

IT IS TIME FOR THE SUPREME COURT TO VOICE ITS OPINION ON ECONOMIC SUBSTANCE

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** For the genesis of this article, see Yoram Keinan, *The Economic Substance Doctrine—Past, Present, and Future*, 47 TAX MGMT MEMO 259, 275-76 (2006) and Yoram Keinan, *The Many Faces of the Economic Substance’s Two-Prong Test: Time for Reconciliation?*, 1 N.Y.U. J.L. & BUS. 371 (2005).

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I. OVERVIEW

The economic substance doctrine is a common law anti-abuse doctrine, pursuant to which a court may deny 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.¹ The last couple of years witnessed the occurrence of several important developments in case law related to the application of the economic substance doctrine.² The first case in the series was *Long Term Capital Holdings v. United States*, which was decided in August 2004 for the government.³ In the subsequent two months, however, two district courts and the Court of Federal Claims held for the taxpayers in cases involving an economic

1. *Ferguson v. Comm'r*, 29 F.3d 98, 101 (2d Cir. 1994) ("An activity will not provide the basis for deductions if it lacks economic substance."); *Karr v. Comm'r*, 924 F.2d 1018, 1023 (11th Cir. 1991) ("[E]xpenses incurred in connection with a sham transaction are not deductible"); *Killingsworth v. Comm'r*, 864 F.2d 1214, 1216 (5th Cir. 1989) ("[C]ourts 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."); U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 56 (1999), <http://www.ustreas.gov/offices/tax-policy/library/ctswwhite.pdf> ("[T]he IRS can use non-statutory standards to challenge the tax benefits of a particular tax-advantaged transaction . . . 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.")

2. See generally Yoram Keinan, *The Economic Substance Doctrine—Past, Present, and Future*, 47 TAX MGMT MEMO 259 (2006) [hereinafter *Economic Substance Doctrine*] (providing an in-depth discussion of these events); Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?*, 1 N.Y.U. J.L. & BUS. 371 (2005) [hereinafter *Time for Reconciliation?*] (same).

3. 330 F. Supp. 2d 122, 128 (D. Conn. 2004).

substance analysis.⁴ In 2005, however, the pendulum swung back, and the Tax Court issued two cases holding for the government.⁵ The government's victories continued in 2006, with an unprecedented series of four reversals in seven months occurring in its favor; in all four cases, four different circuit courts reversed lower courts' taxpayer-favored decisions, with implicit criticism on how the lower courts had applied the economic substance doctrine.⁶

In August 2004, in *Long Term Capital Holdings*, a district court in the Second Circuit held that a transaction whereby a partnership sold stock with a built-in loss lacked both economic substance and a valid business purpose besides tax avoidance.⁷ Following Second Circuit precedent,⁸ the court first applied an objective profit potential test, then tried to find a subjective business purpose, and determined that the transaction at issue had neither.⁹ Additionally, the court upheld accuracy-related penalties imposed by the IRS, notwithstanding the fact that the taxpayer had obtained and relied on favorable tax advice from two separate law firms.¹⁰

However, just several weeks later, two cases were decided for the taxpayers which chilled the government's cheering of its victory.¹¹ As discussed herein, the government appealed all

4. See *TIFD III-E Inc. v. United States*, 342 F. Supp. 2d 94, 98 (D. Conn. 2004); *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621, 622 (D. Md. 2004); *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716 (2004); see also David B. McGinty, *Economic Substance, Business Purpose, and Tax Avoidance in Section 351 Contingent Liability Transactions after Black & Decker, Coltec, and Hercules*, 36 CUMB. L. REV. 1 (2006). While the government argued that contingent liability transactions violate current tax law, the government was unsuccessful in both *Black & Decker* and *Coltec*, but in *Hercules* obtained a settlement for the full value of the contingent liability loss. *Id.* These different results mean greater "uncertainty" for "the tax community."

5. See *Santa Monica Pictures, LLC v. Comm'r*, 89 T.C.M. (CCH) 1157 (2005); *CMA Consolidated Inc. v. Comm'r*, 89 T.C.M. (CCH) 701, 731 (2005).

6. See *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006), *rev'g* 342 F. Supp. 2d 94 (D. Conn. 2004); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *vacating* 62 Fed. Cl. 716 (2004); *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006), *rev'g* 340 F. Supp. 2d 621 (D. Md. 2004); *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), *rev'g* 250 F. Supp. 2d 748 (E.D. Mich. 2003).

7. *Long Term Capital Holdings*, 330 F. Supp. 2d at 186-87.

8. In particular, the court looked to *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966). *Id.* at 204.

9. *Id.* 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. *Id.* at 195-96.

10. *Id.* at 196. In 2005, the Second Circuit affirmed the lower court, upheld the penalties, and found no reasonable cause for the understatement. See *Long Term Capital Holdings v. United States*, 150 F. App'x 40, 42-44 (2d Cir. 2005).

11. See generally Julie Brienza & Karla L. Miller, *Economic Substance Trips up IRS*

three cases and won all three appeals.

In *Black & Decker Corp. v. United States*, a contingent liability case originating in a district court in the Fourth Circuit, Black & Decker prevailed at summary judgment on the grounds that the transaction had economic substance, even though it lacked business purpose.¹²

In *Coltec Industries, Inc. v. United States*, the U.S. Court of Federal Claims held for the taxpayer, in a contingent liability transaction somewhat similar to the one in *Black & Decker Corp.*, finding that not only the transaction occurred within the statutory requirements of I.R.C. § 357, it also had both economic substance and business purpose.¹³ The court also noted that because the transaction satisfied both statutory prongs, it therefore satisfied the economic substance doctrine *ipso facto*.¹⁴

In *TIFD III-E Inc. v. United States* (“Castle Harbour”), a district court in the Second Circuit held for the taxpayer, finding that the creation of the partnership with several banks, who were guaranteed a fixed return, with almost no risk of loss from the engagement, was not a sham¹⁵

In addition, during the fall of 2004, the American Jobs Creation Act of 2004 was finalized and finally signed by the president, but without the proposed codification of the economic substance doctrine.¹⁶

The pendulum swung back to the government’s side in 2005 in two Tax Court opinions.¹⁷ In *CMA Consolidated Inc. v. Commissioner*, the Tax Court held that deductions claimed by a promoter of lease stripping transactions, who acquired a position

in Coltec, Castle Harbour Cases, 105 TAX NOTES 780 (2004), available in TAX NOTES TODAY, 2004 LEXIS TNT 214-4.

12. *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621, 623-24 (D. Md. 2004). As one commentator indicated, a contingent liability case works as follows: “[a]fter the assumption of a non-accrued deductible contingent liability in a [§] 351 transaction involving a high-basis asset, the transferor sells the stock received at a loss and claims a loss deduction. These transactions allow corporations to accelerate or, in a sense, monetize deductions for contingent liabilities by turning future expense deductions into current losses on the disposition of stock received in [§] 351 transactions.” See McGinty, *supra* note 4, at 2.

13. 62 Fed. Cl. 716, 756 (2004). Unless otherwise expressly stated, all uses in this article of the term “Section” or “§” refer to the Internal Revenue Code.

14. *Id.* at 754.

15. 342 F. Supp. 2d 94, 98, 113 (D. Conn. 2004).

16. See generally American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of 26 U.S.C.).

17. See *Santa Monica Pictures, LLC v. Comm’r*, 89 T.C.M. (CCH) 1157, 1191 (2005); *CMA Consolidated Inc. v. Comm’r*, 89 T.C.M. (CCH) 701, 731 (2005); see generally Mark H. Leeds, *The Pendulum Swings Back: IRS Successfully Challenges Loss Shifting in Santa Monica Pictures*, 107 TAX NOTES 1669 (2005), available in TAX NOTES TODAY, 2005 LEXIS TNT 123-32 (discussing the *Santa Monica* case).

in an arrangement that it had tried to market to other investors, should be disallowed on the grounds that the transactions lacked economic substance.¹⁸

In *Santa Monica Pictures, LLC v. Commissioner*, another high-basis, low-value transaction, the Tax Court denied capital losses resulting from a partnership structure.¹⁹ The court imposed accuracy-related penalties, finding that the transactions had neither economic substance nor business purpose.²⁰

The government's victories continued in February 2006. In *Dow Chemical Co. v. United States*, one of four corporate-owned life insurance ("COLI") cases, the Sixth Circuit reversed and remanded a district court decision holding that Dow Chemical's COLI programs were economic shams and had no economic substance.²¹ Although the court commended the lower court's profit analysis in general, it determined the lower court erred in considering positive cash flows that were contingent on the taxpayer's eventual spending of significant amounts of cash.²²

That same month, in *Black & Decker Corp. v. United States*, the Fourth Circuit partially affirmed and partially reversed the district court's decision, holding that Black & Decker was not required to reduce its subsidiary's stock basis when the corporation transferred the contingent liabilities to the subsidiary, but remanded to determine whether the transaction had a reasonable profit expectation.²³

Recently, however, the last two taxpayer victories were also reversed. In July 2006, the Federal Circuit vacated the Court of Federal Claims' decision in *Coltec Industries, Inc. v. United States*, holding that even though the transaction satisfied the literal requirements of the Code, the loss should be disallowed on

18. *CMA Consolidated Inc. v. Comm'r*, 89 T.C.M. (CCH) 701, 731 (2005). The Tax Court also imposed accuracy-related penalties. *Id.*

19. *See Santa Monica Pictures*, 89 T.C.M. at 1191.

20. *See id.* at 1191, 1236.

21. 435 F.3d 594, 605 (6th Cir. 2006), *rev'g* 250 F. Supp. 2d 748 (E.D. Mich. 2003).

22. *See id.* at 601-02 (finding the transaction to be similar to the one in *Knetsch v. United States*, 364 U.S. 361 (1960), because the COLI plans would become profitable only in rare circumstances); *see generally* Yoram Keinan, *The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine*, 11 TAX NOTES 327 (2006), available in TAX NOTES TODAY, 2006 LEXIS TNT 74-29 [hereinafter *COLI Cases*] (providing an in-depth discussion on the application of the economic substance/sham transaction doctrine to the four COLI cases, including *Dow Chemical*).

23. *See* 436 F.3d 431, 443 (4th Cir. 2006); *see generally* Karen C. Burke, *Black & Decker in the Fourth Circuit: Tax Shelters and Textualism*, 111 TAX NOTES 315 (2006), available in TAX NOTES TODAY, 2006 LEXIS TNT 74-28 [hereinafter *Tax Shelters and Textualism*] (discussing the implications of the court's textualist approach in interpreting the statutory provisions on the economic substance doctrine).

the grounds that the transaction lacked economic substance.²⁴ Finally, in August 2006, the Second Circuit reversed the district court's decision in *TIFD III-E, Inc. v. United States* and held that the creation of Castle Harbour LLC was a sham, primarily on the grounds that the Dutch banks who invested in Castle Harbour were not bona fide equity participants but rather secured lenders.²⁵

These recent cases have emphasized the controversial application of the economic substance doctrine and illustrated how courts, the government, and taxpayers are divided in their interpretation of the doctrine.²⁶ In particular, the fact that four different circuit courts have reversed lower court decisions over a short period illustrates not only that circuit courts, district courts, and the Tax Court are applying the economic substance doctrine inconsistently, but also there could be inconsistent application of the doctrine within a given circuit. In the absence of a statutory standard, it is time for the Supreme Court to reconcile such differences.²⁷

From *Gregory v. Helvering*²⁸ to *Frank Lyon Co. v. United States*,²⁹ the Supreme Court has been relatively active in establishing and providing guidance with respect to common law anti-abuse principles. As early as 1935, in *Gregory*, the Court established the requirement that tax-motivated transactions must have a business purpose to be given effect.³⁰

In 1938, the "step transaction doctrine" was born. In *Minnesota Tea Co. v. Helvering*, a corporation was organized and its stock immediately distributed to its shareholders.³¹ Soon thereafter, the corporation acquired 18,000 shares of another company's stock and \$426,842 in cash.³² "The cash was immediately transferred to and divided among [the corporation's]

24. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1343 (Fed Cir. 2006), *vacating* 62 Fed. Cl. 716 (2004).

25. 459 F.3d 220, 240-41 (2d Cir. 2006), *rev'g* 342 F. Supp. 2d 94 (D. Conn. 2004).

26. *See Time for Reconciliation?*, *supra* note 2, at 375.

27. Since 1999, various proposals to codify the economic substance doctrine have been made, none of which have been adopted so far. *See Economic Substance Doctrine*, *supra* note 2, at 264-75.

28. 293 U.S. 465, 469 (1935) (holding that a reorganization was "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the 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 [taxpayer].").

29. 435 U.S. 561 (1978).

30. *Gregory*, 293 U.S. at 469-70.

31. 302 U.S. 609 (1938).

32. *Id.* at 610.

stockholders . . . in pursuance of a plan of reorganization” that required the stockholders to assume the corporation’s debts.³³ The Supreme Court held that:

In pursuance of the resolution, the stockholders received the money from petitioner to the extent of \$106,471.73, not as a distribution for their benefit but as a fund the equivalent of which they were bound to pass on, and did pass on, to the creditors. The conclusion is inescapable, as the court below very clearly pointed out, that by this roundabout process petitioner received the same benefit “as though it had retained that amount from distribution and applied it to the payment of such indebtedness.” Payment of indebtedness, and not distribution of dividends, was, from the beginning, the aim of the understanding with the stockholders and was the end accomplished by carrying that understanding into effect. . . . The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit. The controlling principle will be found in *Gregory v. Helvering*, 293 U.S. 465, 469-470; and applying that principle here, the judgment of the court below is [*affirmed*].³⁴

The Court concluded that “a given result at the end of a straight path is not made a different result because reached by following a devious path.”³⁵

33. *Id.*

34. *Id.* at 613-14.

35. *Id.* at 613; see also *Comm’r v. Clark*, 489 U.S. 726, 738 (1989) (“Under [the step transaction] doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction.”); *True v. United States*, 190 F.3d 1165, 1174 (10th Cir. 1999) (stating that the step transaction doctrine is an “incarnation of the basic substance over form principle”); *Greene v. United States*, 13 F.3d 577, 583 (2d Cir. 1994) (“By emphasizing substance over form, the step transaction doctrine prevents a taxpayer from escaping taxation. The doctrine treats the ‘steps’ in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked.”); *Associated Wholesale Grocers, Inc. v. United States*, 927 F.2d 1517, 1521 (10th Cir. 1991) (“The step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form.”); *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983) (“The

In *Moline Properties, Inc. v. Commissioner*, 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.³⁶ The Supreme Court set forth a different but strongly related doctrine, namely the recognition of the separate existence of a corporation for tax purposes.³⁷

United States v. Cumberland Public Services Co. involved an in-kind partial liquidation distribution from a closely held corporation to its shareholders followed by a sale of the distributed assets by the shareholders to a third party.³⁸ A similar situation was reviewed by the Supreme Court five years before in *Commissioner v. Court Holding Co.*³⁹ The Commissioner in *Court Holding Co.* prevailed because the court found that the corporation had in fact negotiated the sale but “called [it] off” at the last moment.⁴⁰ In *Cumberland Public Services Co.*, the taxpayer prevailed because the court found that the corporation never negotiated the sale; rather, the court determined that the sale was negotiated by the shareholders.⁴¹

In *Knetsch v. United States*, the Supreme Court set forth the

step transaction doctrine is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form.”); *Penrod v. Comm’r*, 88 T.C. 1415, 1428 (1987) (“The step transaction doctrine is in effect another rule of substance over form; it treats a series of formally separate ‘steps’ as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.”).

36. 319 U.S. 436, 436 (1943). *Moline Properties* established a two-prong disjunctive test for determining whether a separate corporate entity should be recognized: (i) a subjective test 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 test requiring that the entity has engaged in sufficient business activity. See *Rogers v. Comm’r*, 34 T.C.M. (CCH) 1254, 1256 (1975).

37. *Moline Props.*, 319 U.S. at 439.

38. 338 U.S. 451, 452 (1950).

39. 324 U.S. 331, 333-34 (1945). In both *Cumberland Public Services Co.* and *Court Holding Co.*, the Court determined that tax at the corporate level resulting from the asset sale could not be avoided by using the shareholders as a “conduit through which to pass title.” See *id.* at 334; *Moline Properties*, 319 U.S. at 440.

40. *Court Holding Co.*, 324 U.S. at 334 (“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.”).

41. See *Cumberland*, 338 U.S. at 454-55. The opinion suggests that if shareholders liquidate corporate assets, it is more akin to an in-kind shareholder distribution rather than a corporate sale by directors, which would be a taxable event. See *id.* In such a situation, the shareholders are not acting as a conduit to the corporation; thus, tax liability cannot be imputed to the corporation. See *id.*

distinction between factual and substantive shams⁴² and held that even if a transaction actually takes place, it can still be disregarded if it has no economic substance.⁴³

The case of *Frank Lyon Co. v. United States* involved a sale-and-leaseback transaction.⁴⁴ The Supreme Court established the foundation for the two prongs of the economic substance test: objective economic substance and subjective business purpose.⁴⁵

Since *Frank Lyon Co.*, however, the Supreme Court has not issued any significant economic substance cases. As suggested in this article, the inconsistencies and disparate interpretations of the economic substance doctrine require an intervention by the Supreme Court.⁴⁶

II. *LONG TERM CAPITAL HOLDINGS V. UNITED STATES*⁴⁷

A. *Facts*

During 1996, Onslow Trading & Commercial LLC (“OTC”) contributed cash and stock with a built-in loss to Long-Term Capital Partners LP (“LTCP”) in exchange for a partnership

42. See generally *COLI Cases*, *supra* note 22 (describing the difference between economic shams and factual shams).

43. 364 U.S. 361, 364-65 (1960). The court held for the government on the grounds that there was no beneficial interest to the transaction except to reduce the taxpayer’s tax liability. See *id.* In reality, the taxpayer had set up an automatic rebate system to recoup sham interest payments made in support of his deductions. *Id.* at 366.

44. 435 U.S. 561, 562 (1978).

45. *Id.* at 583-84. The Supreme Court set forth the following standard to determine when a transaction should be respected for tax purposes: “[W]here . . . 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”

46. See also Daniel L. Korb, IRS Chief Counsel, *The Economic Substance Doctrine in the Current Tax Shelter Environment*, Remarks at the University of Southern California Tax Institute (Jan. 25, 2005), in *TAX NOTES TODAY*, Jan. 26, 2005, available at 2005 LEXIS TNT 16-22 (“It is quite possible that someday soon the Supreme Court will be faced with deciding which test to apply in determining the economic substance of a transaction in connection with one of the so-called listed transactions [which the IRS and Treasury consider abusive and require disclosure]. When that day comes it will be interesting to see what formulation of the test carries the day. Will it be a rigid disjunctive or conjunctive two-prong test or a practical economic consequence test? Only time will tell.”).

47. 330 F. Supp. 2d 122 (D. Conn. 2004); see generally Alvin C. Warren Jr., *Understanding Long Term Capital*, 106 *TAX NOTES* 681 (2005), available in *TAX NOTES TODAY*, 2005 LEXIS TNT 25-48 (examining the underlying party arguments and district court opinion); Richard M. Lipton, *Reliance on Tax Opinions: The World Changes Due to Long Term Capital Holdings and the AJCA*, 101 *J. TAX’N* 344 (2004) (describing case in detail and discussing its significance to tax shelters) [hereinafter *Reliance on Tax Opinions*].

interest in LTCP.⁴⁸ In addition, OTC purchased from Long-Term Capital Management (“LTCM”) a “liquidity put” and a “downside put” with respect to its interest in LTCP.⁴⁹ In December 1997, LTCP sold some of the preferred stock with a basis of \$107 million for approximately \$1 million, resulting in a loss of \$106 million, which was allocated to LTCM under § 704(c).⁵⁰ The IRS disallowed the loss otherwise allocable to LTCM and assessed penalties.⁵¹

B. District Court

1. Economic Substance Analysis

Courts have established over the years that the economic substance doctrine requires an objective and subjective determination of whether a transaction has real, non-tax economic benefit.⁵² Several variations of this two-prong test have emerged since *Frank Lyon v. U.S.*, and almost every circuit has applied a different variation.⁵³ In general, the prevailing variations of the two-prong test include a conjunctive test, a disjunctive test, and a unitary (flexible) test.⁵⁴

In *Long Term Capital Holdings*, the taxpayer argued that the *disjunctive* test prevailed in the Second Circuit,⁵⁵ a standard applied by several circuits (primarily by the D.C. and Fourth Circuits, and occasionally by the Second and Eighth Circuits) and several Tax Courts, pursuant to which the economic substance doctrine will apply to disallow a tax benefit only after a decision that the transaction lacks *either* a business purpose or economic

48. *Long Term Capital Holdings*, 330 F. Supp. 2d at 136.

49. *Id.* at 137. OTC exercised its liquidity put on October 28, 1997, selling its entire interest in LTCP to LTCM for \$12,614,188, representing approximately a twenty-two percent return on OTC's investment. *Id.* at 138. Of course, no § 754 election was made.

50. *Id.* at 139.

51. *Id.* at 127.

52. See e.g., *Frank Lyon v. United States*, 435 U.S. 561, 583-84 (1978) (the United States Supreme Court set forth the two prong test); *ACM P'ship v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998); *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir. 1988) (articulating that the objective analysis is whether “the transaction had ‘economic substance’ beyond the generation of tax benefits”); *Rice's Toyota World, Inc v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985) (stating 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.”).

53. See generally *Time for Reconciliation?*, *supra* note 2 at 392-419 (discussing the different variations of the two-prong test).

54. *Id.* at 393-94.

55. See *Long Term Capital Holdings*, 330 F. Supp. 2d at 171 n.68.

substance.⁵⁶ The court, however, held that the prevailing standard in the Second Circuit was the *unitary* test,⁵⁷ pursuant to which “[a] taxpayer’s subjective business purpose and the transaction’s objective economic substance may be relevant to [the sham transaction] inquiry.”⁵⁸

2. Objective Economic Substance

Courts have developed several views regarding the application of the objective prong of the economic substance test.⁵⁹ In *Long Term Capital Holdings*, the taxpayer argued that the objective economic substance test ought to be only whether there had been a *meaningful change in the taxpayer’s economic position*.⁶⁰ The court, however, rejected the argument that a meaningful change in the parties’ economic position was enough to give the transaction economic substance.⁶¹ Applying a cost-

56. *Id.* (citing cases in other circuits following such a disjunctive test, including *Horn v. Comm’r*, 968 F.2d 1229, 1237 (D.C. Cir. 1992); *Rice’s Toyota World, Inc. v. Comm’r*, 752 F.2d 89 at 91-92 (4th Cir. 1985); *Friendship Dairies, Inc. v. Comm’r*, 90 T.C. 1054, 1062-63 (1998); see also STAFF OF JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 15 (Comm. Print 2005) (describing the disjunctive test as a “narrower approach”).

57. *Long Term Capital Holdings*, 330 F. Supp. 2d at 171 n.68 (reading *Gilman v. Comm’r*, 933 F.2d 143 (2d Cir. 1991) as “stand[ing] for the proposition that the nature of sham analysis is ‘flexible’ and may but is not required to encompass both subjective and objective inquiries”); see also *Rose v. Comm’r*, 868 F.2d 851, 853 (6th Cir. 1989).

58. *Rose*, 868 F.2d at 851, 853. Nevertheless, the court held that even if it would have accepted the disjunctive test, it would not have mattered, because the transaction lacked objective economic substance and the taxpayer entered into the transaction without any business purpose other than tax avoidance. *Id.* at 854.

59. See e.g., *ACM P’ship v. Comm’r*, 157 F.3d 231, 248 (3d Cir. 1998) (“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’”) (citation omitted); *Sochin v. Comm’r*, 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. Comm’r*, 752 F.2d 89, 94 (4th Cir. 1985) (stating that the economic substance inquiry is an objective inquiry into whether the transaction produced any non-tax benefit).

60. *Long Term Capital Holdings*, 330 F. Supp. 2d at 185; see also *Knetsch v. United States*, 364 U.S. 361, 366 (1960) (citing *Gilbert v. Comm’r*, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting)) (disallowing the deduction on the grounds that the taxpayer’s transaction “did ‘not appreciably affect his beneficial interest except to reduce his tax.’”); *ACM P’ship*, 157 F.3d at 248 n.31; *N. Ind. Pub. Serv. Co. v. Comm’r*, 115 F.3d 506, 512-13 (7th Cir. 1997); *Gilbert*, 248 F.2d at 411-12 (“If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. . . . [The *Gregory* doctrine] covers only those transactions that do not appreciably change the taxpayer’s financial position, either beneficially or detrimentally.”); *Skemp v. Comm’r*, 168 F.2d 598, 600 (7th Cir. 1948).

61. *Long Term Capital Holdings*, 330 F. Supp. 2d at 185-86; see also *Bail Bonds by Marvin Nelson, Inc. v. Comm’r*, 820 F.2d 1543, 1549 (9th Cir. 1987); *Johnson v. United*

benefit analysis similar to the one in *Goldstein v. Commissioner*,⁶² the court held that the taxpayer had no realistic expectation of economic profit from the transaction.⁶³ 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.⁶⁴

3. Subjective Business Purpose

The inquiry into whether there was a legitimate business purpose for a transaction involves a subjective analysis of the taxpayer's intent.⁶⁵ To satisfy this prong, the taxpayer must demonstrate a non-tax purpose.⁶⁶ In this case, the court found that the transaction was purely tax-motivated.⁶⁷ The court further observed that 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.⁶⁸

States, 32 Fed. Cl. 709, 716-17 (1995) (elaborating 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.”).

62. 364 F.2d 734 (2d Cir. 1996).

63. *Long Term Capital Holdings*, 330 F. Supp. 2d at 173-74; see also *Rice's Toyota World, Inc. v. Comm'r*, 81 T.C. 184, 209 (1983) (“[E]xamin[ing] the transaction for economic substance [is] an objective test. This requires that we first analyze the transaction as a prudent businessman would to ascertain whether it had any economic substance apart from its beneficial tax consequences.”); see generally Warren, *supra* note 47 (conducting a thorough cost-benefit analysis of *Long Term Capital Holdings*).

64. *Long Term Capital Holdings*, 330 F. Supp. 2d at 175-82. In particular, the costs included legal fees of \$1 million, the Babcock & Brown fee of \$1.2 million, the Turlington settlement of \$1.25 million, and various internal allocations and bonuses paid to principals. *Id.*

65. *Packard v. Comm'r*, 85 T.C. 397, 417 (1985) (“The first prong of the sham inquiry, the business purpose inquiry, is a subjective test and simply concerns the motives of the taxpayer in entering the transaction.”); *Bail Bonds by Marvin Nelson*, 820 F.2d at 1549 (“The business purpose factor often involves an examination of the subjective factors which motivated a taxpayer to make the transaction at issue.”).

66. *Friedman v. Comm'r*, 869 F.2d 785, 792 (4th Cir. 1989) (“[the subjective] prong requires a showing that the *only* purpose for entering into the transaction was the tax consequences.”); *ACM P'ship v. Comm'r*, 73 T.C.M. (CCH) 2189, 2217 (1997) (to satisfy the business purpose requirement, “the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation and intentions.”).

67. *Long Term Capital Holdings*, 330 F. Supp. 2d at 186-87. Most notably, the court asserted that the transaction was brought to the taxpayer as a tax product. *Id.* at 187.

68. *Id.* at 186 (“[T]he construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees itself points to Long Term's true motivation, tax avoidance. Taking fee-generating investments was Long Term's core business and was regularly executed without either the complex

The court concluded that LTCM did not carry out the transaction in a way that indicated it had any motive other than tax savings.⁶⁹

4. Step Transactions Analysis

The court also applied the step transaction doctrine,⁷⁰ using the “end result” test, pursuant to which the step transaction doctrine should apply to “purportedly separate transactions . . . when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.”⁷¹ 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.⁷²

One commentator has criticized the application of the end result test to this case and argued that:

machinations related to OTC's contributions or the attendant millions in transaction costs.”).

69. *Id.* at 186-87 (citing *Boca Investering's P'ship v. United States*, 314 F.3d 625, 631 (D.C. Cir. 2003)). *Boca Investering's* involved similarly elaborate transactions:

[T]he district court never made a finding of fact in regard to the necessity of AHP's acquisition of foreign partners in order to engage in the transactions. No official testified that AHP needed a partnership with a foreign corporation to invest in LIBOR notes or PPNs. AHP's participation in the partnership defies common sense from an economic standpoint, since it could have purchased the PPNs and the LIBOR notes directly, and avoided millions in transaction costs, including the \$7 million fee it paid to Merrill Lynch and the 'premiums' paid to the foreign partners for the purchase of their ownership interests.

Boca Investering's, 324 F.3d at 631.

70. *Long Term Capital Holdings*, 330 F. Supp. 2d at 136. The step-transaction doctrine is a variation on the substance-over-form doctrine, the purpose of which is to ensure that transactions are taxed according to their substance and not their outward form. See *supra* notes 34-35 and accompanying text.

71. *King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969) (quoting DAVID R. HERWITZ, BUSINESS PLANNING 804 (1966)); see also *Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983) (citing *King Enters.*, 418 F.2d at 516); *McDonald's Rests. of Ill., Inc. v. Comm'r*, 688 F.2d 520, 524 (7th Cir. 1982) (citing *King Enters.*, 418 F.2d at 516); *Redding v. Comm'r*, 630 F.2d 1169, 1175 (7th Cir. 1980) (“[O]ne of the tests which the parties ask us to consider is the ‘end result’ test, whereby purportedly separate transactions will be amalgamated into a single transaction when it appears that the successive steps were made ‘in furtherance of, and for the purpose of executing and putting into effect, the plan of reorganization.’”).

72. *Long Term Capital Holdings*, 330 F. Supp. 2d at 191 (“The [g]overnment contends that, under either the end result test or the interdependence test, OTC's contributions of preferred stock to LTCP . . . in exchange for a partnership interest and OTC's subsequent sale of that partnership interest to LTCM . . . must be stepped together into a single sale transaction with the result that LTCM acquired the preferred stock for a cost basis pursuant to 26 U.S.C. § 1012, which, for the combined Quest and Rorer stock, was approximately \$1.1 million. The Court agrees that this result follows from application of the end result test and therefore does not undertake an application of the interdependence test.”).

Nevertheless, certain aspects of *LTCH* are quite troubling. On a substantive basis, the court's view that it can apply the 'end result' test under the step transaction doctrine with respect to the exercise of a put option (at [Fair Market Value]) more than one year later appears questionable. Many taxpayers enter into transactions expecting to sell assets that they receive or expecting to take future steps that will achieve a tax benefit, but such future actions are usually not 'stepped together' with the prior actions unless there was some type of economic or similar compulsion beyond mere intent.

In *LTCH*, OTC may have intended to sell the LTCP interest to LTCM when it received the interest, but it certainly was under no legal or economic obligation to do so. Indeed, OTC simply obtained a put exercisable at FMV, which is a common contractual right that usually does not implicate the application of the step transaction doctrine. The existence of a put or an option always shows an 'intent' or 'expectation' to take a future step, but the presence of such rights should not be the foundation for application of the step transaction doctrine.⁷³

As discussed below, however, the Second Circuit affirmed the application of the step transaction doctrine to this case.⁷⁴ In addition, as discussed in greater detail below, the Tax Court in *Santa Monica Pictures* followed the same exact analysis to disallow the tax benefits resulting from a similar transaction and to impose penalties.⁷⁵

5. Penalties

The court found LTCM liable for gross valuation overstatement under I.R.C. § 6662 as well as for substantial

73. *Reliance on Tax Opinions*, *supra* note 47, at 355-56.

74. *Long-Term Capital Holdings, LP v. United States*, 150 Fed. Appx. 40, 43 (2d Cir. 2005) ("We . . . disagree with Long-Term's argument that the district court erred by applying the step transaction doctrine. The district court did not err in finding that the sole purpose of the transaction here was to transfer losses from OTC to LTCM and that any intervening steps taken in pursuit of this goal were economically meaningless.").

75. *Santa Monica Pictures, LLC v. Comm'r*, 89 T.C.M. (CCH) 1157, 1216-18 (2005).

understatement penalties.⁷⁶ For various reasons, the court held that the legal opinions did not allow the taxpayers to qualify for the “reasonable cause/good faith” exception⁷⁷ to the penalties.⁷⁸

In the author’s view, there was nothing new in the court’s application of the economic substance doctrine in its decision. Because the facts in this case were so extreme, it was easy for the court to conclude that the transaction had neither economic substance nor business purpose. Furthermore, the fact that the taxpayer did not appeal on this point (as discussed below) indicates that there was little chance the decision will be reversed on these grounds.

Government officials, however, viewed this case as a turning point in the government’s fight against abusive tax shelters.⁷⁹ The decision also attracted the attention of leading scholars, including Professor Alvin Warren of Harvard Law School.⁸⁰ Even though this case was decided at the district court level, it contained a thorough analysis of the law on economic substance

76. *Long Term Capital Holdings*, 330 F. Supp. 2d at 199-200. A “substantial understatement” exists when the “correct” tax liability exceeds the tax liability actually reported by the greater of ten percent of the correct tax or \$5,000 (\$10,000 in the case of corporations). *Id.* at 200 (citing I.R.C. § 6662(d)(1)(A)). The rate of penalty is equal to twenty percent of the underpayment. *Id.* (citing I.R.C. § 6662(b)(2)). For this purpose, the term “understatement” generally means “the excess of the amount of the tax required to be shown on the return [for the taxable year] over the amount of the tax shown on the return.” *Id.* (citing I.R.C. § 6662(d)(2)(A)).

77. I.R.C. § 6664(c)(1) provides an exception to the imposition of the accuracy-related penalty if the taxpayer shows there was “reasonable cause” for the underpayment and “the taxpayer acted in good faith.” I.R.C. § 6664(c)(1) (West 2006). “The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.” Treas. Reg. § 1.6664-4(b)(1) (2006). “Generally, the most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability.” *Id.*; see also *Santa Monica Pictures*, 89 T.C.M. at 1229-30 (applying the “reasonable cause/good faith” standard as outlined in I.R.C. § 6664 and Treas. Reg. § 1.6664-4(b)(1) to hold that advice received by petitioner did not satisfy the reasonable cause exception).

78. See *Long Term Capital Holdings*, 330 F. Supp. 2d at 204, 207-08, 210-12.

79. See Mark Everson, IRS Comm’r, & Donald Korb, IRS Chief Counsel, Statement on Court Decision in *Long Term Capital Holdings v. United States*, Statement, (Aug. 30, 2004), in TAX NOTES TODAY, August 31, 2004, available at 2004 LEXIS TNT 169-23 (quoting IRS Commissioner Mark W. Everson’s statement in the aftermath of this decision: “This is an important victory in our ongoing battle against abusive tax shelters. We are very pleased,” and IRS Chief Counsel Don Korb’s statement: “The judge’s decision supports several key areas in our battle against abusive transactions. There must be economic substance behind these transactions, and the judge’s decision recognizes a legal opinion is not a free pass from facing penalties.”); see also Mark H. Leeds & Jeffrey L. Rubinger, *When Common Sense Failed: The Long-Term Capital Holdings Decision and Its Implications for Tax Planning*, 6 DERIVATIVES 1, 9 (2004) (stating that the “decision obviously represents a significant victory for the IRS in its fight against corporate tax shelters.”).

80. See generally Warren, *supra* note 47.

and business purpose doctrines.⁸¹ Furthermore, with respect to the imposition of penalties, the case made it clear that obtaining tax advice from a reputable law firm may not suffice to immunize a taxpayer from penalties.⁸²

Subsequent to the court's decision in *Long Term Capital Holdings*, in a Chief Counsel Notice, the IRS reacted to its victory and advised chief counsel attorneys on the purpose of penalties in tax administration.⁸³ With respect to the reasonable cause exception, the IRS stated that:

One of the most common taxpayer defenses is the claim that the taxpayer reasonably relied in good faith on the advice of a professional tax advisor in taking a return position. I.R.C. [§] 1.6664(c). While professional tax advice can afford taxpayers a defense to the imposition of penalties, the mere fact that the taxpayer obtained such advice does not necessarily, in and of itself, meet the requisite burden of proof. Circumstances may show that the taxpayer did not rely on the advice in good faith, or that the taxpayer's reliance was not reasonable. The regulations under [§] 6664 provide a nonexclusive description of circumstances where taxpayers may not rely on the advice of others as a defense to accuracy-related penalties.⁸⁴

C. *Second Circuit*

On appeal, LTCH only challenged the application of the step transaction doctrine and the imposition of penalties.⁸⁵ In a short opinion, the Second Circuit observed that there was no evidence the taxpayer received tax advice on which it claimed to have relied in reporting the \$106 million loss.⁸⁶ The court further noted that even if the taxpayer had received tax advice, such

81. *Id.* at 696 (remarking that "Judge Arterton is to be congratulated for mastering the transaction, for analyzing the legal issues in depth, and for sustaining penalties imposed by the government on the taxpayers, who should not be allowed to hide behind what the court found to be superficial legal opinions obtained from prominent firms.").

82. *See* *Everson & Korb*, *supra* note 79, at 2 (quoting IRS Chief Counsel Don Korb's statement that a legal opinion would not constitute a "free pass from facing penalties.").

83. Notice from IRS Office of Chief Counsel to IRS Chief Counsel Attorneys 2 (Sept. 22, 2004), in TAX NOTES TODAY, Sept. 22, 2004, available at 2004 LEXIS TNT 186-9.

84. *Id.*

85. *Long-Term Capital Holdings, LP v. United States*, 150 Fed. Appx. 40, 43-44 (2d Cir. 2005).

86. *Id.* at 42.

“advice was [not] based upon all pertinent facts and circumstances,” and the taxpayer “unreasonably rel[ie]d] on statements that [it] knew were unlikely to be true.”⁸⁷ LTCH also “argue[d] that the 40% penalty should not be applied . . . because (1) there was no misstatement of value, only a misstatement of basis; (2) the basis misstatement resulted from a legal dispute, not a factual dispute; [and] (3) the underpayment was not attributable to the basis misstatement.”⁸⁸

The court found LTCH’s arguments were without merit because (1) I.R.C. § 6662(e)(1)(A) “defines ‘valuation misstatement’ to include misstatements concerning the ‘correct amount of [the] valuation or adjusted basis.’”⁸⁹ Therefore, valuation misstatement under § 6662(b)(3) “include[s] both valuation and basis misstatements;”⁹⁰ (2) “§ 6662(e)(1)(A) does not differentiate between factual and legal determinations” and it is incorrect that “the penalty cannot apply where the transaction is ‘recast’ for tax purposes using a legal doctrine such as the step transaction or economic substance doctrine;”⁹¹ and (3) “[t]he underpayment . . . was directly dependent upon the valuation misstatement and the amount of the tax benefit was determined by the amount of the misstatement.”⁹²

In conclusion, the district court held, and the Second Circuit affirmed, that an opinion from a tax advisor will not satisfy the “reasonable cause” exception where: (1) the taxpayer claims the associated benefits on its tax return prior to receiving the written tax opinion,⁹³ (2) the tax opinion is based upon unreasonable

87. *Id.* The Second Circuit found ample evidence in the record to support the district court’s finding that LTCH had made a number of assumptions that it knew “to be false and that it was unreasonable for [its tax advisors] to rely on [those] assumptions when a reasonably diligent review of the pertinent facts and circumstances would have revealed them to be false.” *Id.* at 42-43.

88. *Id.* at 43-44.

89. *Id.* at 44 (addition in original).

90. *Id.*

91. *Id.* (citing *Gilman v. Comm’r*, 933 F.2d 143 (2d Cir. 1991)).

92. *Id.*

93. *Id.* at 42. The Second Circuit observed that there was no evidence that the taxpayer had received, and relied on, an oral advice, prior to entering into the transaction. *Id.* Thus, it may be implicit that oral advice could be adequate if received prior to entering into a transaction, and the taxpayer can establish that it relied on such advice. However, this would be hard to prove. See generally Linda M. Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 VA. TAX REV. 583, 639 (2006) (“The current standard still results in a mixed message, even for significant purpose transactions [“SPTs”]. Although taxpayer penalty protection for many SPTs and other ‘shelter’ transactions is only available under more exacting conditions, advisors’ ability to provide oral advice generally, and written opinions at a level lower than [more likely than not] (even though they cannot be relied upon for penalty protection in respect of many significant-purpose transactions), invites

assumptions, (3) the tax opinion does not adequately analyze the applicable law in the taxpayer's jurisdiction, (4) the tax opinion does not address the economic substance of the transaction,⁹⁴ and (5) the taxpayer does not adequately review a tax opinion received in a timely manner.⁹⁵

III. *BLACK & DECKER CORP. V. UNITED STATES*⁹⁶

A. *Facts*

Black & Decker Corporation created Black & Decker Healthcare Management Inc. ("BDHMI") and transferred to it approximately \$561 million in cash as well as \$560 million "in contingent employee healthcare claims in exchange for newly issued stock in BDHMI,"⁹⁷ in a § 351 transaction.⁹⁸ Subsequently, Black & Decker sold its stock in BDHMI to a third party for \$1 million and claimed approximately \$560 million in capital loss on the stock sale.⁹⁹

exploitation of loopholes. So long as advisors can advise taxpayers to take return positions that they do not expect to prevail on the merits, taxpayers will continue to adopt aggressive positions that might succeed depending on the luck of the draw in the audit lottery and forum selection process.") (footnotes omitted).

94. See Noel B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 29-30 (2004) ("Lawyers' opinions will frequently state that the determination of the presence of business purpose or economic substance is inherently factual and difficult to predict. They do not compare the magnitude of profit potential to tax benefits. Often, they simply assume the problem away. For example, in *Long Term Capital Holdings v. United States*, a highly publicized tax shelter case, a prominent New York law firm issued an opinion assuming that the tax shelter in question would generate a 'meaningful pre-tax profit' and provided no analysis of the economic substance issue.") (footnotes omitted).

95. See Frederic J. Adam & G. Michelle Ferreira, *Penalties and Taxes: Are Both Now Unavoidable?*, TAX NOTES TODAY, Oct. 19, 2004, available at 2004 LEXIS TNT 204-47 ("In light of the U.S. District Court for Connecticut's holding in the Long Term Capital Holdings (LTCH) case, we believe tax professionals will be more careful about the timing and substance of the tax opinions they give.") (footnote omitted).

96. 340 F. Supp. 2d 621 (D. Md. 2004). For an in-depth discussion on the *Black & Decker* case, see Ethan Yale, *Reexamining Black & Decker's Contingent Liability Tax Shelter*, 108 TAX NOTES 223 (2005), available in TAX NOTES TODAY, 2005 LEXIS TNT 132-29.

97. *Black & Decker Corp.*, 340 F. Supp. 2d at 622.

98. See I.R.C. § 351 (West 2006) (regulating transfers to corporations controlled by transferors).

99. *Black & Decker Corp.*, 340 F. Supp. 2d at 622. Black & Decker argued its basis in the stock was \$561 million (i.e., equal to the value of the contingent employee healthcare claims it had transferred to BDHMI) and because the sale price was \$1 million, the resulting loss was \$560 million. *Id.*

B. District Court

The government challenged the transaction on the grounds that “the BDHMI transaction was a tax avoidance vehicle that must be disregarded for tax purposes” under the economic substance doctrine.¹⁰⁰ Under the Fourth Circuit’s disjunctive test, a court will not disallow the tax benefits if the taxpayer can show *either* subjective business purpose or an objective economic substance.¹⁰¹ Applying the disjunctive test, the court held for the taxpayer.¹⁰²

The district court applied a combination of the *Moline Properties* doctrine¹⁰³ and objective economic substance analysis to conclude that “[a] corporation *and its transactions* are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions.”¹⁰⁴ The court concluded that “[t]he BDHMI transaction, therefore, had very real economic implications for every beneficiary of Black & Decker’s employee benefits program, as well as for the parties to the transaction.”¹⁰⁵

C. Fourth Circuit¹⁰⁶

The Fourth Circuit partially affirmed and partially reversed the district court’s decision.¹⁰⁷ The court held that the IRS

100. *Id.* at 623.

101. *Id.* at 624 (citing *Rice’s Toyota World v. Comm’r*, 752 F.2d 89, 96 (4th Cir. 1985)) (“The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes.”).

102. *Id.*

103. *Moline Props., Inc. v. Comm’r*, 319 U.S. 436, 439 (1943) (holding that the taxpayer could not disregard the corporate form of his business organization unless such form was a “sham or unreal,” and explaining that “[i]n such situations the form is a bald and mischievous fiction.”). See *supra* notes 36-37 and accompanying text.

104. *Black & Decker Corp.*, 340 F. Supp. 2d at 623-24 (citing *N. Ind. Pub. Serv. Co. v. Comm’r*, 115 F.3d 506, 512 (7th Cir. 1997); see also *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978); *Moline Props.*, 319 U.S. at 438-39. The court further noted that:

BDHMI: (1) ‘assumed the responsibility for the management, servicing, and administration of plaintiff’s employee and retiree health plans;’ (2) has considered and proposed numerous healthcare cost containment strategies since its inception in 1998, many of which have been implemented by B & D; and (3) has always maintained salaried employees. Moreover, as a result of the BDHMI transaction, BDHMI became responsible for paying the healthcare claims of B & D employees, and such claims are paid with BDHMI assets.

Black & Decker Corp., 340 F. Supp. 2d at 624 (footnotes omitted).

105. *Id.*

106. *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006). See generally Richard M. Lipton, *Will Black & Decker Turn Out to Be a Pyrrhic Victory for the IRS?*, 104 J. TAX’N 200 (2006); *Tax Shelters and Textualism*, *supra* note 23, at 204-06 (examining the Fourth Circuit’s textualist approach in this case).

107. *Black & Decker Corp.*, 436 F.3d at 443.

offered ample evidence to permit a reasonable trier of fact to find the transaction lacked any reasonable expectation of profit.¹⁰⁸

Applying the disjunctive two-prong test it set forth in *Rice's Toyota World, Inc. v. Commissioner*,¹⁰⁹ the Fourth Circuit observed that the district court erred in its objective analysis because it focused on the general business activities of BDHMI under *Moline Properties* rather than the taxpayer's reasonable expectation of profit from the transaction.¹¹⁰ The court emphasized that the test for the objective prong of the economic substance in the Fourth Circuit, as set forth in *Rice's Toyota*, is an objective analysis of any reasonable expectation of profit.¹¹¹

The court stated that *Hines v. United States* illustrated the application of the two-prong test in that circuit.¹¹² The Fourth Circuit, in *Hines*, implied that the subjective prong is tested on an objective basis, creating some overlap between the prongs: "the ultimate determination of whether an activity is engaged in for profit is to be made . . . by reference to objective standards, taking into account all of the facts and circumstances of each case. A taxpayer's mere statement of intent is given less weight than objective facts."¹¹³

The Fourth Circuit in *Black & Decker Corp.* repeated the assertion it made in *Hines* that "a taxpayer's 'mere assertion' of subjective 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.'"¹¹⁴ The court implied in *Hines* that a mere subjective belief that a transaction can generate nontax profit may not suffice.¹¹⁵ The *district court's* decision in *Black & Decker Corp.*, in which Black & Decker admitted from the beginning it had no business purpose in the

108. *Id.* at 442.

109. *Id.* at 441 (citing *Rice's Toyota World Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985)).

110. *See id.* ("[T]he district court mischaracterized the *Rice's Toyota* test, which focuses not on the general business activities of a corporation, but on the specific transaction whose tax consequences are in dispute.")

111. *Id.* (quoting *Rice's Toyota*, 752 F.2d at 94 ("The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits.") (emphasis omitted)).

112. *Id.* (citing *Hines v. United States*, 912 F.2d 736, 739 (4th Cir. 1990)). "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." *Hines*, 912 F.2d at 740.

113. *Hines*, 912 F.2d at 740 (quoting *Faulconer v. Comm'r*, 748 F.2d 890, 894 (4th Cir. 1984)).

114. *Black & Decker Corp.*, 436 F.3d at 443 (quoting *Hines*, 912 F.2d at 740).

115. *Hines*, 912 F.2d at 740.

transaction, is therefore inconsistent with this statement from *Hines*; however, the district court held for the taxpayer on the grounds that the Fourth Circuit's standard was disjunctive and that the transaction at issue had objective economic substance regardless of Black & Decker's subjective belief.¹¹⁶ In other words, consistent with *Hines*, the Fourth Circuit might have suggested a more unitary or flexible test when it decided *Black & Decker* on appeal.¹¹⁷

In conclusion, *Black & Decker* adds to the confusion pertaining to what is the appropriate two-prong standard—disjunctive, conjunctive, or unitary.¹¹⁸ Further, it appears that even within the Fourth Circuit, there is no uniformity with respect to the appropriate standard. The confusion grew even deeper after the Federal Circuit's decision in *Coltec Industries, Inc. v. United States*, as discussed next.

IV. COLTEC INDUSTRIES, INC. V. UNITED STATES¹¹⁹

A. Facts

Similar to *Black & Decker*, this case also involved the contribution of assets (stock, cash, rights from future litigation, and notes) and contingent liabilities to a company and a subsequent sale of the company's stock for a significant loss.¹²⁰ In this case, the contributed contingent liabilities consisted of asbestos litigation cases.¹²¹ Garrison Litigation Management Group, Ltd. ("Garrison"), a "case management subsidiary," was established to handle these asbestos cases.¹²² In return for the

116. *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621, 623 (D. Md. 2004).

117. See *Tax Shelters and Textualism*, *supra* note 23, at 317 ("[T]he Fourth Circuit's admonition concerning the objective character of the business purpose prong may suggest a blending of the subjective and objective standards, along the lines of the unitary test recently adopted by the Third Circuit.").

118. *Id.*; see generally *Time for Reconciliation?*, *supra* note 2, at 393-94 (describing the varying interpretations of the two-prong standard in all circuits: "Some circuits have required that a transaction satisfy both the economic substance and business purpose standards (i.e., a conjunctive test) to validate a transaction. Other circuits have determined that the existence of either economic substance or business purpose (i.e., a disjunctive test) validates a transaction. . . . Finally, some courts have applied a more flexible test, or 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.").

119. 62 Fed. Cl. 716 (2004).

120. See *id.* at 720-29.

121. *Id.* at 723. The court explained that "[b]y the early 1990's, Anchor and Garlock were or had been defendants in approximately 100,000 asbestos cases." *Id.* at 721.

122. *Id.* at 726.

contributed assets and liabilities, Coltec received ninety-three percent of Garrison's stock, and later sold it for a significant loss.¹²³

B. *Court of Federal Claims*

1. Overview

In a clear indication of what its ultimate decision would be, the court began its opinion with the following statement:

Many years ago, the United States Supreme Court in *Atlantic Coast Line v. Phillips . . .*,¹²⁴ 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.'¹²⁵

As opposed to *Black & Decker*, the *Coltec* court comprehensively analyzed the relevant statutory rules before moving to common law principles.¹²⁶ The court began with a long discussion on whether the taxpayer had satisfied the relevant statutory requirements,¹²⁷ then examined the transaction in three main steps.¹²⁸ First, the court held that the contribution of the stock and the promissory notes to Garrison satisfied § 351 because (i) the shareholders transferred qualifying "property" (i.e., the stock and notes) to the corporation;¹²⁹ (ii) the shareholders received only stock from the corporation;¹³⁰ and (iii) directly following the transfer, the shareholders "owned and

123. *Id.* at 737.

124. *Atl. Coast Line R.R. Co. v. Phillips*, 332 U.S. 168 (1947).

125. *Coltec Indus.*, 62 Fed. Cl. at 718 (quoting *Atl. Coast Line*, 332 U.S. at 172-73) (alteration in original).

126. *See id.* at 736-53.

127. *See id.*

128. *See id.*

129. *Id.* at 736-37.

130. *Id.* at 737 ("Coltec received 93% of the equity of Garrison and Garlock received 7% of the equity of Garrison.").

controlled 100% of the total combined voting power of all classes of [the] stock entitled to vote.”¹³¹

Second, the court examined whether the transaction satisfied § 357(b)(1)’s tax avoidance and business purpose tests.¹³² The court first concluded that tax avoidance was not the principal purpose of the transaction.¹³³ As to the business purpose test, the court reviewed several cases discussing § 357(b)¹³⁴ and set forth the following prevailing principles:

First, 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.’” Second, the closer the nature of the liabilities to the customary business of the transferee and its continued viability, the more likely that [§] 357(b)’s principle “business purpose” test will be satisfied. Third, 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. Fourth, 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.”¹³⁵

The court concluded that the taxpayer satisfied these tests and accordingly, had a bona fide business purpose under § 351(b)(1)(B).¹³⁶

In the third step of the statutory analysis, the court concluded that the sale of stock should be respected as a bona fide sale.¹³⁷

131. *Id.*

132. *See id.* at 738.

133. *Id.* at 740-41 (“For all of these reasons, the court has determined that the record establishes by a clear preponderance of the evidence that the principal purpose of Coltec entering into the Garrison transaction was not solely to avoid federal income tax, in light of the highly uncertain legal environment in which Coltec was attempting to conduct business.”).

134. *See id.* at 741-42 (citing *Drybrough v. Comm’r*, 376 F.2d 350, 358 (6th Cir. 1967); *see also Estate of Kanter v. Comm’r*, 337 F.3d 833, 863-66 (7th Cir. 2003); *Easson v. Comm’r*, 294 F.2d 653, 660-61 (9th Cir. 1961); *Treas. Reg. § 1.368-2(g)* (2006) (requiring that reorganization transactions “must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization” in order to qualify as a reorganization)).

135. *Coltec Indus.*, 62 Fed. Cl. at 743 (citations omitted) (alterations in original).

136. *Id.* at 743.

137. *See id.* at 746-52.

2. Economic Substance Analysis

The economic substance discussion in this case was significantly shorter than the discussion on the statutory provisions.¹³⁸ The court began by reviewing the traditional economic substance landmark cases such as *Gregory* and *ACM Partnership* and restated 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”¹³⁹ Thus, in one sentence, the court collapsed all four common law doctrines into one single standard.¹⁴⁰ According to the government, “economic substance, and not *mere* formal compliance with the Code, must inform the interpretation and application of the tax law.”¹⁴¹ However, the *Coltec* court, emphasized that “[a] careful reading of other cases . . . 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.”¹⁴² Thus, as set forth in greater detail below, the court held that it would apply common law doctrines only where the statute is unclear and open to several interpretations.

Furthermore, the Court of Federal Claims reviewed the three Federal Circuit cases cited by the government¹⁴³ to conclude that none endorsed the use of the economic substance doctrine.¹⁴⁴ The court stated that even if it was required to apply

138. See *id.* at 752-56.

139. *Id.* at 752.

140. See *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 n.6 (Ct. Cl. 1969) (“In coping with this and related problems, courts have enunciated a variety of doctrines, such as step transaction, business purpose, and substance over form. Although the various doctrines overlap and it is not always clear in a particular case which one is most appropriate, their common premise is that the substantive realities of a transaction determine its tax consequences.”); S. REP. NO. 108-192, at 83 (2003) (“The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS.”); STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 14 n.39 (Comm. Print 2005) (stating that the economic substance, sham transaction, and business purpose doctrines are “closely related” or even “interchangeable”).

141. 62 Fed. Cl. at 753 (quoting Gov’t Supplemental Letter at 1 (Oct. 4, 2004)).

142. *Id.*

143. *Id.* at 753-54 (examining *Holiday Vill. Shopping Ctr. v. United States*, 773 F.2d 276 (Fed. Cir. 1985); *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463 (Fed. Cir. 1997); and *Terry Haggerty Tire Co. v. United States*, 899 F.2d 1199 (Fed. Cir. 1990)).

144. *Id.* at 753-54 (“In light of the fact that the federal appellate court undertook no analysis of the ‘economic realities’ attributed to [*Gregory v. Helvering*, 293 U.S. 465 (1935)] 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.”) “[W]here the language of the Code is clear, the ‘substance rather than form’ doctrine is irrelevant.” *Id.* at 754; see also *Rubin v. Comm’r*, 429 F.2d 650, 653 (2d Cir.

the economic substance test, the taxpayer satisfied both the statutory business purposes test of § 357(b) (as discussed above) and the judicial economic substance doctrine.¹⁴⁵

In support of its conclusion under the latter doctrine, the court reiterated 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, it also provided the B.F. Goodrich Corporation with a sufficient comfort level to purchase all of the Coltec Group in 1999.”¹⁴⁶

The court concluded with a discussion on the role of the economic substance doctrine in interpreting and applying statutory rules.¹⁴⁷ It quoted Professor Joseph Bankman of Stanford Law School with agreement: “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.”¹⁴⁸ Thus, concluded

1970) (“Resort to ‘common law’ doctrines of taxation . . . have no place where . . . there is a statutory provision adequate to deal with the problem presented.”).

145. *Coltec Indus.*, 62 Fed. Cl. at 754. “[W]here . . . there is a genuine multi-party transaction with economic substance which is compelled . . . by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.” *Id.* (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978)). The court further discussed additional cases supporting the proposition that transactions having business or economic purposes beyond the creation of tax benefits meet the requirements of the economic substance doctrine, including:

United Parcel Serv. of America, Inc. v. Comm’r, 254 F.3d 1014, 1018 (11th Cir. 2001) (“This economic-substance doctrine . . . provides that a transaction ceases to merit tax respect when it has no ‘economic effects other than the creation of tax benefits [i.e., tax avoidance].”); *N. Ind. Pub. Serv. Co. v. Comm’r*, 115 F.3d 506, 512 (7th Cir. 1997) (“[The economic substance doctrine] engender[s] the principle that a corporation *and the form of its transactions* are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in *bona fide* economically-based business transactions.”); *Rice’s Toyota World, Inc. v. Comm’r*, 752 F.2d 89, 91 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by *no business purposes* other than obtaining tax benefits in entering the transaction[.]”); *Black & Decker Corp. v. United States*, [340 F. Supp. 2d 621, 623-24 (D. Md. 2004)] (holding that a “court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes.”).

Id. at 754-55 (last alteration added).

146. *Id.* at 755 (citing *Gilman v. Comm’r*, 933 F.2d 143, 147-48 (2d Cir. 1991) (“[A] court could either inquire whether there were any non-tax economic effects or use the analysis under [§] 183. Whether the terminology used was that of ‘economic substance, sham, or [§] 183 profit motivation’ was not critical; what was important was reliance on objective factors in making the analysis.”).

147. *See id.* at 755-56.

148. *Id.* at 756 (quoting Joseph Bankman, *The Economic Substance Doctrine*, 74 S.

the court, “[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.”¹⁴⁹

In the author’s view, one of the most interesting aspects of the court’s economic substance discussion was its statement that because the taxpayer satisfied the statutory business purpose test under § 357(b), the taxpayer satisfied the judicial economic substance doctrine *ipso facto*.¹⁵⁰ As one commentator noted the court “did not apply an economic substance test despite its lengthy rendition of cases establishing the doctrine.”¹⁵¹ Instead, the court applied a one-prong subjective business purpose test under § 357(b) and concluded that the taxpayer had satisfied it.¹⁵² By virtue of satisfying the subjective test, the court decided the taxpayer also satisfied the judiciary economic substance test.¹⁵³ This conclusion is inconsistent with the well-established principle that the economic substance test encompasses two-prongs.¹⁵⁴

As the same commentator indicated before the vacation of *Coltec Industries* and remand of *Black & Decker Corp.*, the taxpayers won in these cases for the following reasons:

Both Black & Decker and Coltec found sufficient facts to support economic substance. The common facts included the following: (1) both companies had contingent liabilities large enough to threaten the overall success of their business; (2) both companies desired to isolate their contingent liabilities; (3) both companies had a long history of trying to deal with and isolate these liabilities; (4) both companies established subsidiaries or divisions to handle the liabilities; (5) both of the established divisions had employees and administered the liabilities; and (6) both

CAL. L. REV. 5, 29-30 (2000)).

149. *Id.* (“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.”).

150. *Id.* at 754 (“In any event, the court already has considered and held that Coltec satisfied the tax avoidance and business purpose tests in [§] 357(b), therefore, *ipso facto*, the ‘economic substance’ doctrine is satisfied, since that doctrine requires proof of at least one of these tests.”).

151. *See* McGinty, *supra* note 4, at 50.

152. *See Coltec Indus.*, 62 Fed. Cl. at 754.

153. *Id.*

154. *See supra* note 52 and accompanying text.

companies were successful in salvaging the value of their main assets by the isolation of the contingent liabilities. These actions and results were sufficient in shifting economic realities to legitimize the transactions.¹⁵⁵

Nevertheless, as set forth below, the Federal Circuit in *Coltec Industries, Inc.* was not impressed by these elements and held that there was no substance for the contingent liability transaction.¹⁵⁶ As declared by the same commentator, “[u]ntil Congress or the Supreme Court acts, contingent liability transactions and judicial doctrines seeking to combat tax shelters will remain in limbo.”¹⁵⁷ The author shares the same view.

C. *Federal Circuit*

The Federal Circuit vacated the decision of the Court of Federal Claims.¹⁵⁸ The court first examined whether the transaction satisfied the literal requirements of the Code.¹⁵⁹ Stating that “Garlock’s loss from the sale of its Garrison stock falls within the literal terms of the statute,” the court next considered the government’s economic substance argument and found that the transaction had no substance aside from tax benefits.¹⁶⁰ First acknowledging it disagreed with the lower court’s holding that the economic substance doctrine could be viewed as opposing the separation of power principle, the court held that “[t]he economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code.”¹⁶¹ Thus, the court observed that even though the taxpayer satisfied the literal application of the statute in this case, a review of the transaction must still be conducted under the common law economic substance standard.¹⁶²

In applying the economic substance principle, the court first noted that the test should be conjunctive.¹⁶³ In particular, the

155. McGinty, *supra* note 4, at 56.

156. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1360 (Fed. Cir. 2006).

157. McGinty, *supra* note 4, at 61.

158. *Coltec Indus.*, 454 F.3d at 1360. See generally John F. Prusiecki, *Coltec: A Case of Misdirected Analysis of Economic Substance*, 112 TAX NOTES 524 (2006), available in TAX NOTES TODAY, 2006 LEXIS TNT 152-83.

159. *Coltec Indus.*, 454 F.3d at 1347-51.

160. *Id.* at 1351-60.

161. *Id.* at 1353.

162. *Id.* at 1351.

163. See *id.* at 1355 (“While the [economic substance] doctrine may well . . . apply if the taxpayer’s sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the

court disagreed with the disjunctive test set forth by the Fourth Circuit and implied that the Supreme Court's decision in *Frank Lyon* should be interpreted to mandate a conjunctive test.¹⁶⁴

Furthermore, the court also stated that "the economic substance of a transaction must be viewed objectively rather than subjectively."¹⁶⁵ Thus, in the present case, the court saw "nothing indicating that the transfer of liabilities in exchange for the note effected any real change in the 'flow of economic benefits,' provided any real 'opportunity to make a profit,' or 'appreciably affected' Coltec's beneficial interests aside from creating a tax advantage."¹⁶⁶

The repeal of the lower court decision, in many aspects, did not come as a surprise. As one commentator indicated:

In some ways, the decision in *Coltec* should have been expected. Coltec attempted to create a tax deduction by transferring a liability from one subsidiary to another. Although the law technically supported the taxpayer's position, there was no economic cost to the taxpayer and, moreover, there was no impact on third parties. The only real consequence of the transaction was an inflation of the taxpayer's basis in a small minority of the shares of a subsidiary, which shares could be sold without any significant economic impact (other than realization of a large tax benefit).¹⁶⁷

In the author's view, the lower court's decision looked "too good to be true." Even though the creation of a subsidiary to manage the asbestos liabilities could, in some circumstances, assist Coltec in veil-piercing cases, it could not justify the sale of the high-basis low value stock to generate the large losses.¹⁶⁸

transaction without proof that the taxpayer's sole motive is tax avoidance.") (footnotes omitted).

164. *Id.* at 1355 n.14; see also Richard Lipton, *What Will Be the Impact of the Government's Economic Victory in Coltec?*, 105 J. TAX'N 136, 142 (2006) [hereinafter *What Will Be the Impact*] ("[T]he Federal Circuit parted company with the Fourth Circuit concerning the manner in which the economic substance test is to be applied. The Fourth Circuit reinforced in *Black & Decker* its view that a transaction lacks economic substance only if there is neither an objective nor a subjective business purpose for the transaction. The Federal Circuit adopted a disjunctive test, under which the lack of *either* an objective or a subjective business purpose would be grounds to disregard a transaction.") (emphasis added).

165. *Coltec Indus.*, 454 F.3d at 1356.

166. *Id.* at 1360.

167. See *What Will Be the Impact*, *supra* note 164, at 141-42.

168. See *id.* at 141.

In a first reaction to the court's order to vacate the district court decision, Eileen O'Connor, assistant attorney general for the Justice Department's Tax Division said:

Today's decision by the United States Court of Appeals for the Federal Circuit confirms that illusionary losses purportedly created by the so-called 'contingent liability' tax shelter are not deductible against actual taxable income. The Court's decision is the second from a United States Court of Appeals to address this tax shelter scheme, and represents a significant advance in the Justice Department's ongoing effort to combat abusive tax shelters and restore integrity to the tax laws.¹⁶⁹

In conclusion, the three most important elements of the Federal Circuit's decision pertaining to the economic substance doctrine were: (1) the clear statement that satisfying the literal application of tax law would not result in allowing the tax benefits if the transaction lacked economic substance; (2) the conclusion that the economic substance doctrine is a one-prong objective test;¹⁷⁰ and (3) the rejection of the disjunctive test.

With respect to the first element, the Federal Circuit clearly criticized the lower court and stated that the principle set forth by the Supreme Court in *Gregory v. Helvering* and subsequent cases meant that "the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality."¹⁷¹ In the author's view, the Supreme Court would clearly have to weigh in on this issue because it pertains to the separation of powers between Congress and the judicial system.

With respect to the second element, as discussed above, it is well-established that the economic substance test is a two-prong test.¹⁷² Some courts have collapsed to the two prongs into a single objective test, but this situation is relatively rare.¹⁷³ The better view is that the test is two-pronged and that the subjective prong should be given weight.

Finally, with respect to the last element, the Federal Circuit

169. Eileen O'Connor, Assistant Attorney General, Statement (July 12, 2006), in *TAX NOTES TODAY*, July 12, 2006, available at 2006 LEXIS TNT 134-17.

170. See generally *Time for Reconciliation?*, *supra* note 2, at 403-07 (discussing cases where courts only applied the objective test).

171. *Coltec Indus.*, 454 F.3d at 1352.

172. See *What Will Be the Impact*, *supra* note 164, at 140 n.18.

173. See *Time for Reconciliation?*, *supra* note 2, at 403-07.

clearly decided against previous cases in the Federal Circuit in which the courts have concluded that the disjunctive test should apply,¹⁷⁴ As the author explains in another article, circuits are divided on how to apply the two-prong test,¹⁷⁵ but it is generally known that the Federal Circuit usually applies the disjunctive test.¹⁷⁶ The Federal Circuit's decision just adds to the already existing confusion as to the proper application of the economic substance standard.¹⁷⁷

V. *TIFD III-E INC. V. UNITED STATES* ("CASTLE HARBOUR")¹⁷⁸

A. *Facts*

This case involved a partnership ("Castle Harbor") between three subsidiaries of General Electric Capital Corporation ("GECC"), a subsidiary of General Electric Company ("GE") and two Dutch banks.¹⁷⁹ The Dutch banks contributed over \$117 million to the partnership (which amounted to eighteen percent of the partnership's capital).¹⁸⁰ Pursuant to the partnership agreement:

At the end of eight years, if the Dutch [b]anks' capital accounts had actually earned a rate of return 9.03587%, [their] capital accounts, i.e., ownership interests, would be decreased to near zero, . . . if the Dutch [b]anks' capital accounts were credited with partnership income at a rate

174. See *Drobny v. United States*, 86 F.3d 1174 (Fed. Cir. 1996); *Johnson v. United States*, 32 Fed. Cl. 709, 714 (1995).

175. See *Time for Reconciliation?*, *supra* note 2, at 373; see also CHARLES GRASSLEY, REPORT ON JUMPSTART OUR BUSINESS STRENGTH (JOBS) ACT, S. REP. NO. 108-192, at 84-85 (2003); STAFF OF JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 15-16 (2005).

176. Even the IRS has stated that the Federal Circuit applies the disjunctive test. See Internal Revenue Service, *IRS Issues Settlement Guidelines on Notional Principal Contracts*, TAX NOTES TODAY, Feb. 13, 2006, at n.4, available at 2006 LEXIS TNT 29-11; Internal Revenue Service, *Coordinated Issue Paper Addresses Partnership Straddle Tax Shelters*, TAX NOTES TODAY, May 12, 2005, at n.26, available at 2005 LEXIS TNT 91-27.

177. See *Prusiecki*, *supra* note 158, at 527 ("The Coltec court thus adds to the general confusion as about what the economic substance doctrine is, when and how it should be applied, and whether it has become an all-purpose talisman to be invoked by the court at its discretion in setting tax policy.").

178. 342 F. Supp. 2d 94 (D. Conn. 2004); see generally Karen C. Burke, *Castle Harbour: Economic Substance and the Overall-Tax-Effect Test*, 107 TAX NOTES 1163 (2005), available in TAX NOTES TODAY, 2005 LEXIS TNT 104-39 [hereinafter *Overall-Tax-Effect Test*] (discussing in depth the *Castle Harbour* case and how the economic substance doctrine applies).

179. *TIFD III-E Inc.*, 342 F. Supp. 2d at 96-98.

180. *Id.* at 97-98.

less than 9.03587%, the capital accounts would be negative after eight years; if the accounts were credited at a rate greater than 9.03587%, the capital accounts would be positive.¹⁸¹

Furthermore, ninety-eight percent of the net operating income was allocated to the banks, while only two percent of the income was allocated to the GECC subsidiaries.¹⁸²

B. *District Court*

1. Economic Substance Analysis

The court first defined the sole question in the *Castle Harbour* case: “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.”¹⁸³

The court restated the general principle of the economic substance/sham transaction doctrine pursuant to which “a transaction will be deemed a ‘sham’ and disregarded when calculating taxes if it has no business purpose or economic effect other than the creation of tax benefits.”¹⁸⁴ The taxpayer argued the court was required to apply the disjunctive test,¹⁸⁵ while the government urged the court to apply a unitary standard.¹⁸⁶ The court noted that the decisions in the Second Circuit were

181. *Id.* (“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.”) (citation omitted).

182. *Id.* at 101. “Operating [i]ncome was comprised of income less expenses,” where “[i]ncome 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 . . .” *Id.* at 100.

183. *Id.* at 108.

184. *Id.* at 108. The court also elaborated that “[t]o 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.” *Id.* at 108-09.

185. *Id.* at 109.

186. *See id.*; *see also Time for Reconciliation?*, *supra* note 2, at 393-94 (“[S]ome courts have applied a more flexible test, or 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.”).

inconsistent with respect to which test to apply.¹⁸⁷ The court, however, asserted that it did not have to decide which standard to apply, because “under either reading [the court] 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.”¹⁸⁸

The government argued that because the return earned by the Dutch banks was essentially guaranteed, the transaction did not have economic substance.¹⁸⁹ In other words, the government asserted that the lack of risk, as it pertained to the Dutch banks, should render the whole transaction as lacking economic substance.¹⁹⁰ The court dismissed this argument, concluding that “[i]n return for a significant portion of Castle Harbour’s [o]perating [i]ncome, the Dutch [b]anks contributed approximately \$117 million dollars, which was used by Castle Harbour’s subsidiary CHLI either to purchase aircraft or to retire GECC debt.”¹⁹¹ Although the investment accounts provided the Dutch banks with some guarantee of return, the court held the “lack of risk is not enough to make a transaction economically meaningless.”¹⁹²

2. Business Purpose

The court continued to discuss the business purpose test but acknowledged that when the economic substance of a transaction is being evaluated, “courts are cautioned to give more weight to objective facts than self-serving testimony.”¹⁹³ The court found the transaction had a legitimate business purpose, persuaded by TIFD III-E’s contentions “that GECC’s non-tax purpose in

187. *TIFD III-E Inc.*, 342 F. Supp. 2d at 109.

188. *Id.*

189. *Id.* at 109-10.

190. *Id.* at 110.

191. *Id.* at 109 (footnote omitted).

192. *Id.* at 110. The court elaborated that “[e]ven with an 8.5% guaranteed return, the Dutch [b]anks still participated in the - economically real - upside of the leasing business. . . . Participating in upside potential, even with some guarantee against loss, is economically substantial. . . . [T]he 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.” *Id.* The court concluded that “[t]he economic reality of such a transaction is hard to dispute.” *Id.* at 109; *cf. ASA Investorings P’ship v. Comm’r*, 201 F.3d 505, 514 (D.C. Cir. 2000) (“[I]n the ‘sham transaction’ context, . . . a transaction will be disregarded if it did ‘not appreciably affect [taxpayer’s] beneficial interest except to reduce his tax.’”) (quoting *Knetsch v. United States*, 364 U.S. 361, 366 (1960)).

193. *TIFD III-E Inc.*, 342 F. Supp. 2d at 111 (citing *Lee v. Comm’r*, 155 F.3d 584, 586 (2d Cir. 1998)).

entering into the Castle Harbour transaction was 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.”¹⁹⁴ 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.”¹⁹⁵ Therefore, the court found “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.”¹⁹⁶

3. Economic Substance of the Partnership

The government separately challenged the economic substance of the partnership, arguing that “for tax purposes the Dutch [b]anks were not partners of the GECC entities but rather were their creditors.”¹⁹⁷ The court rejected the government’s argument and held:

[T]he transaction that created Castle Harbour was not a sham. In other words . . . there was valid business purpose and economic reality in the arrangement by which the GECC entities and the Dutch [b]anks came together to form Castle Harbour, i.e., there was economic substance in not only the actions, but also the formation, of the partnership.¹⁹⁸

The district court distinguished this case from *ASA Investering Partnership v. Commissioner*,¹⁹⁹ mainly on the grounds that in *ASA Investering*, the foreign partners were entirely indifferent to the partnership’s activities (because their return was one hundred percent guaranteed).²⁰⁰ By contrast, in *Castle Harbour*, the court observed that the Dutch banks could have suffered some downside (albeit limited) and earned more

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.* at 113 (emphasis omitted) (noting that the decision to form a partnership may be economically insubstantial, even though the partnership undertakes a legitimate business, and finding economic substance in both the actions and the formation of the partnership at issue here).

199. 201 F.3d 505 (D.C. Cir. 2000).

200. See *TIFD III-E Inc.*, 342 F. Supp. 2d at 112-13.

profit than the guaranteed return.²⁰¹ The court further concluded that “[t]he Dutch [b]anks had a very real stake in the transaction because their return was tied directly to the performance of the aircraft leasing business.”²⁰²

C. *Second Circuit*

The Second Circuit reversed the district court’s decision in *Castle Harbour*, primarily on the grounds that the Dutch banks were not bona fide equity participants but rather secured lenders.²⁰³ After conducting a thorough debt/equity analysis, the court concluded that the Dutch banks’ interests in the partnership were, in substance, those of lenders.²⁰⁴ Further, the court elaborated that the district court erred in conducting the debt/equity analysis when it accepted “at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities.”²⁰⁵

The Second Circuit observed:

[T]he Dutch banks’ interest was overwhelmingly in the nature of a secured lender’s interest, which would neither be harmed by poor performance of the partnership nor significantly enhanced by extraordinary profits. The banks had no meaningful stake in the success or failure of Castle Harbour. While their interest was not totally devoid of indicia of an equity participation in a partnership, those indicia were either illusory or insignificant in the overall context of the banks’ investment. The IRS appropriately rejected the equity characterization.²⁰⁶

After examining *Commissioner v. Culbertson*, a Supreme Court case from 1949 involving a partnership between a father and four children, the court concluded that the district court

201. *Id.*

202. *Id.* at 113-14 (distinguishing *ASA Investerings* where the foreign banks “were guaranteed an *exact* amount of return regardless of the business’s performance.”).

203. *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 240 (2d Cir. 2006). The court noted that “the IRS properly refused to accept the partnership’s characterization because the banks did not meaningfully share in the business risks of the partnership venture and their interest was overwhelmingly in the nature of secured debt.” *Id.* at 227.

204. *Id.* at 239-49. For a discussion on debt/equity distinction in the partnership context, see J. William Dantzler Jr., *Debt vs. Equity in the Partnership Context*, 110 TAX NOTES 497 (2006), available in TAX NOTES TODAY, 2006 LEXIS TNT 20-37.

205. *TIFD III-E*, 459 F.3d at 230-31.

206. *Id.* at 231 (emphasis omitted).

erred in relying on the sham transaction doctrine rather than the totality-of-the-circumstances test set forth in *Culbertson*.²⁰⁷

For one commentator, the repeal of the district court decision came as no surprise.²⁰⁸ Two other commentators predicted the outcome of the appeal in an article published after the lower court's decision:

It is of course perfectly obvious that the annual distributions to the Dutch banks were simply a return of the banks' capital investment in the partnership (plus 9.1% interest), although characterized as "income" under the partnership agreement. The banks were creditors in all but name, and the annual distribution of book income was nothing more than a "fast-pay" repayment of debt plus interest. Nevertheless, finding that the partnership had "economic substance" and that the banks took some risk, however modest, the district court held for the taxpayer.²⁰⁹

In the author's view, the district court and the Second Circuit simply followed different paths. The lower court relied on the "traditional" two-prong economic substance test and found that the transaction satisfied both prongs.²¹⁰ Persuaded by the result of this test, the district court continued and held that the partnership itself had substance as well.²¹¹ The Second Circuit gave less weight to the economic substance analysis and decided

207. *Id.* (citing *Comm'r v. Culbertson*, 337 U.S. 733 (1949)). In *Culbertson*, the court examined:

[W]hether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Culbertson, 337 U.S. 733 at 742. See also *Comm'r v. Tower*, 327 U.S. 280, 286-87 (1946) ("A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.") (footnote omitted).

208. See *Overall-Tax-Effect Test*, *supra* note 178, at 1173-74.

209. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1966 (2005).

210. See *TIFD III-E, Inc. v. United States*, 342 F. Supp. 2d 94, 108-11 (D. Conn. 2004).

211. See *id.* at 113.

to examine the latter question more carefully, focusing on the general principles pertaining to the validity of a partnership (*Culbertson*) and on the issue of whether the Dutch banks were real partners.²¹²

VI. *CMA CONSOLIDATED, INC. V. COMMISSIONER*²¹³

A. *Facts*

This case involved “lease strips” in which “the rental income was allocated to a tax-indifferent or tax-neutral party in order to allow another party to claim a greatly disproportionate share of the related tax benefits.”²¹⁴ As structured, the lease strip interest was intended to generate over \$4.2 million of potential tax deductions at an out-of-pocket cost of \$40,000.²¹⁵

B. *Economic Substance Analysis*

The Tax Court described the factual circumstances in this case as a “Byzantine labyrinth of complex transactions,” and further noted that most of the transactions were undertaken solely to achieve a tax effect.²¹⁶ In evaluating whether the transaction lacked economic substance, the court conducted the traditional two-pronged economic substance inquiry.²¹⁷ The court noted, however, that “the two tests have much in common and are not necessarily discrete prongs of a ‘rigid two-step analysis.’”²¹⁸ In other words, the court preferred the “unitary” or flexible analysis.²¹⁹

Similar to cases like *ACM Partnership*²²⁰ and *Rice’s Toyota*

212. See *TIFD III-E*, 459 F.3d at 231-33.

213. 89 T.C.M. (CCH) 701, 731 (2005); see also Richard M. Lipton, *New Tax Shelter Decisions Present Further Problems for the IRS*, 102 J. TAX’N 211, 217 (2005), available at 2005 WL 880191 [hereinafter *New Tax Shelter Decisions*] (“In contrast to *Coltec* and *Black & Decker*, the third recent decision illustrates the problems that a taxpayer will face in a transaction that is viewed by the court as a contrived tax shelter.”) (italics added).

214. *CMA Consol.*, 89 T.C.M. at 703. The specific lease-stripping transaction in this case “involve[d] computer and photo processing equipment subject to two existing end-user leases” and a prior lease stripping arrangement. *Id.*

215. *Id.*

216. *Id.* at 714.

217. *Id.* (citing *ACM P’ship v. Comm’r*, 157 F.3d 231, 247-48 (3d Cir. 1998); *Casebeer v. Comm’r*, 909 F.2d 1360, 1363 (9th Cir. 1990); *Kirchman v. Comm’r*, 862 F.2d 1486, 1490-91 (11th Cir. 1989)).

218. *Id.*

219. See *Time for Reconciliation?*, *supra* note 2, at 393-94 (identifying the unitary standard and describing it as flexible).

220. *ACM P’ship*, 157 F.3d at 247-48.

World,²²¹ the Tax Court in *CMA Consolidated* focused on the profit test in applying both prongs.²²² In response to the government's argument that the taxpayer could not have reasonably expected a pre-tax profit from the transaction, CMA argued "it expected to earn a pretax profit from the equipment rental income or the income produced from disposition of the residual interests."²²³ However, the court found the taxpayer's behavior was "inconsistent with a genuine pretax profit motive for entering into the second lease strip deal."²²⁴ The court further held that the lease strip deals were "mere tax-avoidance devices or subterfuges mimicking a leasing transaction."²²⁵ With regard to the objective prong, the court stated that it must "examine the potential for economic profit" from the disputed transaction.²²⁶ The taxpayer's expert, of course, attempted to prove the taxpayer could have reasonably expected a profit from the transaction,²²⁷ while the government's expert argued there would not have been a realistic profit potential.²²⁸ The court concluded that the IRS's appraisal expert was correct in determining there was no expectation of any residual value even if the drafting error were corrected, and thus there could have been no reasonable expectation of a more than de-minimis pre-tax return.²²⁹

221. *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91-92 (4th Cir. 1985).

222. *CMA Consol.*, 89 T.C.M. at 715-21. Most notably, the court observed that "[d]e minimis or inconsequential pretax profits relative to a taxpayer's artificially and grossly inflated claim of potential tax benefits may be insufficient to imbue an otherwise economically questionable transaction with economic substance." *Id.* at 715 (citing *ACM P'ship*, 157 F.3d at 257; *Sheldon v. Comm'r*, 94 T.C. 738, 767-68 (1990)).

223. *Id.* at 717.

224. *Id.*; see also *New Tax Shelter Decisions*, *supra* note 213, at 218 ("The transaction was seriously flawed even without regard to any tax issues that might be raised. The taxpayer had conceded that its only possibility for realizing an economic profit from the lease position depended on rental income being produced from the residual lease interests with respect to the equipment that was subject to the lease—but the lease term provided for no actual residual interests! (The so-called 'over lease' expired on the same dates as the master leases, so that the taxpayer did not have any period in which it could serve as the lessor of the equipment.)").

225. *CMA Consol.*, 89 T.C.M. at 717 (noting that "[t]he obvious purpose was to obtain unwarranted and substantial tax benefits."). The court observed the taxpayer could only enjoy a return from the lease rentals after expiration of the user leases and prior to the ultimate equipment return; however the documents were drafted incorrectly and contained dates which eliminated this period entirely. *Id.* Thus, even though the taxpayer argued that this should be corrected, the court concluded that the fact that CMA paid no attention to the error and never corrected it was evidence that it had no interest in the underlying leasehold interest. *Id.*

226. *Id.*

227. *Id.* at 718-19.

228. *Id.* at 720-21.

229. *Id.* at 721.

In reaching the conclusion that the transaction “did not have any objectively demonstrable, practical economic profit potential” for CMA, the court added a non-qualitative element to the economic substance analysis and observed that the disputed transaction was consummated through various entities, a number of which either were related to, or were owned and/or controlled by others who regularly cooperated with CMA.²³⁰ Thus, the court considered the fact that the entities involved were related as an important factor in determining that the transaction had no substance.²³¹ As such, it found that the second lease strip lacked objective economic substance.²³² In conclusion, the court held the taxpayer had neither profit motive nor a valid non-tax business purpose for entering into the lease strip deal apart from tax benefits.²³³

In the author’s view, this decision was very much to be expected because the facts were extremely similar to those in *Andantech LLC v. Commissioner*;²³⁴ the Tax Court simply followed its earlier decision and held for the government. Furthermore, as one commentator noted:

[A]s *CMA* indicates, the courts (particularly the Tax Court) will not be receptive to a taxpayer’s technical arguments if a transaction has neither business purpose nor economic substance. This will be particularly true if, as in *CMA*, a taxpayer enters into a tax-motivated transaction in which there is no possibility of profit because of a “glitch” in the paperwork. Put simply, the taxpayer in *CMA* was doomed the moment the IRS discovered that there was no lease for the residual period on

230. *Id.* at 721-22 (noting that “[t]he other participants involved in the first and second lease strip deals, in most instances, were not acting at arm’s length and shared a common interest in inflating the values of the underlying equipment and the values of the leases and residual interests to generate substantial potential tax benefits for the ultimate beneficiaries/customers.”).

231. *See id.*; *see also* *Higgins v. Smith*, 308 U.S. 473, 477 (1940) (“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.”); *Decon Corp. v. Comm’r*, 65 T.C. 829, 839 (1976) (“[The taxpayer] was effectively dealing with himself in transferring the escrow position to Decon, and this lack of arm’s-length dealing gives us cause to scrutinize the transaction in applying the substance versus form test.”).

232. *CMA Consol.*, 89 T.C.M. at 722.

233. *Id.* at 721.

234. 83 T.C.M. (CCH) 1476 (2002); *see also* *CMA Consol.*, 89 T.C.M. at 712 n.13 (referring to *Andantech*).

which the taxpayer based its case.²³⁵

VII. *SANTA MONICA PICTURES, LLC V. COMMISSIONER*²³⁶

A. *Facts*

Similar to *Long Term Capital Holdings*, this case also involved the sale of high-basis, low-value partnership interests, which the Tax Court described as having “tantalizing tax attributes.”²³⁷ The transaction was generally accomplished in three steps: (1) the high-basis assets and cash were contributed to the partnership in exchange for partnership interests; (2) within the same month, the partnership interests were sold to another partner; and (3) shortly thereafter, some of the assets were sold, with the loss being allocated to the partner that had purchased the partnership interest of the original owner of the assets.²³⁸ The facts in this case were even more extreme than those in *Long Term Capital Holdings*, particularly because three weeks after the formation of the partnership in *Santa Monica Pictures*, some partners exited it to facilitate the losses to the other partners.²³⁹

B. *Economic Substance Analysis*

The substantive question discussed by the Tax Court was whether the claimed losses should be disallowed even though the taxpayer literally satisfied the relevant partnership basis and loss provisions.²⁴⁰ Applying the unitary standard,²⁴¹ the Tax Court held that the transactions lacked economic substance.²⁴² The court rejected the taxpayer’s argument that formalistic compliance with statutory provisions necessarily entitles it to the tax benefits provided therein, and held that “[n]otwithstanding its form, the transaction did not, in substance, represent

235. *New Tax Shelter Decisions*, *supra* note 213, at 219.

236. 89 T.C.M. (CCH) 1157 (2005).

237. *Santa Monica Pictures*, 89 T.C.M. at 1162-63; *see Long Term Capital Holdings, LP v. United States*, 150 F. App’x 40 (2d Cir. 2005).

238. *Id.* at 1191. For the technical application of the partnership rules to the transaction, *see id.* at 1188-89.

239. *Compare Long Term Capital Holdings*, 150 F. App’x at 42-43 (stock sale took place one year after the formation of the partnership), *with Santa Monica Pictures*, 89 T.C.M. at 1191 (sale took place after three weeks).

240. *See Santa Monica Pictures*, 89 T.C.M. at 1215-16.

241. *See Time for Reconciliation?*, *supra* note 2, at 393-94 (identifying and discussing the unitary standard).

242. *Santa Monica Pictures*, 89 T.C.M. at 1191.

contributions of property in exchange for partnership interests”²⁴³ It concluded that no parties to the transaction had a business purpose other than tax avoidance.²⁴⁴

Similar to *Long Term Capital Holding*, the Tax Court also applied the end result test of the step transaction doctrine to conclude that the contributions of the receivables and stock to the partnership and the purchase of preferred interests in it were really component parts of a single transaction, intended from the outset to transfer the built-in tax losses in them to the Ackerman group.²⁴⁵

C. Accuracy-Related Penalties

The Tax Court further held the “[§] 6662(h) 40-percent penalty for gross valuation misstatements applies to the underpayments that result from adjustments to the tax bases that [the partnership] reported” on its tax returns for the relevant years.²⁴⁶ The taxpayer argued that, technically, the penalty should only apply when the value of property is misstated, and not for inflation of basis.²⁴⁷ However, the court disagreed, observing that the § 6662(h) gross valuation misstatement penalty applied to inflation of basis and was not limited to cases of overvaluation of property.²⁴⁸ Furthermore, the court refused to allow the taxpayer to rely on the “reasonable cause” exception by virtue of having obtained several opinions from tax counsel.²⁴⁹

243. *Id.* at 1216.

244. *Id.* at 1191 (“We conclude that, in substance, the banks did not become partners of SMP; rather, they transferred their high-basis, low[-]value receivables and SMHC stock, along with whatever associated tax attributes might survive the transfer, to the Ackerman group for \$10 million.”).

245. *Id.* at 1217 (“[T]he step transaction doctrine applies to [the] contributions of the SMHC receivables and stock and [the] purchase of . . . preferred interests in SMP. . . . [W]e find that [the] contributions were made solely for the purpose of transferring built-in tax losses to the Ackerman group. The Ackerman group could not obtain the built-in tax losses through a direct purchase of the SMHC receivables and stock, but could only obtain those losses by interposing a partnership and manipulating the partnership basis rules. From the beginning, both parties planned and understood that CLIS would receive a \$5 million advisory fee and that the banks would exercise their put rights at the earliest possible point . . . , exiting the partnership. The contributions, the payment of the advisory fee, and the exercise of the put rights were mutually interdependent steps taken to dispose of [the] ‘bad’ investments in the SMHC receivables and stock and to transfer the built-in tax losses to the Ackerman group.”). *See also supra* notes 34-35 and accompanying text (discussing the end result test of the step transaction doctrine).

246. *Id.* at 1225.

247. *Id.*

248. *Id.* at 1226.

249. *Id.* at 1236.

Santa Monica Pictures has been distinguished from *Long Term Capital Holdings* by one commentator on the following grounds:

The *Santa Monica Pictures* decision contrasts markedly with the facts in *Long Term Capital*, in which sophisticated business people relied on conclusions provided by their professional advisers (without asking how those conclusions were reached), ignored common sense, and claimed substantial tax benefits. In *Santa Monica Pictures*, the sophisticated tax advisers acted as principals, claimed the tax benefits themselves, and also sold duplicated tax benefits to a corporation [for which] one of the principals served as a director.²⁵⁰

Both cases share one most important element, which was the extreme difference between the value and basis of the sold interests at issue.²⁵¹ Thus, in both cases, the courts did not find it very hard to disallow the losses. Another crucial element in *Santa Monica Pictures* was that the banks entered into the partnership only to exit three weeks later, a time period so short it left the court no choice but to decide the banks never intended to be partners in a partnership.²⁵² As to the accuracy-related penalties, both cases illustrate that obtaining tax advice from a law firm is not enough—a taxpayer must review the advice prior to entering into the transaction, and act reasonably on any “red flags” it may raise.²⁵³

Finally, as opposed to *Long Term Capital Holding*, where the taxpayer never appealed on the application of the economic substance doctrine but instead focused on the penalties, Santa

250. Leeds, *supra* note 17, at 1674.

251. See Darryll K. Jones, *The Venerable Firms Behind Santa Monica Pictures*, 109 TAX NOTES 257, 258 (2005), available in TAX NOTES TODAY, 2005 LEXIS TNT 196-27.

252. *Santa Monica Pictures*, 89 T.C.M. at 1191 (“On the basis of all the evidence in the record, we conclude that the transaction whereby the banks purported to become partners in SMP, only to exit some 3 weeks later, was not in substance what it appeared to be in form. The exclusive purpose of this apparent transaction, we conclude, was to transfer to the Ackerman group enormous tax attributes associated with the banks’ high-basis, low-value receivables and SMHC stock. To that end, the banks purported to join SMP as partners, contributing these receivables and stock.”).

253. *Id.* at 1228. The court also cautioned that a reasonable taxpayer would have concluded that the tax benefits associated with the transaction were “too good to be true.” *But see* N. Jerold Cohen, *Too Good to be True and Too Bad to be True*, 109 TAX NOTES 1437, 1442 (2005), available in TAX NOTES TODAY, 2005 LEXIS TNT 238-26 (“[T]he courts do not seem to have adopted a doctrine of ‘too good to be true’ as the basis of their decisions; rather, they analyze the facts, circumstances, and law in researching their conclusions.”).

Monica has appealed to the Second Circuit, arguing, among other things, that the losses should not have been disallowed under the economic substance doctrine.²⁵⁴

VIII. CONCLUSIONS

IRS Chief Counsel Donald Korb's reaction to the recent victories was as follows:

At [the] time [*Coltec* and *Black & Decker* were decided for taxpayers in district courts,] a number of [practitioners] were jumping up and down, saying the IRS had lost the war on tax shelters. As we all know, it did not work out that way, based on what happened with *Coltec* in the Federal Circuit and *Black & Decker* in the Fourth Circuit²⁵⁵

The unmistakable signal sent by the various courts involved is that courts are expected to be tougher on taxpayers in economic substance cases. Furthermore, within a period of seven months, four different circuit courts have held for the government, reversing previous lower court decisions.²⁵⁶ This series of reversals is unprecedented—in only a few cases since *Gregory v. Helvering* have the lower courts ruled in the taxpayer's favor, with the courts of appeals going in the other direction.²⁵⁷

Moreover, this series of reversals came only several years after the opposite situation occurred; between 1999 and 2001, three cases were decided for the government, but on appeal, the circuit courts reversed and held for the taxpayer. In *United Parcel Service of America, Inc. v. Commissioner*, the Eleventh Circuit reversed and remanded the Tax Court's decision which had been in favor of the IRS.²⁵⁸ Although the Eleventh Circuit observed that the transaction was "more sophisticated and complex than the usual tax-influenced form-of-business," it found

254. See *LLC Argues Transactions Had Economic Substance*, TAX NOTES TODAY, April 12, 2006, available at 2006 TNT 70-33 (including Santa Monica's appellate brief).

255. See *Recent Son-Of-Boss Loss Not Holding IRS Back, According to Korb*, TAX NOTES TODAY, Aug. 3, 2006, available at 2006 LEXIS TNT 150-3.

256. See *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006), *rev'g* 342 F. Supp. 2d 94 (D. Conn. 2004); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed Cir. 2006), *vacating* 62 Fed. Cl. 716 (2004); *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006), *rev'g* 340 F. Supp. 2d 621 (D. Md. 2004); *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), *rev'g* 250 F. Supp. 2d 748 (E.D. Mich. 2003).

257. See, e.g., *Boca Investering's P'ship v. United States*, 167 F. Supp. 2d 298 (D. D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003).

258. *United Parcel Serv. of Am. v. Comm'r*, 254 F.3d 1014, 1020 (11th Cir. 2001), *rev'g* 78 T.C.M. (CCH) 262 (1999).

that the transaction had “economic substance.”²⁵⁹ During the same period, the Tax Court in *Compaq Computer Corp. v. Commissioner*²⁶⁰ and the district court in *IES Industries, Inc. v. United States*²⁶¹ disallowed the losses and tax credits claimed in connection with the purchase and immediate sale of American Depository Receipts (“ADRs”) on the grounds that the disputed ADR transactions lacked both economic substance and business purpose.²⁶² In 2001, the Eighth and Fifth Circuits reversed *IES Industries* and *Compaq Computers*, respectively.²⁶³ Both reversed upon finding that the ADR transactions had both economic substance and business purpose.²⁶⁴

Thus, it appears that the confusion among district courts, tax courts, and courts of appeal with respect to the role of the economic substance doctrine and its practical application has worsened in recent years.²⁶⁵ Furthermore, it appears that the circuit courts have become more critical than ever of lower courts’ application of the economic substance test and the results of such application. In particular, the Federal Circuit in *Coltec* criticized the district court not only on its “separation-of-powers” statement but also on the substantive application of the economic substance doctrine (the disjunctive vs. conjunctive test).²⁶⁶ In addition, in *Black & Decker*, the Fourth Circuit criticized the district court’s application of the objective prong of the economic substance test, and held that the test should be an objective profit potential test.²⁶⁷

259. *Id.*

260. 277 F.3d 778, 783-84 (5th Cir. 2001) (stating that “[a] taxpayer’s subjective intent to avoid taxes . . . will not by itself determine whether there was a business purpose to a transaction” and that steps to avoid risk may show “good business judgment consistent with a subjective intent to treat [a] trade as [a] money-making transaction[.]”) (citations omitted), *rev’g* 113 T.C. 214 (1999).

261. 253 F.3d 350 (8th Cir. 2001), *rev’g* *IES Indus., Inc. v. United States*, No. C97-206, 1999 U.S. Dist. LEXIS 22610, (N.D. Iowa 1999).

262. *See Compaq*, 113 T.C. at 219-20 (holding that Compaq’s “ADR transaction was deliberately predetermined and designed . . . to eliminate all economic risks” and that Compaq “had no business purpose for [its] purchase . . .”); *IES Indus.*, 1999 U.S. Dist. LEXIS 22610, at *4-7 (holding that “the transaction did not change IES’s economic position” and the “related interest, commission and foreign tax payments were simply substantive fees paid to buy the tax credits, and not separable economically substantive items . . . distinct from the sham aspects of the ADR transactions . . .”).

263. *See Compaq*, 277 F.3d at 778; *IES Indus.*, 253 F.3d at 350.

264. *See Compaq*, 277 F.3d at 781-82; *IES Indus.*, 253 F.3d at 356. Today, I.R.C. § 901(k) denies tax credit for dividends if a taxpayer holds the shares for less than fifteen days, but this provision was not applicable to the *Compaq* case. *See* I.R.C. § 901(k) (West 2006).

265. *See Time for Reconciliation?*, *supra* note 2, at 453.

266. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1352-55 (Fed. Cir. 2006).

267. *Black & Decker Corp. v. United States*, 436 F.3d 431, 441-43 (4th Cir. 2006).

Proposals to codify the economic substance doctrine keep coming.²⁶⁸ Nevertheless, due to intensive criticism across the border, the likelihood of codifying (or “clarifying”) the doctrine in the near future is not high.²⁶⁹ Thus, the absence of a statutory standard and in light of all the recent developments discussed herein, it is time for a Supreme Court decision that would shed some light both on the role of the economic substance doctrine in cases where the statutory requirements are fully met and on how the economic substance doctrine should work (i.e., the two-prong test).²⁷⁰ In particular, the *Coltec* decision illustrates that the Supreme Court should, once and for all, determine the role of common law doctrines in cases where the taxpayer satisfies the black-letter law.²⁷¹

At the time of publication, the taxpayers in *Coltec Industries, Inc. v. United States* and *Dow Chemical Co. v. United States* had recently filed petitions for writs of certiorari with the Supreme Court.²⁷² Given the circuit tension discussed above with regard

268. See *Tax Shelters and Textualism*, *supra* note 23, at 325 (“*Black & Decker* represents a significant victory for the government on the economic substance issue. While heralded as justifying the Bush administration’s opposition to codifying the economic substance doctrine, the Fourth Circuit’s decision might also (and perhaps more appropriately) be viewed as strengthening the argument for codification.”). The most recent proposal is the Nonitemizer Real Property Tax Deduction Act of 2006, introduced by then Senate Finance Committee ranking minority member Max Baucus, D-Mont. S. 3738, 109th Cong. § 3 (2006).

269. See generally Monte A. Jackel, *For Better or for Worse: Codification of Economic Substance*, 103 TAX NOTES 1069 (2004), available in TAX NOTES TODAY, 2004 LEXIS TNT 96-33; see also *Economic Substance Doctrine*, *supra* note 2, at 8.

270. See Martin J. McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES 1017, 1025 (2002), available in TAX NOTES TODAY, 2002 LEXIS TNT 38-32.

271. For a similar view, see Letter from Edward L. Froelich & John W. Westmoreland, Attorneys, to Editor, Tax Notes (Feb. 7, 2005), in 106 TAX NOTES 723, 723 (2005), available in TAX NOTES TODAY, 2005 LEXIS TNT 25-44 (“Because the formulation of the economic substance doctrine varies significantly from circuit to circuit, with apparently no published Federal Circuit opinion (see *Coltec*), the doctrine itself may appear detrimental to the rule of law. However, as a creation of the federal common law, the differing interpretations of the doctrine should be resolved by the Supreme Court.”) (*italics added*).

272. See *Coltec Petitions Supreme Court for Review of Refund Case*, TAX NOTES TODAY, Nov. 16, 2006, available at 2006 TNT 221-16 [hereinafter *Coltec Petitions Supreme Court*]; *Dow Chemical Seeks Supreme Court Review of Denied COLI Interest Deductions*, TAX NOTES TODAY, Oct. 12, 2006, available at 2006 TNT 197-15 [hereinafter *Dow Chemical Seeks Review*]. In *Coltec*, one of the questions presented to the Court for review is:

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

to the economic substance doctrine, the author hopes the Supreme Court will grant writ of certiorari in one or both of these cases and make a decision based on substantive grounds to provide more clarity in this matter.

economic benefits for the taxpayer?

Coltec Petitions Supreme Court, supra this note.

The question presented in the petition for writ of certiorari in *Dow Chemical* similarly sought clarification with respect to the economic substance doctrine and asked:

Whether the Sixth Circuit erred by creating, in direct conflict with decisions of this Court and other circuits, an exclusionary rule for economic substance cases that bars consideration of future taxpayer investment merely because the taxpayer has engaged in a long-term transaction in which a substantial portion of its out-of-pocket expenditure is deferred.

Dow Chemical Seeks Review, supra this note.