The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?

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The fall of 2004 saw the occurrence of several important developments in relation to the ongoing debate on the application of the economic substance doctrine. It started with the issuance of the opinion in *Long Term Capital Holding v. United States*[1] in the end of August, a case in which a 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. The court upheld penalties assessed by the IRS despite the taxpayer's argument that it obtained and relied on two "should" level opinions supporting its position.

During the fall, the Jobs Act of 2004 was finalized and finally signed by the president on October 22, 2004, leaving out the proposed codification of the economic substance doctrine. Subsequent to the Government's victory in *Long Term Capital Holding v. United States*,[2] three District Courts have held for the taxpayers in cases involving an economic substance analysis. First, in *Black & Decker Corp. v. United States*[3]a U.S. District Court has granted Black & Decker Corp.'s motion for summary judgment in its refund suit for over $ 57 million in federal taxes arising from a contingent liability transaction, on the grounds that the transaction had economic substance. Second, in *TIFD III-E Inc. v. United States*[4] a U.S. District Court (in the Second Circuit) has ordered the IRS to refund $ 62 million to TIFD, the tax matters partner of Castle Harbour-I LLC, applying the economic substance doctrine and finding that the LLC's creation was not a sham designed solely to avoid taxes) Finally, in *Coltec Industries Inc. v. United States*[5] a U.S. Court of Federal Claims has ordered the IRS to refund to Coltec Industries Inc. $ 82.8 million in federal taxes arising from a contingent liability transaction, almost similar to the one in *Black & Decker*, on the grounds that the transaction satisfied the statutory language and requirements and, only as a backstop, applying the economic substance

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[1] 2004 WL 1924931(D. Conn. Aug. 27, 2004).

[2] Id.

[3] No. WDQ-02-2070, Doc 2004-20637, (N.D. Md. 2004),reprinted in 2004 TNT 205-6.
[4] No. 3:01cv1839 (SRU); No. 3:01cv1840 (SRU).
[5] No. 01-072T (United States Court of Federal Claims), reprinted in 2004 TNT 214-16.

doctrine to conclude that the transaction had both business purpose and economic substance.[6]

These events have emphasized the controversial application of the doctrine, and how divided are courts, the Government and taxpayers in their interpretation of the doctrine. In a previous article, this author has explored the profit potential issue, an ongoing debatable issue in relation to the doctrine.[7] This article will focus on another unsettled issue, namely the application of the two prong test. *Frank Lyon v. United States*[8] has been construed to establish a two-prong standard for examining if a transaction lacks economic substance. Under the general two-prong test described in greater detail herein, the economic substance doctrine is based on an objective and subjective determination of whether a transaction has real, nontax economic benefit.[9] Nevertheless, since *Frank Lyon v. United States*, the United States Supreme Court has not issued an important decision involving economic substance analysis, and interpretations of the doctrine subsequent to *Frank Lyon v. United States* was left to the circuits. As a result, circuits and courts are divided with respect to the application of the two-prong test, and several variations have emerged, each of which may result in a different way.
This article will present the competing views regarding the application of the two prong test, and suggest a practical solution to reconcile these differences. The conclusions advanced are that the two-prong test ought to be collapsed into a single objective test, which would generally consist of the current objective prong.

I. History

The following is an overview of some of the landmark economic substance cases. A more comprehensive discussion of these cases is set forth below.

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[6] See also *Antantech L.L.C. v. Commissioner*, (equipment sale and leaseback transactions designed to practice tax benefits through membership in an LLC lack business purpose and economic substance and are disregarded for tax purposes);*Nicole Rose Corp v. Commissioner*, 320 F.3d 282 (2d Cir. 2003) aff'g 117 T.C. 328 (2001) (court applied the two-part analysis to disallow ordinary business expense deductions relating to leaseback and trust fund interests held for less than one day); FSA 200218022 (citing *Nicole Rose Corp. v. Commissioner*, the Chief Counsel's Office applied section 482 to reallocate rental income, rental deductions, and loss deductions claimed in several stripping transactions and transfers of stripped leasehold interests).

[7] Yoram Keinan, *The Profit Requirement Under the Economic Substance Doctrine*, 21 J. Tax'n Inv. 81 (2003).

[8] *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

[9] *ACM Partnership v. Commissioner* 157 F.3d 231, 248 (3d Cir. 1998) *aff'g in part, ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, *cert. denied*, 119 S. Ct. 1251 (1999) ("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 832, 837 (2d Cir. 1990)); *Sochin* v. *Commissioner* 843 F.2d 351, 354 (9th Cir. 1988) (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 89, 94 (4th Cir. 1985) (stating that the economic substance inquiry is an objective inquiry into whether the transaction produced any nontax benefit).

As early as 1935, in *Gregory v. Halvering,*[10] the Supreme Court established the requirement that tax motivated transactions must involve a business purpose to be given effect. In this case, the taxpayer was the sole owner of a corporation. The corporation owned securities with a built-in gain. To convert ordinary income on the securities into capital gains, the taxpayer incorporated a new corporation and transferred the securities to the new corporation. The old corporation distributed the stock of the new corporation, and immediately after, the new corporation was liquidated. Finally, the securities were sold. The taxpayer argued that the gain from the sale was capital gains.

The Second Circuit, and, subsequently, the Supreme Court, disagreed. 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.[11]

In *Higgins v. Smith*,[12] the Supreme Court 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

[10] 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

[11] *Id*. at 469-470.

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

> 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 may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.[13]

In *Moline Properties v. United States,*[14] 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 grounds that the existence of the corporation was "merely fictitious" for federal income tax purposes.[15] 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,"[16] setting forth 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.

In *Knetsch v. United States*,[17] the taxpayer purchased 30-years deferred annuity bonds with a face amount of $4,000,000 bearing interest of 2.5 percent. The purchase price was funded by a loan bearing interest of 3.5 percent. The Supreme Court observed that: "it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[18] The court ruled against the taxpayer on the grounds that the transaction had "no substance or purpose aside from the taxpayer's desire to obtain a tax benefit."

In *Goldstein v. Commissioner*,[19] the taxpayer borrowed $945,000 from two banks at 4 percent interest, and investing the proceeds in U.S. Treasury securities maturing in 3 or 4 years, with a face amount of $1,000,000, which paid interest of 1.5 percent. Similar to *Knetsch*, the taxpayer in *Goldstein* had locked in an economic loss from the inception of the transaction. The Court of Appeals rejected the Tax Court's characterization of the transactions as a "sham" transaction on the grounds that the transactions were made with two different and independent banks, on a non-recourse basis. The court concluded, therefore, that the transactions did, in fact, take place and therefore could not be ignored as "shams." The Court of Appeals, however, affirmed the Commissioner's decision to

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[13] See also *Commissioner v. Court Holding Co*., 324 U.S. 331, 334 (1945) ("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.").

[14] 319 U.S. 436 (1943).
[15] 319 U.S. at 439.
[16] *Id.* at 438-39.
[17] 364 U.S. 361 (1960), *aff'g* 272 F.2d 200 (9th Cir. 1959).

[18] 364 U.S. at 366.

[19] 364 F.2d 734 (2nd Cir. 1966).

disallow the deductions on the grounds that the taxpayer's purpose in entering into the transaction was solely to obtain tax benefits. The Circuit Court disallowed the interest deduction claimed under Section 163 citing a lack of economic substance as well as a lack of a non-tax business purpose as the reason for disallowance.

Twelve years later, in *Frank Lyon v. United States*, the Supreme Court was faced with a sale-leaseback transaction. In this case, the taxpayer borrowed $7.1 million, bought a building from a bank for $7.6 (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 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 United States 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. [20]

Frank Lyon established the two-prong test pursuant to which the economic substance test comprised of two prongs: objective economic substance and subjective business purpose. This standard is discussed in greater detail below.

In *Rice's Toyota World Inc. v. Commissioner*,[21] another case involving a lease transaction, the taxpayer purchased a 70 percent 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 non-recourse 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 pretax cash flows to the taxpayer were $10,000 per year. In fact, the only amounts ever to change hands were

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[20] 435 U.S. 561 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976).

[21] *Rice's Toyota World, Inc. v. Commissioner,* 752 F.2d 89, 91 (4th Cir. 1985).

the $10,000 annual payments, representing the excess of the taxpayer's income over its debt obligation.

The Fourth Circuit interpreted the two prong test established by the Supreme Court in *Frank Lyon* 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 that the transaction has no economic substance because no reasonable possibility of profit exists."[22]

ACM Partnership v. Commissioner[23] was the first CINS transaction reviewed by the Tax Court. Generally, 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.

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.[24]

Courts have observed, however, that the application of the economic substance and similar doctrines is limited. In *Northern Indiana Public Service Company v. Commissioner ("NIPSCO),*[25] similar to *Aiken Industries*, the taxpayer's goal was to obtain exemption under the treaty between the United States and the Netherlands Antilles treaty. 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.

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[22] *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 90 (4th Cir. 1985).

[23] *Partnership v. Commissioner*, 157 F.3d 231, 252 (3d Cir. 1998), aff'g in part, *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, cert. denied, 119 S. Ct. 1251 (1999).

[24] *ACM Partnership v. Commissioner,* 73 T.C.M. at 2215.

[25] 115 F.3d 506 (7th Cir. 1997), *aff'g* 105 T.C. 341 (1995).

The IRS argued that the subsidiary was merely a conduit and should be disregarded The Tax Court rejected the IRS's argument and distinguished from *Aiken* on the grounds 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.

The Seventh Circuit upheld the Tax Court's decision, stating that:

> *Knetsch* and the captive insurance company cases do not dictate the outcome the Commissioner desires. Those cases allow the Commissioner to disregard transactions which are designed to manipulate the Tax Code so as to create artificial tax deductions. They do not allow the Commissioner to disregard economic transactions, such as the transactions in this case, which result in actual, non-tax-related changes in economic position.[26]

Similarly, as the District Court indicted in *Coltec Industries*, "if a taxpayer clearly satisfies unambiguous statutory and/or regulatory requirements, courts may decline to apply the economic substance doctrine." [27] For example, the district Court stated that the U.S. Supreme Court declined to apply the doctrine in Nebraska Department of Revenue v. Lowenstein, 513 U.S. 123 (1994), and stated that "whatever the language Frank Lyon v. United States] . . . may mean, our decision in that case . . . was founded on an examination . . . of 27 specific facts.").[28]

The IRS has also applied the doctrine in numerous rulings and other guidance. In Rev. Rul. 2000-12, [29] the IRS described the fundamentals of the economic substance

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[26] 115 F.3d at 513. See also *United Parcel Services of America v. Commissioner,* 254 F.3d 1014 (11th Cir. 2001), *rev'g and rem'g,* 78 TCM 262 (1999).

[27] Citing *Holiday Village Shopping Center 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." See also *Executie Jet Aviation v. United States*, 125 F.3d 1463 (Fed. Cir. 1997), another decision cited by the court for the proposition that when the statute is clear enough, there is no place for common law doctrines stating that "where the language of the Code is clear, the 'substance rather than form' doctrine is irrelevant. See also *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.").

[28] Citing also *Commissioner v. Clark*, 489 U.S. 726, 738 (1989) (emphasis added) (wherein the Court relied on "[o]ur reading of the statute . . . [which] is reinforced by the well established 'step-transaction' doctrine[.]") and *Knetsch v. United States,* 364 U.S. 361, 367 (1960) (emphasis added) (in determining "whether the transactions created a true obligation to pay interest[,] [u]nless that meaning plainly appears, we will not attribute it to Congress. . . . We, therefore, look to the statute . . . to its construction for evidence that Congress meant in section 264 (a)(2) to authorize the deduction of payments made under sham transactions entered into before 1954.").

[29] 2000-1 C.B. 744.

doctrine**:**

> 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.[30]

Since 2000, several legislative proposals have been made to codify or clarify the economic substance doctrine into the Internal Revenue Code. As of today, none of these proposals have been enacted. The most recent version has not been included in the Jobs Act of 2004, which was signed into law by the president in October 22, 2004. These proposals are discussed in greater detail below

II. <u>The Economic Substance Doctrine</u>

A. <u>General</u>

Under the general application of the judicial economic substance doctrine, the tax benefits of transactions lacking such attributes may be denied.[31] "An activity will not provide the basis for deductions if it lacks economic substance."[32] A transaction that would otherwise result in beneficial tax treatment to a taxpayer will be disregarded if the transaction lacks economic substance.[33] Nevertheless, as numerous courts have indicated, taxpayers are generally free to structure their affairs so as to minimize their tax

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[30] Citing *ACM Partnership v. Commissioner*, 157 F.3d 231, 252 (3d Cir. 1998), aff'g in part, *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, cert. denied, 119 S. Ct. 1251 (1999) ("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."), cert. denied, 526 U.S. 1017 (1017); *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)."

[31] *Killingsworth v. Commissioner*, 864 F.2d 1214, 1216 (5th Cir. 1989) ("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 1018, 1023 (11th Cir. 1991) ("expenses incurred in connection with a sham transaction are not deductible."); Treasury 1999 White Paper, 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."); *Horn v. Commissioner*, 296 U.S. App. D.C. 358 ("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. Commissionerr*, 861 F.2d 494, 497 (7th Cir. 1988). ("There is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer [a tax] advantage.")

[32] *Ferguson v. Commissioner*, 29 F.3d 98, 101 (2d Cir. 1994) (per curiam).

[33] *Killingsworth v. Commissioner*, 864 F.2d 1214, 1216 (5th Cir. 1989) *Boynton v. Commissioner*, 649 F.2d 1168, 1172 (5th Cir. 1981) *cert. denied*, 454 U.S. 1146 (1982); *Swain v. United States*, 651 F.2d 1066 (5th Cir. 1981); *Kuper v. Commissioner*, 533 F.2d 152 (5th Cir. 1976).

liability; therefore, a transaction does not lack economic substance merely because it is tax motivated.[34]

A finding that a transaction lacks economic substance will result in disallowance of any tax benefits from the transaction. As the Tax Court specified 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.[35]

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)[36] Thus, a taxpayer may not combine a valid transaction with the disputed transaction to assert that the overall position had economic substance. [37]

Frank Lyon has been construed to establish a two-prong standard for examining if a transaction lacks economic substance. Under the general two-prong test described in greater detail below, the economic substance doctrine is based on an objective and

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[34] *Salina Partnership LP, FPL Group, Inc. 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, *aff'd. in part, rev'd. in part, remanded*, 752 F.2d 89 (4th Cir. 1985)). S*ee also 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 1277, 1281 (2d Cir. 1983) ("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."); *Northern Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d 506, 511 (7th Cir. 1997) ("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. Commissionerr,* 861 F.2d 494, 497 (7th Cir. 1988) ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."); *Aiken Industries, Inc. v. Commissioner,* 56 T.C. 925, 933 (1971), *acq.*, 1972-2 C.B. 1 ("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. 595, 600 (1968) ("[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.")

[35] 87 T.C. 1087, 1177 (1986).

[36] See *Long Term Capital Holding v. United States*, 2004 WL 1924931(D. Conn. Aug. 27, 2004), citing *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282, 284 (2d Cir. 2002).

[37] *ACM Partnership v. Commissioner,* 157 F.3d at 256 n.48, cited by the Senate Report on the JOBS Act of 2004

subjective determination of whether a transaction has real, nontax economic benefit.[38] Courts have applied various tests to evaluate whether a transaction lacks such nontax economic benefits. For example, several courts have compared the disputed transaction with transactions that might normally be expected to occur in bona fide business settings.[39] Other courts have applied a cost v. potential profit to determine the existence or lack of substance.[40] A minority of courts have 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.[41]

Generally, the taxpayer carries the burden of proof to show she has not been acting to avoid taxes.[42] Courts have found a business purpose in several cases even though the taxpayer may have been primarily or predominantly motivated by tax benefits. Under this approach, a transaction lacks a business purpose only if the taxpayer's <u>sole</u> motivation is tax avoidance.[43] As the Eleventh Circuit indicated in *UPS*, "no-business-purpose cases concern tax-shelter transactions or investments by a business or investor

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[38] *ACM Partnership v. Commissioner* 157 F.3d 231, 248 (3d Cir. 1998) *aff'g in part, ACM Partnership v. Commissioner,* T.C. Memo. 1997-115, *cert. denied,* 119 S. Ct. 1251 (1999) ("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 832, 837 (2d Cir. 1990)); *Sochin* v. *Commissioner* 843 F.2d 351, 354 (9th Cir. 1988) (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 89, 94 (4th Cir. 1985) (stating that the economic substance inquiry is an objective inquiry into whether the transaction produced any nontax benefit).
[39] *Merryman v. Commissioner*, 873 F.2d 879, 881 (5th cir. 1989), citing *Est. of Baron v. Commissioner*, 83 T.C. 542, *aff'd*, 798 F.2d 65 (2d Cir. 1986), *Hilton v. Commissioner*, 74 T.C. 305, 344-46 (1980). *aff'd*, 671 F. 2d 316 (9th Cir. 1983), *cert. den'd* 459 U.S. 907 (1982).
Thomas v. Commissioner, 792 F.2d 1256, 1259 (4th Cir. 1986); *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984).
[40] See *Long Term Capital Holding v. United States,* 2004 WL 1924931(D. Conn. Aug. 27, 2004).

[41] See *Long Term Capital Holding,* 2004 WL 1924931 (D. Conn. Aug. 27, 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 recent Jobs Act of 2004, as discussed below.

[42] *Packard v. Commissioner*, 85 T.C. 397, 418 ("The precise degree of business motive or economic substance that must be present in a transaction for tax recognition is not clearly defined", citing *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 202 See also *Decon Corp. v. Commissioner*, 65 T.C. 829 (1976), note 3, citing *Hoffman Motors v.United States,* 473 F.2d 245, 257 (2d Cir. 1973); *Starday Recording & Publishing v. United States*, 281 F. Supp. 106, 108 (M.D. Tenn 1967); Davis v. Commissioner, 585 F.2d 807, 812 (6th Cir. 1978); *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).")

[43] *Zmuda v. Commissioner,* 731 F.2d 1417, 1421 (9th Cir. 1984) *Friedman v. Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989) (" this prong [business purpose] requires a showing that the *only* purpose for entering into the transaction was the tax consequences.") *Pacific Gamble Robinson v. Commissioner*, 54 T.C.M. 915, 927 (1987);*Ockels v. Commissioner*, 54 TCM 785, 796 (1987); *UPS Of America v. Commissioner*, 254 F.3d 1014, 1019 (11th Cir. 2001) ("A "business purpose" does not mean a reason for a transaction that is free of tax considerations. ")

that would not have occurred, *in any form,* but for tax-avoidance reasons." (Emphasize in original).[44]

B. The Two-Prong Test

1. Overview

Numerous courts have 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.[45] The same principle was recently stated by the Senate report in the Jobs Act of 2004. This standard will be referred to herein as the "two-prong" test. The business purposestandard focuses on the motives of the taxpayer for entering into the transaction, while the economic substance standard involves an objective analysis of the taxpayer's economic position before and after the transaction.[46] As set forth below, several variations have emerged for each prong.

In addition, several courts have incorporated the substance-over-form doctrine as a third prong of the economic substance doctrine. As the Ninth Circuit stated in *Bail Bonds v. Commissioner*:

> 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.[47]

In *Frank Lyon Co. v. United States*,[48] the Supreme Court held 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

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[44] *UPS*, at 1020, citing *ACM Partnership v. Commissioner* 157 F.3d 231, 248 (3d Cir. 1998) *aff'g in part, ACM Partnership v. Commissioner,* T.C. Memo. 1997-115*, cert. denied,* 119 S. Ct. 1251 (1999), *Karr v. Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991), Kirchman and *Rice's Toyota World, Inc v. Commissioner*, 752 F.2d 89 (4th Cir. 1985).

[45] *See ACM Partnership*, 157 F.3d at 247 (citing decisions by the Courts of Appeals for the Sixth, Ninth and Tenth Circuits); *Winn-Dixie Stores, Inc.*, 113 T.C. at 280, 285 (also citing decisions by the Courts of Appeals for the Third, Eighth and Eleventh Circuits).

[46] See *Sochin*, 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.").

[47] *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987). See also *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989) (**"**The analysis of whether a transaction is a substantive sham, however, addresses whether a transaction's substance is that which its form represents.")

[48] *Frank Lyon Co. v. United States*, at 583-84.

labels attached . . ."[49] *Frank Lyon* has been construed to create the two-prong test for determining whether a transaction 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?"[50]

Frank Lyon has been interpreted differently in almost every circuit. The Fourth Circuit Court of Appeals in *Rice's Toyota World, Inc. v. Commissioner*[51] has interpreted the two-prong inquiry set forth in *Frank Lyon* as follows: a tax-favored transaction may be treated as an economic sham and tax benefits would be denied where (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.[52]

While in *Rice's Toyota*[53] the Fourth Circuit has treated economic substance and business purpose as two prongs of a disjunctive test, a position adopted by other circuits, as discussed below, other courts have applied a conjunctive test pursuant to which the taxpayer must satisfy both prongs to be eligible for the tax benefits. Finally, several circuits have 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."[54]

2. Conjunctive/Disjunctive/Unitary

Circuits are divided on how to apply the two-prong test.[55] Some circuits have required that a transaction will satisfy both the economic substance and business purpose (i.e., a conjunctive test) standards to validate a transaction.[56] Other circuits have determined,

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[49] *Id. See also United States v. Wexler*, 31 F.3d at 122, and cases cited; *Peerless Industries, Inc. v. United States*, 94-1 USTC ¶ 50,043 at 83,171 (E.D. Pa. 1994), *aff'd in an unpublished opinion*, 37 F.3d 1488 (3d Cir. 1994); *Seykota v. Commissioner*, 61 T.C.M. (CCH) 2706, 2721 and 2726 (1991).

[50] *See also Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990); *Rasmussen v. Commissioner*, 63 T.C.M. (CCH) 2710 (1992); *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1548-49 (9th Cir. 1987).

[51] 752 F.2d at, 91-95.

[52] *See* also *Andantech L.L.C. 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*, ("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*.")

[53] 752 F.2d at 91.

[54] *ACM Partnership*, 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)

[55] See Senate Report on the JOBS Act of 2004, citing *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.")

[56] See Senate Report, citing as an example *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993). See also Larsen v. Commissioner, 89 T.C. 1229, 1252, n13: ("The presence of business purpose does not

however, that the existence of either economic substance or business purpose (*i.e.*, disjunctive test) would validate a transaction.[57] In addition, some courts have given more weight to one prong than the other and in several cases, focused primarily on one prong and disregarded the other. For example, in applying the two-prong test, several courts have focused primarily on the objective prong in determining the validity of a transaction, and gave no, or minimal weight to the subjective prong.[58] Other courts, however, have focused on the subjective intent of the taxpayer, frequently applying a profit motive test similar to that under section 183, as discussed herein.[59]

In addition, some courts have applied a more flexible test, generally referred to as the "unitary analysis" pursuant to which economic substance and business purpose are "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[60] Finally, courts are

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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.") See also *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.")

[57] See Senate Report for the JOBS Act of 2004, citing *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (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, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001) ("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 *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."). As recently stated by a District Court residing in the Fourth Circuit, the Fourth Circuit's standard, as stated in *Rice's Toyota*, is the disjunctive test. *See Black and Decker Corp v. United States*, No. WDQ-02, 2004 US Dist LEXIS 21201 at 6 (N.D. Md. Oct. 22, 2004).

[58] *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989) ("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.). In, *Rose*, the Tax 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. Accordingly, under this standard, a transaction that has a business purpose or profit objective will survive the *Rose* [the proper test is "whether the transaction has any practicable effects other than the creation of income tax losses."

[59] *Smith v. Commissioner*, 91 T.C. 733 (1988).

[60] *See* Senate Report for the JOBS Act of 2004, citing *ACM Partnership v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998), *aff'g in part & rev'g in part* 73 TCM 2189 (1997) ("[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), *aff'g* 87 T.C. 905 (1986) and *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider .... We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'."); *Thompson v. Commissioner*, 631 F.2d 642 (9th Cir. 1980), *cert. denied*, 452 U.S. 961 (1981). See also *Long Term Capital Holding v. United States*, 2004 WL 1924931 (D.

divided on what each prong means; although it is clear that one is objective and the other subjective, several variations have emerged for each prong. Regardless of whether the rigid two-prong or the unitary test is applied, however, most courts agree that the objective economic substance and subjective business purposes are two different standards.[61]

In 1972, six years before *Frank Lyon*, the Ninth Circuit presented in *Brooke v. United States*,[62] some of these competing views regarding the application of the two-prong test. The court first discussed the Government's view of the test as a conjunctive 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.[63]

The court went on and presented the view that only the objective test is relevant:

> Other cases require only that the transfer be grounded in substantial economic reality.[64]

Finally, the court concluded that the conjunctive test ought to apply:

> [A] transfer solely to avoid taxes will not be recognized.[65]

<u>The Objective Prong</u>

We first turn into the question what is the objective standard. In general, there are several views regarding the application of the objective prong of the economic substance test. As the Third Circuit recently summarized in *CM Holding*:

Conn. Aug. 27, 2004); *Sochin v. Commissioner*, 843 F.2d 351, cert. denied, 488 U.S. 824 (1988) affg. *Brown v. Commissioner*, 85 T.C. 968 (1985); see also *Gilman v. Commissioner*, 933 F.2d 143, 147-148 (2d Cir. 1991), affg. T.C. Memo. 1990-205; *Jacobson v. Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990), affg. in part and revg. in part T.C. Memo. 1988-341

[61] *Cherin v. Commissioner*, 89 T.C. 986, 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 1417, 1420 (9th Cir. 1984) ("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.")
[62] 468 F.2d 1155, 1158 (9th Cir. 1972).
63 Citing *Gregory v. Helvering*, 293 U.S. 465, 469, 55 S. Ct. 266, 79 L. Ed. 596 (1935); *Van Zandt v. Commissioner of Internal Revenue*, 341 F.2d 440, 443-444 (5th Cir. 1965); Commissioner of Internal Revenue v. Transport Trading & Term. Corp., 176 F.2d 570, 572 (2d Cir. 1949).
64 Citing Alden B. Oakes, 44 T.C. 524 (1965); Albert T. Felix, 21 T.C. 794 (1954). Cf. Gilbert v. Commissioner of Internal Revenue, 248 F.2d 399, 406 (2d Cir. 1957). According to the court, Alden B. Oakes, 44 T.C. 524 (1965), expressly eschews the "business purpose" test. See also, Skemp v. Commissioner of Internal Revenue, 168 F.2d 598 (7th Cir. 1948); John T. Potter, 27 T.C. 200 (1956).
65 Citing *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935); Audano v. United States, 428 F.2d 251 (5th Cir. 1970).

> 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 Partnership we required a "net economic effect on the taxpayer's economic position." 157 F.3d at 249. 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.

Under the broadest view, courts focus 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. Under this approach, economic substance is determined by an objective evaluation of the changes in the taxpayer's economic position, aside from tax benefits.[66] As summarized by the Tax Court, "[e]conomic substance . . . is determined by objective evaluation of changes in economic position of the taxpayer (economic effects) aside from tax benefits."[67] The Senate Report of the JOBS Act of 2004 stated differently:"[the economic substance] doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.".[68] In *Long Term Capital Holding v. United States*, the taxpayer argued that the objective test ought to be whether the transaction has changed the economic positions/rights of the parties other than tax savings. The District Court, however, rejected this standard and applied the cost v. reasonably expected standard discussed below. Finally, recent proposals to codify the economic substance doctrine supported this broader view. Specifically, a transaction would be viewed as satisfying the objective prong of the economic substance doctrine if the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position.[69]

A narrower view would focus on the taxpayer's expected <u>benefits</u> from the transaction.[70] In other words, under this approach, not only the taxpayer's position must change, it must be a change providing a benefit to the taxpayer. For example, sometimes a

[66] *Winn-Dixie Stores, Inc.*, 113 T.C. at 280, 285. *Cf. Long Term Capital Holding v. United States* 2004 WL 1924931 (D. Conn. Aug. 27, 2004), rejecting this test and applying the cost v. reasonably expected profit instead.
[67] *Winn Dixie*, 113 T.C. at 284.
[68] *Johnson v. United States*, 32 Fed. Cl. 709 , 716-717 (1995).

[69] See proposed IRC 7701(n)(1)(B)(i)(I) and (II).

[70] *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987).

taxpayer derives a profit from the form of entity, from incorporation (limited liability), accounting benefits and other benefits not specifically translated into "profit."[71]

Finally, the narrowest view would focus on the taxpayer's reasonably-expected profits from the transaction.[72] In contrast to the previous views, this approach would require a quantification of benefits in the form of an economic profit. 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.

In *Long Term Capital Holding v United States*[73], the District Court applied a cost v. reasonably expected profit formula to conclude that the disputed transaction had no objective economic substance.[74] The Federal Court of Claims expanded the definition and held 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." 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. A similar view was earlier expressed by the Second Circuit in *Gilman v. Commissioner*,[75] where the Second Circuit affirmed the Tax Court's economic substance analysis, which was approached from "the standpoint of a prudent investor."[76]

To conclude, the objective standard can either take the form of a narrow cost v. potential profit analysis, a broader potential benefit standard, or a, even broader test of evaluating changes in the taxpayer's position before and after the transaction. Satisfying the profit potential standard would, therefore, satisfy the objective prong.

The Subjective Prong

As set forth above, the inquiry into whether there was a legitimate business purpose for a transaction involves a subjective analysis of the taxpayer's intent.[77] To satisfy this prong,

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[71] For example, in *TIFD*, the taxpayer claimed other benefits, such as to raise capital and to demonstrate to investors, rating agencies, and its senior management, that it *could* raise capital.
[72] For a comprehensive discussion on what constitutes adequate profit potential, see Yoram Keinan, the Profit Motive under the Economic Substance Doctrine. A discussion on the amount of profit required to satisfy this standard is beyond the scope of this article.

[73] 2004 WL 1924931(D. Conn. Aug. 27, 2004).

[74] See *also Cherin v. Commissioner*, 89 T.C. 986, 993 ("A business transaction by its very nature must have economic substance, that is, a realistic potential for profit.") citing *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990), *aff'g* 87 T.C. 905 (1986).
[75] *Gilman v. Commissioner*, 933 F.2d 143, 148 (2d Cir, 1991).

[76] See *Long Term Capital Holding*, citing *Gilman v. Commissioner*, 933 F.2d at 147.

[77] *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. at 278, *aff'd*, 254 F.3d 1313 (11th Cir. 2001); *Lee v. Commissioner*, 155 F.3d 584, 587 (2d Cir. 1998); *United States v. Wexler*, 31 F.3d 117, 125 (3d Cir. 1994);

the taxpayer must demonstrate a nontax purpose to satisfy the subjective prong. Some courts have held that the taxpayer's business purpose must be primary, i.e., of greater importance than tax benefits.[78]

Generally, subjective intent may be 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.[79] Some courts even stated the subjective prong "is similar to the 'primarily for profit' standard of §§ 165 and 108."[80] Nevertheless, the fact that the principal (but not the only) purpose of a transaction is to obtain a favorable tax treatment is not a reason for disallowing such favorable treatment.[81] For example, in *UPS*, the Seventh 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.[82]

Similarly, the D.C. Circuit established in *Boca Investerings* and *ASA Investerings* 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 as legitimate for tax purposes.[83]

ACM Partnership v. Commissioner, T.C. Memo 1997-115, *aff'd. in part, rev'd. in part, dismissed in part,* 157 F.3d 231 (3d Cir. 1998) cert. denied, 526 U.S. 1017 (1999).

[78] *Ramsay v. Commissioner*, 83 T.C. 793, 810 (1984); *Surloff v. Commissioner*, 81 T.C. 210, 232-33 (1983) *Brannen v. Commissioner*, 78 T.C. 471 (1982), aff'd 722 F.2d 695, 704 (11th Cir. 1984).

[79] *ACM Partnership v. Commissioner*, 115 F.3d at 134-35. See also *TIEF* ("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 584, 586 (2d Cir. 1998); *Shriver v. Commissioner*, 899 F.2d 724, 726 (8th Cir. 1990) ("The business purpose inquiry 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.")

[80] *Friedman v. Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989).

[81] *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978); *Goldstein v. Commissioner*, 364 F.2d 734, 741 (2d Cir. 1966) (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"). See also *Northern Ind. Pub. Serv. Co. v. Commissioner*, 115 F.3d 506, 511 (7th Cir. 1997) ("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."), citing *Yosha v. Commissioner*, 861 F.2d 494, 497 (7th Cir. 1988). ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."); *Aiken Industries, Inc. v. Commissioner,* 56 T.C. 925, 933 (1971), *acq.,* 1972-2 C.B. 1. ("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. 595, 600 (1968) ("[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.").

[82] UPS, at 1019.

[83] *Boca Investerings v. United States*, 314 F.3d 625, 631 (D.C. Cir. 2003), citing *ASA Investerings* 201 F.3d at 513.

As noted in *ASA Investerings*:

> 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.[84]

In *Long Term Capital Holding v. United States*, the court added another factor to the business purpose analysis - -the "reasonable means" factor. 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."[85] Thus, a court can disregard a nontax 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.

In the Circuits in which the disjunctive standard is applied, even if the sole business purpose was to achieve tax benefits, the transaction may still be validated if it has economic substance.[86] In some cases, the objective economic substance may be dispositive if the amount of economic substance is significant enough.[87]

As described in greater detail below, courts frequently focus on the profit motive of the taxpayer in applying the subjective test. "The 'business purpose' test involves the consideration whether a taxpayer had an 'actual and honest profit objective' in engaging in the transactions at issue."[88] Thus, many taxpayers have attempted to prove that they entered into the disputed transaction to make a profit, in order to satisfy this prong.[89] In other cases, such as *TIFD III-E Inc. v. United States,*[90] however, the court found that the transaction had a legitimate business purpose, accepting the taxpayer's argument that it entered into the partnership agreement to raise capital and, more importantly, to

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[84] Id.

[85] Citing Boca Investerings P'ship, 314 F.3d at 631-32.

[86] In *Black and Decker Corp v. United States*, No. WDQ-02, 2004 US Dist LEXIS 21201 (N.D. Md. Oct. 22, 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.

[87] *Saba Partnership 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 nontax business purpose"); *Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506, 512 (7th Cir. 1997) (economic substance doctrine "do[es] not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax-related changes in economic position").

[88] *Coffey v. Commissioner*, T.C. Memo 1991-516.

[89] See, for example, *IES* and *Compaq*, in which the taxpayer's arguments focused on the profit potential from the transactions.

demonstrate to investors, rating agencies, and its senior management, that it *could* raise capital.

3. The Conjunctive Test

Under the conjunctive standard, if a court finds the lack of either of the prongs, it, presumably, is not required to examine the other prong, and may invalidate the transaction.[91] In other words, a taxpayer is required to establish the presence of both prong**s** for the transaction to withstand court scrutiny.

The conjunctive test has certain variations. The basic principle is that a transaction must satisfy both standards, objective and subjective; nevertheless, some courts give more weight to one prong over the other, while others will treat them equally. While some courts begin with the subjective prong (usually by evaluating the profit motive) other courts have first tested the objective standard and if it were found that the transaction lacked economic substance, the court would stop and invalidate the transaction.[92] As the Seventh Circuit indicated in *UPS*, "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance."[93]

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.[94] On the other hand, if the court finds that the transaction lacked objective economic substance, it is not required to examine whether the taxpayer had business purpose. In *Ferguson v. Commissioner*,[95] the court held that:

> Having concluded that the partnerships' Koppelman Process activities lacked economic substance, those activities must be disregarded for tax purposes and

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[90] No. 3:01cv1839 (SRU); No. 3:01cv1840 (SRU).

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

[92] *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989) (**"**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 584, 586 (2d Cir. 1998), citing ,*Jacobson v. Commissioner*, 915 F.2d 832, 839 (2d Cir 1990); *Gilman v. Commissioner*, 933 F.2d 143, 148, n. 5 (2d Cir. 1991) ("section 183 applies after a transaction has been determined to have economic substance.") cert. denied, 116 L.Ed. 2d 776, 112 S. Ct. 871 (1992); *Mahoney v. Commissioner*, 808 F.2d 1219, 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.")

[93] *UPS of America v. Commissioner*, 254 F.3d 1014, 1018 (7th Cir. 2001).

[94] *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.")

[95] 29 F.3d 98, 102 (1994),

> 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.

Other courts applying the conjunctive test have begun with the subjective prong. Because the taxpayer must prove both prongs to prevail, showing an honest nontax business purpose would not suffice under this standard. As the Tax Court indicated in *Cherin*:

> 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.[96]

The Tax Court in *Sheldon*[97] and *ACM Partnership*[98] also started with the subjective standard, which was basically, a profit motive test. In both of these cases, the Tax Court considered the profit potential to be probative of the taxpayer's motivation. Because the courts found the potential for profit to be insignificant, the Tax Court concluded that the taxpayer was motivated solely by tax benefits. In general, if the court applies the conjunctive test, begins with the-profit potential standard, and finds it to be no more than de-minims, the court can stop and hold that the transaction should be invalidated and tax benefits be denied. Nevertheless, in these two cases as well as in many others, the courts went on to perform the objective analysis.

As set forth in greater detail below, all recent legislative proposals to codify the economic substance doctrine specifically would apply the conjunctive test. Specifically, pursuant to the most recent proposal (which was not enacted into law), a transaction 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 nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[99]

To conclude, as a practical matter, the conjunctive test works similarly to the unitary test described below. Under both standards, a court would, generally, not validate a transaction unless the taxpayer satisfies both prongs in one way or the other. In addition, courts applying the conjunctive or unitary test give more weight to the objective analysis, and in some cases, as discussed in the next section, completely disregard the subjective prong.

4. Applying Only the Objective Test

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[96] *Cherin*, at 994[96] *See Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989) ("It is clear that transactions whose sole function is to produce tax deductions are substantive shams, *regardless of the motive* of the taxpayer.")

[97] *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[98] 73 T.C.M 2189 (1997), *aff'd*, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999).

[99] See proposed IRC 7701(n)(1)(B)(i)(I) and (II).

In several cases, the economic substance objective prong has been the sole basis for the courts in disregarding the form of the transaction where the taxpayer's only claimed business purpose was to earn a profit. Some courts completely disregarded the subjective standard and focused primarily on the objective standard. The rationale behind this standard is 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* which was also guided by accounting and regulatory concerns, the two prongs of the test overlap to a large extent.

A similar view was expressed by both Treasury and the Joint Committee of Taxation in 1999, in their lengthy reports on tax shelters. Treasury 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.[100]

This definition resembles the test applied by the IRS in Notice 98-5.[101] In both Notice 98-5 and the Treasury's proposed definition, the subjective motives of the taxpayer are not taken into account. Rather, the motives of the taxpayer are analyzed objectively based on whether the taxpayer reasonably expects an economic profit from the transaction in question. Thus,Treasury decided against adopting a subjective test and in favor of the objective leg of the economic substance doctrine. The rationale behind Treasury's proposal was that a subjective test would likely prove inadequate for the following reasons. First, the Treasury argued that corporations exist to make a profit and therefore, will be presumed to satisfy the potential for profit test even if its expectation of profit is unreasonable. Second, permitting corporate taxpayers to enter into transactions with unreasonable expectations of profit would permit corporations to engage in transactions solely for tax benefits.[102]

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[100] U.S. Dep't of the Treasury, *The Problem of Corporate Tax shelters: Discussion Analysis, and Legislative Problems* (1999)
[101] 1998-3 I.R.B. 49
[102] U.S. Dep't of the Treasury, T*he Problem of Corporate Tax shelters: Discussion Analysis, and Legislative Problems* (1999)

According to the Joint Committee, a transaction will not be recognized for tax purposes if "[t]he reasonably expected pretax profit from the arrangement is insignificant relative to the reasonably expected tax benefits."[103]

As discussed above, 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. Thus, as a practical matter, the court applies objective analysis under both prongs.

As the Second Circuit indicated in *Rosenfeld v. Commissioner*:[104]

> [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.

In *Carlson v. Commissioner*, 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. Comr., 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. . . . 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. . . . 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.[105]

This standard of review may be viewed as a part of the disjunctive test, because the existence of one prong, namely the objective prong, would validate a transaction. Even though, technically, the disjunctive test discussed in the next section would allow a taxpayer to demonstrate either economic substance or business purpose, as a practical

[103] Joint Committee on Taxation, *Study of Present Law Penalty and Interest Provisions, as Required by Section 3801 of the Internal Service Restructuring and Reform Act of 1998* (JCS-3-99), Released on July 22, 1999, at 229.
[104] 706 F.2d 1277, 1282 (2d Cir. 1983).
[105] citing *James v. Commissioner*, 87 T.C. 905 (1986). n.5

matter, most taxpayers would focus on showing objective substance under the disjunctive test.[106]

5. Disjunctive Test

A standard applied by some Circuits (primarily by the D.C., Federal and Fourth Circuits, and occasionally by the Eighth Circuit) and several Tax Courts is a disjunctive test pursuant to which the economic substance doctrine will 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).[107] The leading case cited for this proposition is *Rice's Toyota*.[108]

Generally, in the Fourth Circuit, a transaction will be treated as a sham (or having no economic substance) if the court finds "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. .[109]

As the Fourth Circuit elaborated:

> 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.[110]

Five years later, in *Hines v. Commissioner*, the Fourth Circuit followed this standard and held that:

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[106] See, for example, *Black & Decker*, where the taxpayer and Government stipulated that there was no business purpose, because the taxpayer relied on the prevailing disjunctive test in the Fourth Circuit.

[107] *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.)

[108] See also *Black and Decker Corp v. United States*, No. WDQ-02, 2004 US Dist LEXIS 21201 (N.D. Md. Oct. 22, 2004), holding that the Fourth Circuit applies the disjunctive standard. The court relied on *Hunt v. Commissioner*, 938 F.2d 466, 471 (4th Cir. 1991) and *Hines v. United States*, 912 F.2d 736, 738-39 (4th Cir. 1990) for its decision. See also *Friedman v. Comm'r*, 869 F.2d 785, 792 (4th Cir. 1989); *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); Fisher v. United States, 1990 U.S. Dist. LEXIS 11655, at *10 (W.D.N.C. 1990).

[109] *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 90 (4th Cir. 1985).

[110] Id.

> 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. [111]

Citing *Faulconer v. Commissioner*,[112] the Fourth Circuit 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, asserted 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." [113]

Thus, the Fourth Circuit implied that a mere subjective belief that a transaction can generate nontax profit may not suffice. This assertion may be viewed as inconsistent with the court's decision in *Black & Decker v. United States*[114] where it was stipulated from the beginning that there was no business purpose, but the court held for the taxpayer on the grounds that the transaction had objective economic substance.

In *Black & Decker v. United States*,[115] the District Court (in the Fourth Circuit) followed the Fourth Circuit's disjunctive standard. "The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes." Accordingly, the BDHMI transaction cannot be disregarded as a sham." Thus, for purposes of its motion for summary judgment, Black & Decker 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 (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.[116]

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[111] *Hines v. United States*, 912 F.2d 736, 739 (4th Cir. 1990), citing *Rice's Toyota*, 752 F.2d 96.

[112] 748 F.2d 890, 894 (4th Cir. 1984).

[113] *Hines v. United States*, 912 F.2d 736, 739 (4th Cir. 1990), citing *Rice's Toyota*, 752 F.2d 96.

[114] *Black and Decker Corp v. United States*, No. WDQ-02, 2004 US Dist LEXIS 21201 (N.D. Md. Oct. 22, 2004)

[115] *Id.*

[116] Citing *N. Indiana Public Serv. Co. v. Commissioner*, 115 F.3d 506, 512 (7th Cir. 1997); *Moline Properties Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943); *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

The 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.

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.[117]

In general, the D.C. Circuit has also adopted the disjunctive standard. In *Horn v. Commissioner*,[118] the Court of Appeals for the D.C. Circuit held that to treat a transaction as a sham, <u>the court must find</u> 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. The court cited *United States v. Consumer Life Ins. Co*.,[119] where the Court found that two types of reinsurance arrangements were not shams because they "served [other] valid and substantial nontax purposes," specifically, risk allocation.[120] . . . a transaction will not be considered a sham if it is undertaken for profit *or* for other legitimate nontax business purposes."[121] Thus, the court held that establishing that the transaction was undertaken

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[117] *Cf. ASA P'ship*, where the D.C. Court noted that satisfying the "business activity" test under *Moline Properties* is not enough – the transaction entered into by the entity must also have substance. ("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 nontax business motive. *See Knetsch v. United States*, 364 U.S. 361, 364-66 (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 nontax business purpose is fatal.")

[118] 968 F.2d 1229 (D.C. Circuit, 1992).

[119] *United States v. Consumer Life Ins. Co*., 430 U.S. 725, 736-39 (1977).

[120] Id. at 739.

[121] 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). Cf. *Gardner v. Commissioner*, 954 F.2d 836 (2d Cir. 1992) cert. denied sub nom. *Falk v. Commissioner*, 112 S. Ct. 1940 (1992); *Lerman v. Commissioner*, 939 F.2d 44 (3d Cir. 1991) cert. denied, 112 S. Ct. 590 (1991).

for profit (presumably under the objective prong) or any legitimate nontax business purpose (under the subjective prong) will validate the transaction.

In *Boca Investerings Partnership v. Commissioner*[122] the Federal District Court followed *Horn*, applied a disjunctive test and held that the test should a disjunctive test. 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."[123] Although this decision was reversed by the Court of Appeals for the D.C. Circuit, the repeal was not based on the standard applied by the District Court but rather on the grounds that in the view of the Court of Appeals, the disputed transaction had neither business purpose nor economic substance.[124]

In *Andantech L.L.C. v. Commissioner*,[125] in evaluating the economic substance of the sale leaseback transactions, the Tax Court also followed *Horn* 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.[126] Note that the Tax Court applied a separate analysis with respect to the validity of the partnership, as discussed in greater detail below. 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.[127]

In *Coltec Industries Inc. v. United States,*[128] the U.S. Federal Court of Claims has also indicated that the economic substance test is disjunctive:

> In any event, the court already has considered and held that Coltec satisfied the tax avoidance and business purpose tests in Section 357(b), therefore, ipso

[122] *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003). rev'g 167 F. Supp 2d, 298 (D.D.C. 2001).

[123] Thomas A. Humphreys, James A. Gouwar, J. Brandon Holder, *Boca Investerings and the Future of the Economic Substance Doctrine*, Derivatives Report Vol 3(5) (2001) at 9-10.

[124] *Boca Investerings P'ship v. United States*, 314 F.3d 625 (D.C. Cir. 2003). See also *Saba Investment v. Commissioner* 273 F.3d 1135 (D. C. Cir. 2000), *vac’g and rem’g* T.C. Memo 1999-359 and *ASA 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.

[125] T.C. Memo 2002-97, at 115.

[126] Id. at 116.). See also *Friedman v. Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989) (" '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 89, 91-92 (4th Cir. 1985).

[127] 331 F.3d 972 (D. C. Cir. 2003).

[128] No. 01-072T (United States Court of Federal Claims), reprinted in 2004 TNT 214-16.

> facto, the ‘economic substance’ doctrine is satisfied, since that doctrine requires proof of at least one of these tests.[129]

Frequently, other circuits have applied the disjunctive test even though it may not be the prevailing standard in the circuit. For example, in *Shriver v. Commissioner*, the Eighth Circuit followed *Rice’s Toyota* and applied the disjunctive test:

> 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*.[130]

The Eighth Circuit, however, also asserted in *Shriver* 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.” [131]

The court, therefore, applied in addition the unitary analysis discussed below.

Subsequently, in *IES*, the Eighth Circuit did exactly the same. First, it stated the general rule that

> [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. Comm’r, 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).

Nevertheless, the Eighth Circuit acknowledged, again, that it does 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, "We 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

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[129] See also *Johnson v. United States*, 32 Fed. Cl. 709 , 716-717 (1995), where the Court of Claims has followed the disjunctive test.

[130] *Shriver v. Commissioner,* 899 F.2d 724, 726 (8th Cir. 1990).

[131] Id. at 727

> 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.[132]

Thus, it is unclear what standard is prevalent in the Eighth Circuit. Similarly, it is unclear what standard is applied by the Second Circuit. While the court in *Long Term Capital Holding v. United States*[133] asserted that the Second Circuit applies the unitary test, the taxpayer in *TIFD III-E Inc. v. United States,*[134] however, urged the court to apply the disjunctive test, and the court implied that the disjunctive test may also be applicable in the Second Circuit (although the court held that it does not matter for the particular case, because the taxpayer satisfied both prongs).

A support for the taxpayer's argument could be found in the Second circuit's decision in *Gilman v. Commissioner*.[135] In this case 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 substance. 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."

The Second Circuit supported the *Rice's Toyota*'s disjunctive test, thereby 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.[136]

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[132] See also *Compaq Computer Corp. v. Commissioner* ("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.")

[133] 2004 WL 1924931(D. Conn. Aug. 27, 2004).

[134] No. 3:01cv1839 (SRU); No. 3:01cv1840 (SRU).

[135] T.C. Memo 1989-684.

[136] *Gilman v. Commissioner*, 933 F.2d 143, 147 (2d Cir. 1991). *Cf. Jacobson*, 915 F.2d at 837 (quoting *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.")

Finally, the Third Circuit acknowledged in *ACM Partnership* (footnote 31) 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.” Such assertions imply that the absence of business purpose.”

The Third Circuit cited for this proposition in the footnote the Seventh Circuit’s decision *in Northen Indiana Pub, Serv. Co. v. Commissioner*[137]:

> 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.[138]

Several other Tax Courts followed the disjunctive test, generally quoting *Rice’s Toyota* and *Frank Lyon*.

In *Packard v. Commissioner*,[139] the Tax Court cited 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.

The Tax Court in *Torres v. Commissioner*,[140] followed the same standard two years later in a sale and leaseback case 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

[137] 115 F.3d 506, 512 (7th Cir 1997)

[138] *ACM,* at 247, footnote 31. The District Court in *Coltec Industries* also cited *Northen Indiana Pub, Serv. Co. v. Commissioner* for the proposition that the economic substance standard is a disjunctive test. Note, however, that *Northen Indiana Pub, Serv. Co. v. Commissioner* is inconsistent with the Seventh Circuit’s decision in *Yosha*,861 F.2d 494 where the Seventh Circuit explicitly applied the conjunctive test (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.)

[139] 85 T.C. 397, 417 (1985).
[140] 88 T.C. 702, 718-19 (1987).

> apart from tax benefits but also that petitioner was virtually assured of realizing such a profit.[141]

Because a taxpayer is only required to satisfy one prong, under the disjunctive standard, even if a court finds that the taxpayer had no, or insignificant, non-tax motivation, it would validate a transaction if it finds the transaction had objective economic substance. In *Sanderson v. Commissioner,*[142] 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."

Similarly, the Tax Court in *Saba Partnership v. Commissioner*[143] relied on *Horn v. Commissioner* and asserted that " a transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a nontax business purpose."

Although in most cases applying the disjunctive test the taxpayer prevailed by showing objective economic substance, a taxpayer may still prevail on the grounds of having subjective business purpose, and not having to show objective economic substance. Citing *Rice's Toyota*, the Tax Court indicated in *Mukerji v. Commissioner:* [144]

> 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

[141] Id.,citing *Packard v. Commissioner*. See also *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. 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."); *Estate of Thomas*, 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)

[142] T.C. Memo 1985-477.

[143] T.C. Memo 1999-359.

[144] 87 T.C. 926, 960 (1987).

transaction to an objective economic analysis to determine whether there could have been an opportunity for profit.[145]

6. *Moline Properties*[146]

In *Moline Properties*, the Supreme Court set forth the standards for recognizing a formal entity for federal income tax purposes. The taxpayer in *Moline Prop*erties, 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 individually on the grounds that the existence of the corporation was "merely fictitious" for federal income tax purposes.[147] 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."[148] Courts subsequently have consistently applied this standard in determining whether a given corporation qualifies as a separate entity.[149]

Moline Properties set 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. 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. The second prong applies an objective standard requiring that the entity has engaged in sufficient business activity. If either prong is satisfied, the entity will be recognized as a separate entity.[150] The amount of business activity necessary to satisfy the objective standard, however, may be minimal.[151]

In *Northern Indiana Public Service Co. v. Commissioner,*[152] 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." The Seventh Circuit held that "[t]hese cases engender the principle that a corporation and the form of

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[145] Cf. *Hines v. United States*, where 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."

[146] 319 U.S. 436 (1943).
[147] 319 U.S. at 439.
[148] *Id.* at 438-39.
[149] *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).
[150] *Rogers v. Commissioner*, 34 T.C.M. (CCH) 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.").
[151] *Siegel v. commissioner*, 45 T.C. 566 (19XX).
[152] 115 F.3d 506, 513-14 (7th Cir 1997).

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."

As set forth above, the District Court in *Black & Decker v. United States*[153] cited both *Moline Properties* and *Northern Indiana Public Service Co.* (along with *Frank Lyon* and *Hunt*) for the proposition that the economic substance standard is disjunctive. However, as set forth by the D.C. Circuit in *ASA* (see above), a taxpayer must prove not only that the entity was engaged in a business activity, but also that the entity's transactions were not sham.[154]

To conclude, the disjunctive test is clearly more favorable to taxpayer than the conjunctive test. Taxpayers, therefore, generally attempt to convince the court that it should apply the disjunctive test, while the Government, naturally, attempts to convince the court that either the conjunctive test or the unitary analysis is appropriate.[155] As set forth above, in some circuits it is clear enough which standard prevails (Fourth, D.C. and Federal), while in others, it is up to the taxpayer to convince the court (Eighth, Second).

As a general rule, even if a court applies the disjunctive test, it would settle for a one prong test only if such test would clearly allow the court to reach a conclusion. Courts may begin with the subjective prong and if they have enough evidence to validate a transaction on the grounds that the taxpayer honestly expected an actual profit, there is no need to utilize an additional objective test. The latter test would be necessary, however, when the taxpayer cannot prove by clear evidence its honest pursuit for profit. In most cases, the court would have to apply the objective test. If the court begins with the objective analysis, it may not need to examine subjective intention if it finds that the transaction had objective economic substance

7. The Unitary Analysis

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[153] *Black and Decker Corp v. United States*, No. WDQ-02, 2004 US Dist LEXIS 21201 (N.D. Md. Oct. 22, 2004).

[154] "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 nontax business motive. See Knetsch v. United States, 364 U.S. 361, 364-66, 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 nontax business purpose is fatal."

[155] See *Long Term Capital Holdings v. United States*2004 WL 1924931(D. Conn. Aug. 27, 2004), for example.

The origins of the unitary analysis are found in *Zmuda v. Commissioner*, [156] 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."
Under this approach, "[a] taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to [the sham transaction] inquiry."[157] Thus, the two prongs are no more than other relevant factors in determining if the transaction ought to be respected for tax purposes.[158] Nevertheless, courts that apply the unitary analysis often apply the two-prong test, either as a part of the unitary analysis[159] or as an alternative test.[160]

As the Third Circuit indicated in *ACM Partnership*:

> 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.[161]

Similarly, in *Sochin v. Commissioner*, [162] 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

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[156] 731 F.2d 1417, 1420 (9th Cir. 1984).

[157] *Rose*, at 853, citing *Sochin v. Commissioner*, 843 F.2d 351, 354, *cert. denied*, 488 U.S. 824 (1988).
[158] *ACM Partnership*, 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.")

[159] *See Friedman v. Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989) (holding that although tax court did not apply the "exact test" of *Rice's Toyota World*, there was nevertheless ample support for the court's finding of a sham transaction). See also 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.").

[160] *Shriver v. Commissioner*, ("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.)
[161] *ACM Partnership*, at 247.

[162] *Sochin v. Commissioner*, 843 F.2d 351, *cert. denied*, 488 U.S. 824 (1988).

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.[163]

The flexible, or unitary, test has been adopted by the Second, Sixth, Eighth, Ninth, Tenth and Eleventh Circuits as well as by several Tax Courts.[164] As discussed herein, however, in some circuits, such as the Second and Eighth, it is not that clear that the unitary test is the prevailing doctrine. Due to the flexible nature of the unitary standard, different versions of this flexible analysis have emerged.[165] One notable version of this test, namely the "generic tax shelter" view, is discussed below.

A court applying the unitary analysis would, generally, discuss both prongs, and would make a decision based on its findings as to these prongs; however, the decision will be made based on the transaction's overall effect (in particular, does it have any practical

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[163] 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).

[164] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995); rev'g 64 T.C.M. 1003 (1992); *Gilman v. Commissioner*, 933 F.2d 143, 148 (2d Cir. 1991) *cert. denied*, 112 S. Ct. 871(1992); *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, 908-9 (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 1486, 1492 (11th Cir. 1989); *Collins v. Commissioner*, 857 F.2d 1383, 1385 (9th Cir. 1988); *Sochin v. Commissioner*, 843 F.2d 351, 354 *cert. denied*, 488 U.S. 824 (1988). cert. denied, 488 U.S. 824 (1988) ("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."); *Zmuda v. Commissioner*, 731 F.2d 1417, 1421 (9th Cir. 1984) See also Provizer v. Commissioner, 996 F.2d 1216 (6th Cir. 1993); (stating Rice's Toyota World test but citing Rose as authority), aff'g per curiam 63 T.C.M. 2531, 2548 (1992); Rosenfeld v. Comr., 706 F.2d 1277 (2d Cir. 1983). Jackson v. Comr., 966 F.2d 598, 601 (10th Cir. 1992); Gardner v. Comr., 954 F.2d 836, 839 (2d Cir. 1992), aff'g Fox v. Comr., 56 T.C.M. 863(1988), cert. denied sub nom., Falk v. Comr., 112 S. Ct. 1940 (1992); Lerman v. Comr., 939 F.2d 44, 55 (3d Cir. 1991), aff'g Fox v. Comr., 56 T.C.M. 863, cert. denied, 112 S. Ct. 590 (1991); Shriver v. Commissioner, 899 F.2d 724, 726 (8th Cir. 1990); Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989) aff'g Glass v. Comr., 87 T.C. 1087(1986); Forseth v. Comr., 845 F.2d 746, 748 (7th Cir. 1988), aff'g 85 T.C. 127 (1985)(fictitious sham); Mahoney v. Comr., 808 F.2d 1219, 1220 (6th Cir. 1987), aff'g Forseth v. Comr., 85 T.C. 127.

165 For example of the different types of standards applied by different courts, see Mahoney, 808 F.2d at 1220 (inquiry is whether transaction has any practical economic effects beyond the creation of tax benefits); Boynton, 649 F.2d at 1172 (transactions that have no economic effect other than creation of tax losses are shams); *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"); Julien v. Commissioner, 82 T.C. 492 (1984) (interest expenses incurred in silver straddles disallowed under I.R.C. § 162(a) because transactions served no economic purpose beyond generating interest deductions); *Zmuda v. Commissioner*, 731 F.2d 1417, 1420 (9th Cir. 1984) (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.); *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.)

effect other than tax effect), and not on the precise findings for each prong.[166] The focus, therefore, is on the transaction's effect on the taxpayer, other than a tax effect.

The unitary analysis allows the court to be more flexible with respect to the weight given to each prong, and, in fact, it also allows the court to completely ignore one prong, if the court views it unnecessary to apply such prong. As set forth above, in many cases, courts have presented the two alternative tests, the disjunctive and unitary, and concluded, generally, that under either test they would have reached the same conclusion (*Shriver, IES, Compaq, TIFD III-E Inc. v. United States*[167]). In addition, in those circuits, the disjunctive test has been used at least one time, and, naturally, taxpayers have attempted to convince the court to apply this test, while the Government has attempted to persuade the court that the unitary test ought to apply.

For example, in *Long Term Capital Holding v. United States*,[168] the District Court (whose decision could be appealed to the Second Circuit), the taxpayer claimed that under the Second Circuit's test, a transaction is valid if it has either economic substance or business purposes.[169] The District Court, however, dismissed this argument,[170] and thoroughly discussed the Second Circuit's flexible view of the economic substance.[171] As the court indicated, "[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."[172]

In contrast, in *TIFD III-E Inc. v. United States,*[173] the court was not as clear as the court in *Long Term Capital Holding v. United States* with respect to which doctrine is predominant in the Second Circuit. The taxpayer asked the court to apply the disjunctive test, while the government asked it to apply the unitary test. The court did a two prong analysis and held that the taxpayer had both business purpose and economic substance. Thus, the court said id did not have to decide which standard to apply.

To conclude, under the unitary standard, 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 may simply apply a flexible sham

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[166] See also *Zmuda v. Commissioner*, 731 F.2d 1417, 1421 (9th Cir. 1984) ("the unitary test is whether the transaction has any practical economic effects other than the creation of income tax losses.")

[167] No. 3:01cv1839 (SRU); No. 3:01cv1840 (SRU).
[168] 2004 WL 1924931(D. Conn. Aug. 27, 2004).

[169] Id. at footnote 68.
[170] 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. See Gilman. . . .").
[171] *Long Term Capital Holding v. United States*, 2004 WL 1924931,(D. Conn. Aug. 27, 2004).
[172] Citing *Gilman v. Commissioner*, 933 F.2d 143, 148 (2d Cir. 1991) and *Lee v. Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998) (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.'")
[173] No. 3:01cv1839 (SRU); No. 3:01cv1840 (SRU).

transaction analysis to determine if the transaction has any benefit to the taxpayer other than the tax benefit. Practically, however, there is little difference between the unitary and conjunctive standards, because a court applying the former test would examine both prongs to reach a conclusion.

8. "Generic Tax Shelters"

A modified version of the unitary standard has emerged in the Tax Court, defined by several courts as a "generic tax shelter" standard.[174] The Tax Court adopted the "generic tax shelter" test in *Rose v. Commissioner*.[175] Under this test, transactions involving "generic tax shelters" are disregarded for tax purposes if the transactions are devoid of economic substance.[176]

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.[177]

Pursuant to the Tax Court, whether a transaction involving a "generic tax shelter" is devoid of economic substance under this test is to be determined by evaluating the following factors: 1) the investment activities of the taxpayers; 2) the relationship between the asset's price and fair market value; 3) the structure of the financing; and 4) the perceived congressional intent.[178]

The Sixth Circuit affirmed the Tax Court's decision but declined, however, to adopt the "generic tax shelter" test. 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.[179]

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[174] *Rose v. Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989) ("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.").
[175] *Rose v. Commissioner*, 88 T.C. 386 (1987), aff'd 868 F.2d 851, 853 (6th Cir. 1989)
[176] *Hunt v. Commissioner*, 938 F.2d 466, 471 (4th Cir. 1991).
[177] Id., citing *Rose* 88 T.C. 386 (1987)
[178] Id., citing *Rose* at 415-422.
[179] 868 F.2d at 854.

Thus, the Sixth Circuit found that the "generic tax shelter" test is similar to the unitary analysis discussed above. [180] Thus, as the Fourth Circuit indicated in *Hunt*, there was no need to adopt another standard.[181]

III. Recent Economic-Substance Court Cases

A. *Long Term Capital Holding v. United States*[182]

A U.S. 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. 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.

1. 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 section 351 transactions ("CHIPS" and "TRIPS"). The key was that the lease obligations were not treated as a liabilities under section 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). The petitioners received a "should" level opinion from Shearman & Sterling supporting OTC's tax basis in the loss stock, and paid approximately $513,000 for the opinion.

In April and November of 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 worth approximately $5M.. OTC borrowed the cash component of its contribution from Long-Term Capital Management UK, a UK entity related to Long-Term Capital Management LP ("LTCM"), the general partner of LTCP.

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[180] *Hunt v. Commissioner*, 938 F.2d 466, 471 (4th Cir. 1991).

[181] Id., at 471-72. See also *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988) ("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.") See also *Rybak v. Commissioner*, 91 T.C. 524 (1988).

[182] 2004 WL 1924931 (D. Conn. Aug. 27, 2004)

In addition, OTC purchased from LTCM a "liquidity put" and a "downside put" with respect to its interest in LTCP. 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 section 754 election was made.

In December 1997, LTCP sold some of the preferred stock with a basis of $107M for approximately $1M, producing a loss of $106x, which was allocated to LTCM under section 704(c). King & Spalding rendered a should opinion on the partnership aspects of the transaction. The opinion was not delivered, however, until 1999. LTCM paid a fee to K&S of approximately $500K.

Babcock & Brown, which designed the CHIPS and TRIPS transactions and (with help from Turlington) the partnership transaction and brought OTC and Long Term together, received a partnership interest in LTCP (held through UBS) and a 12-month consulting arrangement for unspecified services for which it was paid $1.2 million.

Turlington claimed he had earned a fee for his role in the transaction. This claim was settled by Long Term paying Turlington $1.25 million and B&B paying $550K.

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. In addition, King & Spalding gave a "should" level opinion regarding the recognition and the allocation of LTCP's loss from its subsequent sale of the Loss Stock. The IRS disallowed the loss otherwise allocable to LTCM and assessed penalties.

2. Economic Substance Analysis

The taxpayer argued that the standard in the Second Circuit is a disjunctive test. Thus, the taxpayer asked that if the court finds either business purpose or economic substance, it ought to allow the tax benefits. The court rejected this argument, and 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 does 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. Alternatively, the court held that the transaction could be recast as a direct sale of the loss stock by OTC to LTCM under the step-transaction doctrine's "end result" test.

i. Objective Economic Substance

Relaying on the cost v. benefit analysis conducted by the Second Circuit 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. In particular, the costs included legal fees of $1M, the B&B fee of $1.2M, the Turlington settlement of $1.25M, and various internal allocations and bonuses paid to Long Term principals. 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 $2M.

The taxpayer argued that the 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. The court also rejected the taxpayer's view that the counterparty's business purpose imbues the transaction with business purpose. (Fn. 89)

ii. 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 Long Term 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. The court said, "[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." 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. The court implied that the transaction didn't have a business purpose because its structure was too complex for a regular business transaction. Thus, the court implicitly applied a "reasonable means" test, which, as set forth above, is inconsistent with the majority of courts across all circuits.[183]

3. Step Transactions 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.

4. Penalties

The court found the taxpayers liable for valuation overstatement and substantial understatement penalties. The court held that the S&S and K&S opinions did not allow the taxpayers to qualify for the "reasonable cause/good faith" exception to the penalties

[183] This standard was proposed in the recent version of the codification, as discussed below, but was not included in the final legislations signed by the president.

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.

5. Conclusions

The court's decision contains a thoughtful analysis of the law on economic substance and business purpose, with heavy emphasis on Second Circuit precedent, but essentially, the court offered no new doctrine. The case essentially says that a transaction driven exclusively by tax benefits cannot be dressed up with a thin layer of economic substance and business purpose. In this respect, it seems to differ little from *ACM* and similar cases. Finally, footnote 89 distinguishes the pro-taxpayer decision of the 11th Circuit in *UPS*, which , as explained by the District Court, court involved the restructuring of the taxpayer's business operation to derive a tax advantage, as opposed to Long Term Capital holding, which involved a unique transaction having nothing to do with the taxpayer's business.

The court's primary reason for sustaining the penalties asserted by the IRS appeared to be that the transaction lacked economic substance and business purpose. But the opinion also suggests that the opinion did not protect the taxpayer because it was deficient in its legal analysis and because at most one of the partners in LTCM had read the opinion.

B. *Black & Decker Corp. v. United States*[184]

U.S. District Court (in the Fourth Circuit) in Maryland has 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.

1. 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 section 351 transaction. Subsequently, B & D sold its stock in BDHMI to a third-party for $ 1 million.

B & D argued 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

[184] *Black and Decker Corp v. United States*, No. WDQ-02, 2004 US Dist LEXIS 21201 (N.D. Md. Oct. 22, 2004) reprinted in 2004 TNT 205-6.

offset capital gains it had from selling three businesses in 1998, and the remaining loss to offset gains in prior and future tax years.

Note that In Notice 2001-17,[185] the IRS identified as listed transactions such transactions "involving a loss on the sale of stock acquired in a purported section 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.

2. The Parties' Arguments

The United States argues that the BDHMI transaction was a tax avoidance vehicle that must be disregarded for tax purposes under the economic substance/sham transaction doctrine. B & D argues that because the BDHMI transaction had economic substance, it must be validated. Both parties stipulated that the transaction had no business purpose.

3. Analysis

Generally, in the Fourth Circuit, a transaction will be treated as a sham (or having no economic substance) if the court finds "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.[186] In other words, 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). "The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes."[187] Accordingly, the BDHMI transaction cannot be disregarded as a sham." 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.[188]

The Court looked at the facts and noted:

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[185] 2001-9 IRB 730.

[186] . *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 90 (4th Cir. 1985).

[187] Citing *Rice's Toyota*, 752 F.2d 96.

[188] Citing *N. Indiana Public Serv. Co. v. Commissioner*, 115 F.3d 506, 512 (7th Cir. 1997); *Moline Properties Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943); *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

> 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. *TIFD III Inc. v. United States*[189]

U.S. District Court (in the Second Circuit) in Connecticut has 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.

1. Facts

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 aircraft. In 1992, at least partially in response to concerns about the number of airlines going into bankruptcy, GECC executives began looking for ways to reduce GECC's risk in the aircraft leasing business.

Because of business limitations, selling the aircraft or borrowing money against them were not options. In May 1992, GECC submitted Requests for Proposal to seven investment banks. GECC accepted a proposal that required it to create a separate entity to which it would contribute a number of aircraft. Investors would then be solicited to purchase ownership shares in the new entity. The result would be that GECC would trade some of the risks and returns of those aircraft to the outside investors in exchange for a cash contribution to the newly created entity. The proposal also called for the investors to be foreign tax-neutral entities, an arrangement that would offer lucrative tax savings to GECC.

The proposal was implemented in two stages. First, three GECC subsidiaries formed an LLC ("Summer Street") and transferred to it aircraft, nonrecourse debt, rents receivable, cash, and all the stock of a GECC subsidiary ("TIFD VI") which had zero value. Second,

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[189] No. 3:01cv1839 (SRU); No. 3:01cv1840 (SRU).

later that same year, the GECC subsidiaries sold $50 million of their interest in Summer Street to two Dutch banks ("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 were modified after the Dutch Banks were admitted. Under the operating agreement, 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. The buyout payments were referred to as "Exhibit E" payments. At the end of eight years, if the Dutch Banks' capital accounts had actually earned a rate of return 9.03587%, the Dutch Banks' capital accounts, i.e., ownership interests, would be decreased to near zero. Similarly, if the Dutch Banks' capital accounts were credited with partnership income at a rate less than 9.03587%, the capital accounts would be negative after eight years; if the capital 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; 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. Operating Income was comprised of 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. 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 it was (a) 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 remainder was allocated 99% to the GECC entities and 1% to the Dutch Banks.

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. 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 remainder was allocated 99% to the GECC entities and 1% to the Dutch Banks.

2. Economic Substance Analysis

As the court indicated "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.[190] 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."[191]

The court moved on 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.[192]

The taxpayer argued that the court must apply the disjunctive test pursuant to which if the court would find either a subjective business purpose or objective economic substance, the transaction is not a sham. The government, however, urged the court to apply a flexible two-prong standard that considers both factors but makes neither dispositive (i.e., the unitary analysis).

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*[193] as an example for applying the unitary analysis. The court, however, did not have to decide which standard to apply, because, as the judge 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."

i. Economic Substance

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[190] Citing *Jacobson v. Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990).

[191] Citing *Newman v. Commissioner,* 902 F.2d 159, 163 (2d Cir. 1990).

[192] Citing *Gilman v. Commissioner*, 933 F.2d 143, 148 (2d Cir. 1991).

[193] 2004 WL 1924931 (D. Conn. Aug. 27, 2004)

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. 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, lack of risk is not enough to make a transaction economically meaningless, stated the court. Even with an 8.5% guaranteed return, the Dutch Banks still participated in the economically real upside of the leasing business. Participating in upside potential, even with some guarantee against loss, determined the court, is economically substantial. Further, noted the court, 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.”

ii. Business Purpose

“In evaluating the economic substance of a transaction, courts are cautioned to give more weight to objective facts than self- serving testimony.”[194]

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 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.

3. 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

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[194] Citing *Lee v. Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998).

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*, 201 F.3d 505 (D.C. Cir 2000) [add link], 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.

D. *Coltec Industries Inc. v. United States*[195]

A U.S. Court of Federal Claims has ordered the IRS to refund to Coltec Industries Inc. $ 82.8 million in federal taxes arising from a contingent liability transaction. The first paragraph of the decisions provided a clear indication of what the decision is going to be. The court cited *Atlantic Coast Line v. Phillips*[196] quoting from prior decisions of Justice Holmes and Judge Learned Hand, observed:

> 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.'[197]

1. Facts

[195] No. 01-072T (United States Court of Federal Claims), reprinted in 2004 TNT 214-16.

[196] 332 U.S. 167 (1947).

[197] Id. at 172-173.

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"). The latter is a manufacturer and distributor of industrial gaskets, pump packings, valves, and mechanical seals. 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 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 Garrison 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.

2. <u>Analysis</u>

The court examined the transaction using a three step analysis. First, it examined whether the contribution of the Anchor stock and Stemco promissory note to Garrison was qualified property under section 351 and therefore, non-recognition of gain or loss on the exchange was justified. Second, the court reviewed whether the Garloc’s basis in the Garison’s stock ought to be reduced because of Garrison's assumption of the shareholder’s contingent asbestos liabilities. This step required an examination whether the contingent liabilities constitute "liabilities" under either section 257 or 358(d). Finally, the court explored the question whether the sale of Garrison stock to the banks, which generated the loss, should be respected.

In addition, the court applied the business purpose test contained in section 357(b) as well as, separately, the common law economic substance test to the transaction, and under both standards, held that the transaction was not motivated solely by tax motivations.

i. Section 351

The court held that the contribution of the stock and the promissory notes to Garrison satisfied section 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 section 351 were met in this case.

ii. Garlock's Basis in the Stock

Pursuant to section 358(d)(1), in a stock exchange to which section 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. Treas. Reg. 1.461-1(a)(2)(j) 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."

In the present case, 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. Thus, because section 358(h) was enacted only in 1999 and did not apply to the transaction, the court held that Garlock will reduce its basis in the Garrison stock if and when the liabilities accrue and are satisfied by Garrison.

iii. Sale of the Stock

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; (iii) 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 expected to control the company); (iv) the banks had stakes in Garrison through the life of the venture; and (v) the banks were concerned about veil piercing and they too formed separate corporations to insulate their main business and required further indemnification from Coltec. Finally, tThe court also concluded that the transaction was made in arm's length.

3. 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 section 357(b). In addition, the court required that Coltec demonstrate that assumption of such liabilities also had a "bona fide business purpose." Both of these "tests" must be established by a "clear preponderance of the evidence." Section 357(c).

The court reviewed several cases discussing section 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."[198] (ii) the closer the nature of the liabilities to the customary business of the transferee and its continued viability, the more likely that Section 357(b) 's principle 'business purpose' test will be satisfied;[199] (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;[200] 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."[201]

The court concluded that the taxpayer satisfied these test. 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 Garrisson 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."

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[198] Citing *Drybrough*, 376 F.2d at 356.

[199] Citing Id. See also Treas. Reg. 1.368-2(g) (stating that to qualify as a reorganization, a transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization.").

[200] Citing , e.g., *Drybrough*, 376 F.2d at 358; *Easson*, 294 F.2d at 659.

[201] Citing e.g., *Gregory v. Helvering*, 293 U.S. at 469-70 and *Estate of Kanter*, 337 F.3d at 865-66.

The court concluded that “for these reasons, the court has determined that the record in this case establishes that Garrison's assumption of Garlock's contingent asbestos liabilities had a "bona fide" business purpose that satisfied Section 357(b) by a clear preponderance of the evidence.”

4. 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, however, 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, a court will apply common law doctrines only where the statute is unclear an open to several interpretations.

Furthermore, the Federal court of Claims reviewed the three cases cited by the government from the United States Court of Appeals for the Federal Circuit to conclude that all three did not endorse the use of the economic substance doctrine.[202]

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 busijness 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.”[203]

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[202] Citing *Holiday Village Shopping 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.” See also *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463 (Fed. Cir. 1997). another decision cited by the court for the proposition that when the statute is clear enough, there is no place for common law doctrines stating that “where the language of the Code is clear, the ‘substance rather than form’ doctrine is irrelevant. See also *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.").

[203] Citing for the proposition that the test is disjunctive *Frank Lyon*, 435 U.S. at 583-84 (holding "[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 fights and duties effectuated by the parties,"); United Parcel Service of America 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].'"); *Northern Indiana Public Service v. Commissioner*, 115 F.3d 506, 512 (7th Cir. 1997) ("[The

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.[204]

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."[205]

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."

IV. Legislative Proposals to Codify the Economic Substance Doctrine

A. Overview

In recent years, several legislative proposals to "codify" or "clarify" the economic substance doctrine have been made. These proposals, however, have been criticized not only by commentators but also by Government officials on various grounds.[206] In general, all recent proposals state that the economic substance requirement is a conjunctive two-prong test and cannot be satisfied by reason of a transaction's having a

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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) (emphasis added) ("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 and Decker Corp v. United States*, No. WDQ-02, 2004 US Dist LEXIS 21201 at 6 (N.D. Md. Oct. 22, 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.).

[204] Citing See *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 Section 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).

[205] Joseph Bankman, The Economic Substance Doctrine, 74 S. Cal. L. Rev. 5, 29-30 (2000-01)

[206] Samuel C. Thompson Jr. and Robert Allen Clary II, *Coming In From The 'Cold': The Case For ESD Codification*, 2003 TNT 102-33 (May 23, 2003) (citing Assistant Secretary of the Treasury for Tax Policy Pamela Olson's statement in her nomination hearings before the Senate Finance Committee: "I do not think that codification of the Economic Substance Doctrine will help.").

potential for profit unless both (a) the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected tax benefits and (b) the reasonably expected pre-tax profit from the transaction exceeds a risk free rate of return. As of today, Congress has adopted none of these proposals. Recently, the JOBS Act of 2004 was signed by the president in October 22, 2004, leaving out the latest version of the proposed codification.

B. History

1. 1999-2000: Treasury's and Joint Committee on Taxation's Reports on Tax Shelters

In 1999, both Treasury and the joint Committee on Taxation released comprehensive reports discussion corporate tax shelters and suggested alternative routes to fight such transaction. Both reports have officially suggested, for the first time, the possibility of "codifying" the common law doctrine of economic substance. In its July 1999 Report on Tax Shelters, Treasury suggested to codify the economic substance doctrine.[207] As set forth above, Treasury 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." Thus, Treasury suggested to apply a single objective standard rather than the two prong test.

A similar proposal was included in the Clinton Administration's Budget Proposal for the Fiscal Year 2001.[208]

The Joint Committee on Taxation proposed a similar standard in its July 1999 report. Under the Joint Committee's proposal tax benefits will be disallowed in "[t]he reasonably expected pretax profit from the arrangement is insignificant relative to the reasonably expected tax benefits." [209]

2. 2001-2002: First Drafts

During 2001-2002, two legislative proposals were made pursuant to which the economic substance doctrine would be codified as part of section 7701.[210] Under proposed new section 7701(m)(B):

> *A transaction has economic substance only if*--

[207] U.S. Dep't of the Treasury, *The Problem of Corporate Tax shelters: Discussion Analysis, and Legislative Problems* (1999)

[208] U.S. Dep't of the Treasury, General Explanation of the Administration's Revenue Proposals (Feb. 2000).

[209] Joint Committee on Taxation, *Study of Present Law Penalty and Interest Provisions, as Required by Section 3801 of the Internal Service Restructuring and Reform Act of 1998* (JCS-3-99), Released on July 22, 1999, at 229.

[210] House Ways and Means Committee member Lloyd Doggett's H.R. 2520, 107th Cong. 1st Sess. (July 17, 2001); House Ways and Means Committee Chair William Thomas's H.R. 5095, 107th Cong. 2d Sess., "American Competitiveness Act of 2002," (July 11, 2002).

(I) the transaction changes in a meaningful way (apart from Federal Income Tax effects) the taxpayer's economic position, and
(II) the taxpayer has a substantial nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.

Thus, the proposal adopted the two-prong conjunctive test. Congress, however, has not adopted these proposals during 2001 and 2002.

3. 2003-2004: Jobs Acts and Various Similar Proposals

During 2003, the attempts to codify or clarify the doctrines continued with the introduction of two almost identical proposed provisions in: (i) the Jobs and Growth Reconciliation Tax Act of 2003 (Pub. Law No. 108-27), as reported by the Senate Finance Committee on May 8, 2003, and passed by the Senate on May 16, 2003;[211] and (ii) the Care Act of 2003, passed by the Senate on April 9, 2003.[212]

Consistent with previous years' versions, both proposals set forth that a transaction has economic substance only if: (i) the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position; (ii) the taxpayer has a substantial non-tax purpose for entering into the transaction; and (iii) the transaction is a reasonable means of accomplishing that purpose.

In addition, consistent with previous proposed codifications, both proposals stated that the economic substance requirement cannot be satisfied by reason of a transaction's

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[211] S. 1054, 108th Cong., 1st Sess. (May 16, 2003). *See* Joint Committee on Taxation (JCT), "Summary of Conference Agreement on H.R. 2, the Jobs and Growth Tax Relief Reconciliation Act of 2003," JCS-54-03 (May 22, 2003).
[212] Title VII, Subtitle A, Section 701, "Clarification of Economic Substance Doctrine", of the Care Act of 2003, S.476, reported in S. Rpt No. 108-11, 108th Cong., 1st Sess. (February 27, 2003). *See also* similar proposals introduced, among others, by Sen. Mark Dayton, D-Minn. (S. 135), 108th Cong., 1st Sess. (January 9, 2003); Rep. Charles B. Rangel's. H.R. 2286, 108 Cong., 1st Sess. (June 22, 2003); Rep. Lloyd Doggett's "Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003," H.R. 1555, 108th Cong., 1st Sess. April 2, 2003); Rebuild America Act of 2003, S. 1409, 108th Cong., 1st Sess. Section 1101 (2003); Sales Tax Equity Act of 2003, S. 1436, 108th Cong., 1st Sess. Section 201 (2003); Tax Shelter Transparency and Enforcement Act, S. 1937, 108th Cong., 1st Sess. (2003); Tax Shelter Transparency and Enforcement Act, H.R. 3560, 108th Cong., 1st Sess. (November 25, 2003); Progressive Tax Act of 2003, 108th Cong., 1st Sess. (Dec. 8, 2003), 2003 TNT 236-29; S.1072, Title V, Highway Reauthorization And Excise Tax Simplification Act, passed by the Senate on February 12, 2004 and introduced by Senators Grassley and Baucus on February 9, 2004, Section 561 (proposing codification of the economic substance doctrine in new section 7701(n), to be effective for transactions entered into after February 2, 2004), and Section 5614 (proposing new section 6662B, the strict liability economic substance penalty, effective for transactions entered into after February 2, 2004); Senate Amendment No. 2645 to S.1637, the Jumpstart Our Business Strength Act (March 3, 2004), Section 401; Substitute amendment to S. 1637, the Jumpstart Our Business Strength Act, Section 401, 2004 TNT 57-19 (March 23, 2004); Substitute for S. 1637, the Jumpstart Our Business Strength Act, Section 401 (April 5, 2004), 2004 TNT 67-38; S.2210, the Tax Shelter and Tax Haven Reform Act, Section 301 (codification of economic substance doctrine) and 303 (economic substance strict liability penalty), 2004 TNT 51-15 (March 12, 2004), introduced by Senator Levin, Chair of the Senate Permanent Subcommittee on Investigations.

having a potential for profit unless both (a) the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected tax benefits and (b) the reasonably expected pre-tax profit from the transaction exceeds a risk-free rate of return. In determining pre-tax profit for this purpose, fees and foreign taxes are treated as expenses.

On July 25, 2003, House Ways and Means Chairman Bill Thomas introduced the “American Jobs Creation Act of 2003 (H.R. 2896), which was the follow-up proposal to the American Competitiveness and Corporate Accountability Act of 2002 (H.R. 5095). The "American Jobs Creation Act of 2003," did not include the proposal to codify the economic substance doctrine..

Nevertheless, on September 18, 2003, Sens. Charles E. Grassley, R-Iowa, and Max Baucus, D-Mont., the chair and ranking minority member of the Senate Finance Committee, introduced the Jumpstart Our Business Strength (JOBS) Act of 2003, S. 1637. Section 401 of the JOBS Act would codify the economic substance doctrine, consistent with the Charity, Aid, Recovery, and Empowerment (CARE) Act.

4. The JOBS Act of 2004

On May 11, 2004, the JOBS Act passed the Senate by a 92-5 vote. This later version, which was not included in the legislation signed by the president in October 22, 2004, was generally consistent with previous proposals, and applies the rigid two-prong test. Set forth below is a summary of the recent proposed version.

i. Scope of the Doctrine

The proposed standard applies only if a court determines that the economic substance doctrine is relevant for the disputed transaction.[213] If the court determines that the doctrine is relevant, the transaction will be validated only if the proposed standard discussed below is met.[214] Thus, a court may simply decide that there is no need to apply the doctrine on a transaction. For example, as set forth above, in *Coltec Industries*, the Federal Court of Claims cited several cases for the proposition that when the language of the Internal Revenue Code is clear, common law doctrines may not be applied.

Pursuant to proposed IRC 7701(n)(3)(A), the term “economic substance doctrine” means “the common law doctrine under which tax benefits with respect to a transaction are not

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[213] Proposed IRC 7701(n)(1)(a) would set forth that: “[i]n any case in which a court determines that the economic substance doctrine is relevant for purposes of this title to a transaction (or series of transactions), such transaction (or series of transactions) shall have economic substance only if the requirements of this paragraph are met.”

[214] Id. Thus, a court may choose not to apply the new proposed statutory standard. Monte A. Jackel, "*For Better or For Worse: Codification of Economic Substance*," summarized in Tax Notes, May 24, 2004, p. 1069; James M. Peaslee *Dover Done In By Senate ETI Bill; Don't Be The Last To Know*, 2004 TNT 115-37.

allowable if the transaction does not have economic substance or lacks a business purpose." Thus, under the proposal, it is a conjunctive test. Note that the proposed codification only applies to business. For individuals, the doctrine applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.[215]

The proposed legislation sets forth that other common law doctrines are not affected.[216] Nevertheless, as set forth above, 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 would not be affected. In addition, it is unclear whether a court can decide not to apply the economic substance doctrine but to apply the sham transaction standard, and if the court chooses to do so, can the court apply the common law standard as opposed to the proposed codification? These questions remain unanswered.

ii. Rigid Two-Prong Test

Consistent with previous codification proposals, the proposed legislation suggested that a transaction will have 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 nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[217]

There are two main problems with this proposed conjunctive standard. First, as set forth above, courts are divided with respect to how to apply the two-prong test, and, certainly, several recent cases discussed herein have indicated that it is not so common to apply the rigid two-prong conjunctive test. Second, as discussed herein, the proposed prongs do not reflect the prevailing authorities on economic substance. With respect to the first prong, various courts have applied a reasonable expectation for profit test rather than the broader test suggested in the proposed legislation. Second, and more significantly, the second requirement of the subjective test implies that the subjective prong would require not only that the taxpayer has significant nontax purpose, but also that the taxpayer is not free to choose how to get there.

iii. Relying on Potential for Profit

As stated above, many taxpayers attempt to assert that their transaction has economic substance by virtue of having potential for profit. Under Proposed IRC 7701(n)(1)(B)(ii), if a taxpayer attempts to rely on profit potential, "[a] transaction shall not be treated as having economic substance by reason of having a potential for profit unless (i) the present value of the reasonably expected pre-tax profit from the transaction is substantial

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[215] Proposed IRC 7701(n)(3)(C).

[216] Proposed IRC 7701(n)(4).

[217] See proposed IRC 7701(n)(1)(B)(i)(I) and (II).

in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected, *and* (ii) the reasonably expected pre-tax profit from the transaction exceeds a risk-free rate of return."

The first part of the proposed rule requires that not only the potential profit ought to be more than de-minimis, it must significant in relation to the expected net tax benefits from the disputed transaction. As set forth above, this principle has been accepted only by a few courts, and is clearly inconsistent with decisions across all circuits and courts.

Commentators have criticized the comparison with tax benefits approach,[218] and the risk free minimum return approach.[219] As commentators indicated, rather than "codifying" or "clarifying" a common law doctrine, the proposed legislation would set forth a new and higher standard, which has not been adopted by the vast majority of courts.[220] For example, the proposed legislation would change the objective standard from "reasonable possibility of profit" to "reasonably-expected pretax profit,"[221] a change that is inconsistent with the vast majority of cases.[222] Various commentators have warned that the proposed legislation could apply to common tax structuring and otherwise clearly permissible transactions.[223] For example, certain

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[218] Joseph Bankman, *The Economic Substance Doctrine*, at n. 33 (stating that: "This passage suggests that the court [in *Saba*] favored an approach that compared tax benefits to pretax profits - an approach consistent with the Treasury Department's shelter proposals but inconsistent with most case law on point.").

[219] *See NYSBA Objects To Codification Of Economic Substance Provisions*, 2003 TNT 102-19 (May 21, 2003). S*ee* also Alvin C. Warren Jr. *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 in "incoherent.").

[220] *See* Kevin D. Dolan, *Notice 98-5 Foreign Tax Credit Arbitrage*, 455 PLI/Tax 1029, 1047-1050 (1999) (discussing the profit requirement under Notice 98-5).

[221] *See* n. 140 in Senate Finance Report on Care Act (Care Act of 2003) (S. 476; Senate Rpt. 108-11), 2003 TNT 44-49 (February 27, 2003) (stating that "a 'reasonable possibility of profit' will not be sufficient to establish that a transaction has economic substance.").

[222] Recently, the Tax Court has confirmed that the standard should be whether the taxpayer had "realistic potential to earn a meaningful profit." *See Andantech LLC, et al. v. Commissioner*, T.C. Memo. 2002-97. For a similar argument, *see ABA Tax Section Offers Comments, Concerns Regarding Care Act Provisions*, 2003 TNT 81-74 (April 24, 2003), stating that: "This proposal goes beyond present law in that it evaluates the taxpayer's "reasonably expected" pre-tax profit rather than the potential for profit. Measured by this standard, a short sale of a security arguably would have no economic substance because the market expectation of positive returns on stocks and bonds means that the reasonably expected rate of return on a short sale is negative. Thus, at a minimum, it should be clarified that "reasonably expected profit" should not be a simple weighted average of the profit that could be realized under all possible market scenarios but should encompass the case where the taxpayer had a significant profit objective and there was a reasonable possibility that that objective could be achieved." The Joint Committee on Taxation candidly acknowledged a similar concern: "requiring a pre-tax profit test as part of an economic substance analysis could raise concerns with respect to certain customary leveraged lease transactions, financing arrangements in general, and transactions where the tax benefits are both intended by Congress and significant, but the transaction itself is expected to yield little (if any) profit." *See* Staff of the Joint Committee on Taxation, JCX-78-02 (July 19, 2002), at 6-8.

[223] James M. Peaslee, *Economic Substance Codification Gets Worse*, 2003 TNT 97-28 ("The profit test will be failed by many transactions that should be found to have economic substance.**"**) (May 16, 2003); Terrill

types of financial transactions such as swaps might be treated as lacking economic substance even if clearly entered into for business reasons.

Note that pursuant to IRC 7701(n)(1)(C), for purposes of the profit potential test, "[f]ees and other transaction expenses and foreign taxes shall be taken into account as expenses in determining pre-tax profit."

iv. Certain Business Purposes (GAAP Benefits) are Ignored

Taxpayers have argued that a purpose of having a financial accounting benefit is enough to satisfy the business purpose prong of the two-prong test. Proposed IRC 7701(n)(1)(II)(i) clarifies that for purposes of the subjective business purpose prong "[a] purpose of achieving a financial accounting benefit shall not be taken into account in determining whether a transaction has a substantial nontax purpose if the origin of such financial accounting benefit is a reduction of income tax."

v. Special Rules for Certain Transaction with Tax-Indifferent Parties

Financing Transaction: 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 with respect to the transaction is substantially in excess of the present value of the anticipated economic return of the lender. A public offering shall be treated as a borrowing, or an acquisition of financial capital, from a tax-indifferent party if it is reasonably expected that at least 50 percent of the offering will be placed with tax-indifferent parties.[224]

A "tax indifferent party" is defined as "any person or entity not subject to tax imposed by subtitle A [of the Internal Revenue Code]. A person 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 liability under subtitle A [of the Internal Revenue Code]."[225]

Income Shifting or Basis Adjustments: The form of a transaction with a tax-indifferent party shall not be respected if (i) 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 (ii) it results in a basis adjustment or shifting of basis on account of overstating the income or gain of the tax-indifferent party.[226]

A. Hyde and Glen Arlen Kohl, *The Shelter Problem Is Too Serious Not To Change The Law*, 2003 TNT 130-44 (July 03, 2003).

[224] Proposed IRC 7701(n)(2)(A).

[225] Proposed IRC 7701(n)(3)(B).

[226] Proposed IRC 7701(n)(2)(B).

vi. <u>Understatement Penalty for Non-economic Substance Transactions</u>

Section 404 of the JOBS Act of 2004 also suggested to add new IRC 6662B, imposing an understatement penalty for "non-economic substance transactions. This provision was also not included in the bill signed by the president in October 22, 2004. "Noneconomic substance transaction" exists if (A) there is a lack of economic substance, or (B) the transaction fails to meet the requirements of any similar rule of law.[227]

Pursuant to proposed IRC 6662B(a), "[i]f a taxpayer has an noneconomic substance transaction understatement for any taxable year, there shall be added to the tax an amount equal to 40 percent of the amount of such understatement." The penalty rate is reduced to 20% for a transaction with respect to which the relevant facts are disclosed in the return or a statement attached to the return.[228]Finally, under section 417 of the JOBS Act of 2004, revised IRC 163(m) would disallow interest deductions which is attributable to a noneconomic substance transaction understatement (as defined in section 6662B(c))."

V. Conclusion and Proposal

Since *Frank Lyon*, circuits have been divided on how to apply the two prong test. As set forth above, the inconsistency is reflected in several ways. First, each circuit has chosen a different path pertaining to the test; some circuits apply the conjunctive test, others apply a disjunctive test, and the rest apply a unitary analysis. In addition, there are some inconsistencies within some circuits, such as the Second and the Eighth Circuit. In fact, almost every circuit has applied, at least once, the disjunctive test. Tax Courts are also divided and do not follow a uniform standard.

The last three months have showed that the confusion is about to grow. The recent court cases discussed herein illustrate not only circuits are applying the economic substance inconsistently, but also within a certain circuit there could be inconsistent application of the two-prong test. While the court in *Long Term Capital Holding v. United States*[229] seemed convinced that the prevailing standard in the Second Circuit is the unitary analysis (rejecting the taxpayer's attempted reliance on *Gilman v. Commissioner*), the court in *TIFD III-E Inc. v. United States*[230] did not dismiss the taxpayer's assertion that the Second Circuit could apply the disjunctive test.[231] As set forth above, most circuits have discussed, at least once, the possibility of applying the disjunctive test. The Court

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[227] Proposed IRC66662B(c)(2).

[228] Proposed IRC 6662B(b).

[229] 2004 WL 1924931(D. Conn. Aug. 27, 2004).

[230] No. 3:01cv1839 (SRU); No. 3:01cv1840 (SRU).
[231] See above, *Gilman v. Commissioner*.

of Claims in *Coltec Industries Inc. v. United States*[232] not only held that the disjunctive test is the relevant one, but also decided that a section 357(b) business purpose analysis is adequate for purposes of satisfying the two-prong test. By contrast, in *Black & Decker Corp. v. United States,*[233] involving an equivalent situation, the parties stipulated that the taxpayer had no business purpose as a factual matter, and the court only focused on economic substance. Finally, the court in *Black & Decker Corp. v. United States*[234]applied the Fourth Circuit's disjunctive test using a unique combination of *Rice's Toyota* (the prevailing authority in the Fourth Circuit) and *Moline Properties*.

The rejection of the proposed codification of the economic substance doctrine discussed herein added to the confusion regarding the appropriate application of the two-prong test. As set forth above, the proposed legislation suggested a standard which would be not only inconsistent, but also more rigid, than the prevailing standards among all circuits. Thus, the rejection, for now, of the proposed codification is justified, because rather than "codify" or "clarify" the doctrine, the proposed legislation would have created a new higher standard, clearly inconsistent with most authorities discussed herein.

In the absence of codification, it is up to the courts and the IRS to search for uniformity. Having reviewed numerous cases involving economic substance analysis across all circuits and courts, I believe that a possible solution, which would be acceptable by all circuits, could be to transform the two-prong test into a single, flexible objective standard. Such a standard would, in fact, revive the original substance-over-form analysis conducted by the U.S. Supreme Court in *Gregory v. Helvering*, and would not seem to contradict the current standard applied by all circuits.

Specifically, I suggest that the standard would simply be whether the transaction had any economic effect on the taxpayer, apart from tax benefits. In particular, if potential profit from the transaction is measurable, the test should be whether the reasonably expected profit from the transaction exceeded the expected costs. This, is, as the reader would immediately observe, the prevailing standard for the objective prong of the two prong test, and the question is what do we do with the subjective prong, and how do we reconcile it with the view in the Fourth Circuit, for example?. The answer is that in the vast majority of cases, even the ones applying the two prong test, the subjective intent has been incorporated into the objective analysis, either by examining the subjective intent on an objective basis, or simply by inferring business purpose in case where the court found objective economic substance. Put broadly, it is much more likely that a court would first find economic substance and than infer business purpose than the converse situation where the court would infer economic substance from a subjective analysis of the taxpayer's intent. In addition, it is very unlikely that a court, even in the Fourth Circuit, would validate a transaction on the grounds that it had business purpose but not economic substance. (see *Hines*, for example) but much more likely that a court applying the disjunctive test would first find objective economic substance and validate the transaction with no need to examine business purpose. For those who still view the subjective prong

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[232] No. 01-072T (United States Court of Federal Claims), reprinted in 2004 TNT 214-16.

[233] No. WDQ-02-2070, Doc 2004-20637, (N.D. Md. 2004),reprinted in 2004 TNT 205-6.
[234] No. WDQ-02-2070, Doc 2004-20637, (N.D. Md. 2004),reprinted in 2004 TNT 205-6.

as essential, the subjective test could remain relevant, but only as one factor among others in the overall determination of economic substance.

Adoption of such a standard, therefore, would not seem to be inconsistent with the prevailing disjunctive test, because courts would simply collapse the twp prongs into a single test, that reflects the standard such courts have been applying.

Courts applying the conjunctive test would also find this test not inconsistent with their standard, because as of today, such courts must conduct an objective analysis regardless of the subjective test, and, again, it is very likely that a court finding economic substance would validate a transaction by inferring business purpose.

Finally, courts applying the unitary analysis would find it easy to adjust to such a standard, because, in essence, the flexible nature of the unitary analysis allows them to focus on one prong, and, most courts have focused anyway on the objective prong.

In addition, the subjective prong is generally mute in cases involving business entities, because, in general, business entities are created and operate to make a profit. Thus, it is implicit that a business entity will have a business purpose for any transaction the expected benefits of which exceed the expected costs.[235] With respect to individuals, various statutory rules, including sections 108, 165 and 183, contain subjective business purpose requirements (usually in the form of a "primarily-for-profit requirement) for purposes of validating a deduction, and such rules ought to govern in the applicable cases.

In addition, I suggest that the comparison between tax benefits and nontax benefits would not be followed, not only because it is inconsistent with the vast majority of cases across all circuits, but also because it is unfair to taxpayer entering into transaction with expectations for a more than *de-minimis* profit and potential risk of loss. From *Gregory v. Helvering* to *Compaq*, courts have clearly stated that a taxpayer may have significant tax motivation, as long is at has some nontax purpose, and as long as the latter is meaningful, neither the court nor the IRS can establish a higher standard.

For the same reasons, a requirement that the taxpayer earns at least a risk–free return should not be adopted. In other words, there are no legal grounds for the proposition that the taxpayer must make at least a certain return on a transaction in order to be eligible for the tax benefits associated with the transaction.

[235] For a similar view, see Treasury's report on tax shelters from 1999.