider in determining whether a transaction has economic substance). The legislative proposals also clarify that only a "substantial" non-tax business purpose will suffice for purposes of the second prong.

2. Practitioners have generally been opposed to codification. *See, e.g.,* Letter from Richard A. Shaw, American Bar Association Section of Taxation, June 30, 2004, expressing the ABA Tax Section's "serious reservation" regarding codification.

3. The Treasury Department opposes codification; IRS Chief Counsel Donald Korb has repeatedly stated his opposition to any attempt to codify the economic substance doctrine. However, former IRS Commissioner Charles Rossotti supports codification, as did the Clinton Administration.

4. Opponents claim that codification would (1) make the economic substance doctrine inflexible, and therefore, difficult to apply to future-conceived transactions; (2) potentially create a rule that is, at the same time, both "too broad" and "too narrow;" (3) create unnecessary complexity for the IRS in enforcement of the provision; and (4) slow IRS audits.

5. The recent Government victories have not reduced interest in codification. Revenue considerations have lead to the resurrection of these proposals.

B. S. 681 - Stop Tax Haven Abuse Act.

1. In February, senators Levin, Coleman, and Obama introduced this bill to "restrict the use of offshore tax havens and abuse tax shelters to inappropriately avoid Federal taxation …."

2. Section 401 of the bill would amend section 7701 of the Code to provide a "Clarification of Economic Substance Doctrine."

   a. The proposal provides that a transaction has economic substance only if (1) "the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial nontax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing such purpose. A financial accounting benefit may not be taken into account if the origin of the benefit is a reduction in federal income taxes.

   b. If the taxpayer relies on profit potential to prove economic substance, the proposal requires that (1) the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits, and (2) the reasonably expected pre-tax profit exceeds a risk-free rate of return.

   c. The proposal provides special rules for transactions with a "tax-indifferent party" – "any person or entity not subject to US federal income taxation." However, a party shall be treated as a tax-indifferent party with respect to a transaction if "the items taken into account with respect to the transaction have no substantial impact on such person's [tax] liability …."

(i) “The form of a transaction which is in substance a borrowing of money or the acquisition of financial capital directly or indirectly from a tax indifferent party shall not be respected if the present value of the deductions to be claimed … is substantially in excess of the present value of the anticipated economic return of the person lending the money or providing the financial capital.”

(ii) The form of a transaction with a tax-indifferent party shall not be respected if (1) “it results in an allocation of income or gain to the tax-indifferent party in excess of such party’s economic income or gain,” or (2) “it results in a basis adjustment or shifting of basis on account of overstating the income or gain of the tax-indifferent party.”

3. Section 402 of the bill would add section 6662B to the Code, providing a “Noneconomic Substance Transactions Understatement Penalty.” The proposal would impose a 40-percent penalty on “noneconomic transaction understatements,” except that a 20-percent penalty would apply if the relevant facts of the transaction are adequately disclosed in the return or a statement attached to the return.”

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