THE MANY FACES OF THE ECONOMIC SUBSTANCE'S TWO-PRONG TEST: TIME FOR RECONCILIATION?

YORAM KEINAN*

Since *Gregory v. Helvering*,[1] courts have been applying various anti-abuse common law doctrines to deny the tax benefits of tax motivated transactions.[2] One such doctrine—the economic substance doctrine—has played an important role in recent court decisions and government' proposals to fight cor-

* The author is an Adjunct Professor in Tax at Georgetown University Law Center and at American University's Washington College of Law, and a Manager with Ernst & Young's Financial Services Industry Group and the Capital Markets Tax Practice of the National Tax Department in Washington, D.C. As a manager at Ernst & Young, he specializes in United States taxation of financial products and institutions. He received his M.P.A. and ITP (International Taxation) from Harvard, LL.M. (Taxation), and S.J.D. from the University of Michigan.

1. 293 U.S. 465, 470 (1935).

2. *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (looking at economic substance or reality of sale and leaseback transactions); Knetsch v. United States, 364 U.S. 361, 366 (1960) (interest expense deductions disallowed because only thing of substance to be realized from transaction was tax deduction); Comm'r v. Court Holding Co., 324 U.S. 331 (1945) (recognizing step transaction doctrine, whereby courts must consider all steps of transaction in light of entire transaction, so that substance of transaction will control over form of each step); ACM P'ship v. Comm'r, 157 F.3d 231, 233-43 (3d Cir. 1998) (finding that a sophisticated investment partnership was formed solely to generate a capital loss to shelter some of Colgate-Palmolive's capital gains); Kirchman v. Comm'r, 862 F.2d 1486, 1488-89 (11th Cir. 1989) (finding that option straddles were entered into to produce deductions with little risk of real loss); Karr v. Comm'r, 924 F.2d 1018, 1021 (11th Cir. 1991) (finding energy enterprise to be developed solely to produce deductible losses for investors); Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 95 (4th Cir. 1985) (finding sale-leaseback of a computer by a car dealership to be entered into solely to generate depreciation deductions). *See generally* Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000) [*hereinafter* "Bankman"]; Boris I. Bittker, *Pervasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 HOWARD L. J. 693, 707 (1978) [*hereinafter* "Bittker"]; Office of Tax Policy, Dep't of Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* (1999), *available at* http://www.treas.gov/press/releases/docs/grnbk99.pdf.

porate tax shelters.[3] When a transaction is challenged by the Internal Revenue Service (the "IRS"), a court may apply this doctrine to determine whether to allow the tax benefits associated with the transaction.

Nevertheless, as numerous courts have indicated, taxpayers are generally free to structure their affairs so as to minimize their tax liability; therefore, a transaction does not lack economic substance merely because it is tax-motivated.[4]

In general, the economic substance doctrine is based on an objective and subjective determination of whether a transaction has real, non-tax economic benefit.[5] Since *Frank Lyon*

---

3. Bankman, *supra* note 2, at 6 n.2.

4. *See, e.g.*, United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1019 ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations."); Salina P'ship LP, FPL Group, Inc. v. Comm'r, 80 T.C. M. (CCH) 686 (2000) ("It is well settled that taxpayers generally are free to structure their business transactions as they please, even if motivated by tax avoidance considerations."); Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury"); Rosenfeld v. Comm'r, 706 F.2d 1277, 1281 (2d Cir. 1983) ("a transaction which is otherwise legitimate, is not unlawful merely because an individual seeks to minimize the tax consequences of his activities."); Owens v. Comm'r, 568 F.2d 1233, 1237 (6th Cir. 1977) ("We begin with the principle that a taxpayer, working within the law, may legitimately seek to avoid taxes."); N. Ind. Pub. Serv. Co. v. Comm'r, 115 F.3d 506, 511 (7th Cir. 1997) ("A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes."); Yosha v. Comm'r, 861 F.2d 494, 497 (7th Cir. 1988) ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."); Aiken Indus., Inc. v. Comm'r, 56 T.C. 925, 933 (1971), *acq.*, 1972-2 C.B. 1 ("The fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention."); Bass v. Comm'r, 50 T.C. 595, 600 (1968) ("[A] taxpayer may adopt any form he desires for the conduct of his business, and . . . the chosen form cannot be ignored merely because it results in a tax saving.").

5. David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999) [*hereinafter* "Hariton"]. *See generally* Frank Lyon Co., 435 U.S. 561 (1978) (setting forth the two-prong test); *ACM P'ship*, 157 F.3d at 248 ("In assessing the economic substance of a taxpayer's transactions, the courts have examined 'whether the transaction has any practical economic effects other than the creation of income tax losses' "); 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

Co. v. United States, circuits and courts have been divided with respect to the application of this two-prong test, and several variations have emerged.

The recent year saw the occurrence of several important developments in the application of the economic substance doctrine. In *Long Term Capital Holding v. United States,* the Federal District Court in Connecticut (in the Second Circuit) applied a "unitary" economic substance analysis to a transaction which generated more than $200 million capital losses. The District Court held that the disputed transaction had neither reasonable potential for profit nor business purpose and completely disallowed the loss.[6]

Since the Government's victory in *Long Term Capital Holding,* three District Courts have held for taxpayers in cases involving an economic substance analysis. In *Black & Decker Corp. v. United States,* the Federal District Court in Maryland (in the Fourth Circuit) applied a *disjunctive* analysis; it required the taxpayer to prove *either* subjective business purpose or objective economic substance to be eligible for the claimed losses.[7] Thus, even though the court observed that "tax avoidance was [Black & Decker's] sole motivation" for entering into the transaction, the court found the establishment of a subsidiary to handle contingent employee healthcare claims to have "very real economic implications for every beneficiary of [Black & Decker's] employee benefits program."[8]

---

of tax benefits"); *Rice's Toyota World, Inc.,* 752 F.2d at 94 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.").

6. The court in *Long Term Capital Holdings* also concluded that the capital loss could be disallowed under the step transaction doctrine by applying the end result test. *See generally* 330 F. Supp. 2d 122 (D. Conn. 2004).

7. *See* Jasper L. Cummings & Robert P. Hanson, AMERICAN JOBS CREATION ACT OF 2004 (WG&L ed. 2005) at 4-9 [*hereinafter* "Cummings & Hanson"]. B&D created a subsidiary and transferred to it approximately $561 million along with $560 million in contingent employee healthcare claims in exchange for newly issued stock in the subsidiary. Subsequently, B&D sold its stock in the subsidiary to a third-party for $1 million, and claimed a loss of $560 million. Black & Decker Corp. v. United States, 340 F. Supp. 2d 621, 622-23 (D. Md. 2004).

8. Id. (citing Black & Decker Corp., 340 F. Supp. 2d at 624).

In *TIFD III-E Inc. v. United States*, however, the same court (with a different judge presiding) that decided *Long Term Capital Holding* suggested that there was some ambiguity regarding the proper application of the two-prong standard in the Second Circuit, as a unitary or disjunctive test, even though the judge in *Long Term Capital Holding* clearly rejected the disjunctive test and applied a unitary test.[9] In this case, a subsidiary of General Electric and Dutch banks formed a partnership, where the Dutch banks were guaranteed a fixed return, with almost no risk of loss from the engagement. The District Court held that not only the partnership itself had substance, but the transaction as whole had both economic substance and business purpose, despite the fact that the Dutch Banks were subject to a very limited risk of loss.[10]

In *Coltec Industries Inc. v. United States*, the U.S. Court of Federal Claims held for a taxpayer in a contingent liability transaction, almost similar to the one in *Black & Decker*, on the grounds that the transaction satisfied the statutory language and requirements of the applicable statutory provisions (§ 357[11]) and—only as a backstop—applied the economic substance doctrine to conclude that the transaction had both business purpose and economic substance.[12]

Recently, the government won two cases involving economic substance and accuracy-related penalties matters in the Tax Court. In *CMA Consolidated Inc. v. Commissioner*, the Tax Court held that lease stripping transactions structured using tax-indifferent parties had no economic substance or profit potential aside from the tax benefits, disallowed the claimed deductions, and imposed penalties on the participant for negligence and for a gross undervaluation of certain notes.[13]

---

9. *Id. See also* TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94, 109 (noting that "[t]he decisions in this circuit are not perfectly explicit on the subject [of economic substance].") Judge Arterton adopted the more flexible conjunctive standard, but acknowledged some potentially contrary, or at least ambiguous, language in Long Term Capital Holding. 330 F. Supp. 2d at 171 n.68.

10. *TIFD III-E*, 342 F. Supp. 2d at 112-21.

11. All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder, unless otherwise indicated.

12. 62 Fed. Cl. 716 (2004).

13. T.C. Memo. 2005-16 (Jan. 31, 2005).

Similarly, in *Santa Monica Pictures, LLC v. Commissioner*, the Tax Court denied capital losses stemming from the 1996 sale of certain assets of the parent company of Metro-Goldwyn-Mayer ("MGM"), holding that a number of the transactions lacked economic substance and business purpose, and imposed accuracy-related penalties.[14] In both cases, the Tax Court applied a flexible two-prong economic substance standard and concluded that the disputed transaction had neither business purpose nor economic substance.

During the last year, codification of the economic substance doctrine was proposed, rejected, and most recently, reproposed by Congress. Codification of the economic substance doctrine had been proposed by the Treasury in 1999 as part of its proposals to curb corporate tax shelters,[15] but was subsequently criticized as being unnecessary and potentially harmful to the overall tax shelter effort by the Bush Treasury.[16] The proposal to codify the economic substance doctrine in the Jobs Act of 2004 was widely (if not uniformly) criticized—at least in the form that it had been adopted by the Senate,[17] before the conferees dropped the proposal during the final negotiations on the conference agreement.[18]

These events emphasize the controversial application of the economic substance doctrine in general, and the two-prong test in particular, and illustrate how divided the courts, the government, and taxpayers are in their interpretation of the doctrine.[19] This article will focus on the two-prong test, present the competing views regarding its application, and suggest a practical solution to reconcile these differences. The

---

14. T.C. Memo. 2005-104 (May 11, 2005).

15. *See* DEP'T OF TREASURY OFFICE OF TAX POLICY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS 124 (2000), *available at* http://www.treas.gov/offices/tax-policy/library/grnbk00.pdf.

16. *See* Cummings & Hanson, *supra* note 7, at 4-4.

17. *Id. See* S. REP. NO. 108-192 (2003); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. (1st Sess. 2003).

18. H. REP. NO. 108-548 (2004); American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. (2d Sess. 2004). The proposed codification, in the same form, was re-introduced in H.R. 3, the Highway Reauthorization and Excise Tax Simplification Act of 2005, § 5521.

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

conclusions advanced are that the two-prong test ought to be collapsed into a single objective test, which would generally consist of the current objective prong.

I.
HISTORY

As early as 1935, in *Gregory v. Helvering*, the United States Supreme Court established the requirement that tax-motivated transactions must have a business purpose to be given effect.[20] In this case, a taxpayer, Evelyn Gregory, was the sole owner of United Mortgage Corporation. The corporation owned securities of Monitor Securities Corporation with a built-in gain. Mrs. Gregory sought to transfer to herself one thousand shares of Monitor Securities Corporation. To convert ordinary income on the securities into capital gains, Mrs. Gregory incorporated Averill Corporation, of which she was the sole shareholder, and caused United Mortgage to transfer the Monitor Security stock to Averill as Averill's sole asset. The old corporation distributed the stock of the new corporation, and a few days later, the new corporation was liquidated by distributing its assets—i.e., the Monitor Security stock—to Gregory. Mrs. Gregory immediately sold the stock for $133,333, declaring a capital gain of $76,000 on which she paid tax at the preferred capital gains rate. However, Mrs. Gregory's tax would have been much higher if United Mortgage had sold the Monitor stock and distributed the proceeds to her. The Commissioner disregarded the reorganization and imposed a tax as if United Mortgage had sold the stock and paid Gregory a dividend.

The Second Circuit, and, subsequently, the Supreme Court, disagreed. In the Supreme Court's own words:

> Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually, occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and sole object and accomplishment of which was the consummation of a

20. 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

> preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death. In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking though conducted according to the terms of (the statutory provision), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[21]

Moline Properties v. United States introduced a different but strongly related doctrine, namely the recognition of the separate existence of a corporation for tax purposes.[22] In this case, the sole shareholder of a corporation attempted to characterize gain from the sale of real property—title to which was held by the corporation—as gain to the shareholder, on the grounds that the existence of the corporation was "a bald and mischievous 'fiction'" for federal income tax purposes.[23] The Supreme Court held that the taxpayer could not disregard the corporate form of his business organization unless such form was a "sham or unreal," because "[i]n such situations the form is a bald and mischievous fiction."[24]

Moline Properties was interpreted to establish a two-prong disjunctive test used in determining whether a separate corporate entity should be recognized: first, a subjective standard

21. *Id.* at 469-70.
22. 319 U.S. 436 (1943).
23. *Id.* at 439.
24. *Id.* at 438-39.

requiring the taxpayer to demonstrate a legitimate, non-tax business purpose that is served by the selection of the corporate form, and second, an objective standard requiring that the entity has engaged in sufficient business activity.[25]

In *Knetsch v. United States*, a taxpayer purchased from an insurance company $4 million in deferred annuity 30-year savings bonds for $4,000 cash, bearing interest of 2.5%, and $4 million in non-recourse annuity loan notes, bearing interest of 3.5%.[26] Because the transaction was, in effect, an insurance contract, the bonds had a cash loan value of $100,000 over face each year. The notes were secured by the annuity policies. The terms of the annuities allowed Knetsch to borrow amounts secured by the value in excess of his indebtedness. On the same day he bought the annuities, Knetsch paid the first year's interest on the notes in the amount of $140,000. A few days later, Knetsch borrowed $99,000 against the loan value to make the interest payments, so that the cash loan value of the contract increased by only $1,000 per year. Knetsch claimed a deduction of $143,465 as interest for that year. Knetsch repeated the same practice in the subsequent years and claimed similar interest deductions. The cash value of the annuities at maturity (when Knetsch would have been ninety years old) would have been $8,388,000 paying $90,171 monthly.[27]

Applying the general objective standard, the United States Supreme Court stated that Knetsch's expenditures "did not appreciably affect his beneficial interest except to reduce his tax." The court observed, "it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[28]

The facts in *Knetsch* were almost similar to the facts in a series of cases referred to as the "Livingstone" cases.[29] The

25. Rogers v. Comm'r, 34 T.C.M. (CCH) 1254, 1256 (1975) ("*Moline* establishes a two-pronged test, the first part of which is business purpose, and the second, business activity. . . . Business purpose or business activity are alternative requirements.").

26. Knetsch v. United States, 364 U.S. 349, 362-63 (1960).

27. *Id.* at 364.

28. *Id.* at 366.

29. Alvin C. Warren Jr. *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES, 985-86 (1981) [*hereinafter* "Warren"]. Eli Livingstone was a Boston broker who invented and sold these transactions.

first "Livingstone" case was *Goodstein v. Commissioner* in which a taxpayer purchased $10,000,000 Treasury notes with funds borrowed at an interest rate in excess of the bonds' yield.[30] The interest on the borrowed funds was prepaid; the taxpayer pledged the notes as collateral for the borrowed funds. After the notes were held for at least six months, the taxpayer instructed the lender to sell the notes, and to use the proceeds to pay off the debt. The taxpayer's tax motivation was to obtain interest deductions for the prepaid interest, and to receive a long-term capital gains treatment with respect to the sale of the notes. The taxpayer also made a profit from the transaction, due to an appreciation in the notes' value.[31]

The Tax Court and the Court of Appeals, however, disregarded the potential profit from the transaction and held that the purchase of the notes and the incurred debt were not genuine. The Court of Appeals concluded that the taxpayer and the lender did not have genuine borrower-lender relationships, and therefore, disallowed the interest deductions.[32]

Goldstein v. Commissioner involved a 70-year-old woman who won the Irish Sweepstakes.[33] Her son, an accountant, formulated a plan to use § 163 to obtain interest deductions to reduce his mother's tax burden on her sweepstakes winnings. Accordingly, the taxpayer borrowed $945,000 at four percent interest, and invested the proceeds in Treasury securities maturing in three or four years, with a face amount of $1,000,000, which paid interest of 1.5 percent.[34] Similar to *Knetsch*, the taxpayer had locked in an economic loss from the inception of the transaction. The loans were secured by the Treasury notes and it was contemplated that the overall transactions would result in economic losses, but that the net result would be tax benefits. Mrs. Goldstein argued that she realistically anticipated a gain "due to anticipated appreciation in the value of the Treasury obligations, and that this gain would more than offset the loss that was bound to result because of the unfavorable interest rate differential."[35]

30. Goodstein v. Comm'r, 267 F.2d 127, 130 (1st Cir. 1959).
31. *Id.* at 129-30.
32. *Id.* at 131.
33. Goldstein v. Comm'r, 364 F.2d 734, 736 (2d Cir. 1966).
34. Goldstein v. Comm'r, 44 T.C. 284, 285-87 (1965).
35. *Goldstein*, 364 F.2d at 739.

The Tax Court held that these transactions were shams.[36] The Second Circuit, however, rejected the Tax Court's characterization of the transactions as "sham" transactions on the grounds that they were made with two different and independent banks, on a recourse basis.[37] The Court of Appeals concluded, therefore, that the transactions did, in fact, take place and therefore could not be ignored as "shams."[38] The Court of Appeals, however, affirmed the Tax Court's decision to disallow the deductions on the grounds that the taxpayer's *purpose* in entering into the transaction was solely to obtain tax benefits.[39] The Second Circuit, therefore, disallowed the interest deduction claimed under § 163, citing a lack of economic substance as well as a lack of a non-tax business purpose as the reason for disallowance.[40]

In *Frank Lyon Co.*, the Supreme Court was faced with a sale-leaseback transaction.[41] A taxpayer borrowed $7.1 million, bought a building from a bank for $7.6 million (the loan plus $500,000 of the taxpayer's own funds), and leased the building back to a bank for rent equal to the taxpayer's payments of principal and interest on the $7.1 million loan. The term of the lease was 25 years, with options to extend it up to 40 more years. The lease agreement also provided the taxpayer with a fixed rate of return on its $500,000 investment. At the end of the lease term, the bank could either acquire the building or extend the lease. The taxpayer claimed depreciation deductions from building and interest deductions on the loan, and reported the payments from the bank as income from rent.[42]

---

36. *Goldstein*, 44 T.C. at 298.

37. *Goldstein*, 364 F.2d at 737-38.

38. *Id.* at 738.

39. *Id.*

40. *Id.* at 740 (holding that § 163(a) "does not permit a deduction for interest paid or accrued in loan arrangements . . . that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences."). According to David Hariton, the economic substance doctrine applied to this case because: (1) [the Taxpayer] entered into the transaction for no reason other than to offset her income from the Irish Sweepstakes; and (2) they did not meaningfully change her economic position [she] did not, for example, borrow to invest in the stock of IBM and prepay the interest on her borrowing. *See* Hariton, *supra* note 5, at 249.

41. *Frank Lyon Co.*, 435 U.S. at 561.

42. *Id.* at 566-68.

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

> Where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation.[43]

In *Rice's Toyota World Inc. v. Commissioner*, another case involving a lease transaction, a taxpayer purchased a seventy percent interest in a used IBM computer for $1,455,227.[44] The taxpayer paid the purchase price to a financing company with a $250,000 recourse note, payable over three years, and two non-recourse notes, totaling $1,205,227, payable over eight years. The taxpayer leased the computer back to the financing company for eight years, with rents calculated so that the pretax cash flows to the taxpayer were $10,000 per year. In fact, the only amounts ever to change hands were the $10,000 annual payments, representing the excess of the taxpayer's income over its debt obligation. The transaction was entered into by the taxpayer to generate accelerated depreciation and interest expense deductions in the early years of the lease.[45]

The Fourth Circuit disallowed the deductions on all aspects of the program except for interest payments on recourse debt financing.[46] In so doing, the Fourth Circuit interpreted the two-prong test that was established by the Supreme Court in *Frank Lyon* as a disjunctive test. Specifically, the Fourth Circuit held that a transaction will be treated as having no economic substance if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."[47]

---

43. *Id.* at 583-84.

44. *Rice's Toyota World, Inc.*, 752 F.2d at 93.

45. *Id.* at 91.

46. *Id.* at 95.

47. *Id.* at 91.

In *Glass v. Commissioner*, the Tax Court consolidated more than 1,000 cases with similar facts totaling in excess of $61 million for the years 1975-1980.[48] The taxpayers bought and sold options for future delivery of metal in one year and subsequently entered into offsetting positions, to create approximately equal amounts of losses and gains in the first year. The futures straddles were designed to transform short term capital gain into long term capital gain in the second year. The overall impact of the transactions was that the losses were ordinary and gains were long term capital gains (under the then prevailing law).[49]

The Tax Court found that the transactions had neither non-tax motivation nor economic substance. Accordingly, the Tax Court held that the deductions taken pursuant to the transactions must be disregarded for federal income tax purposes. The Tax Court elaborated that the transactions were "intentional[ly] skew[ed]. . . to realize year one losses. . . ."[50] Although some potential for a profit existed, the Tax Court observed that the taxpayers *avoided* making a profit by realizing losses in the first year which "were not necessary or helpful in profiting from difference gains in petitioners' commodity straddle transactions."[51] *Glass* was affirmed on appeal in the First, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth and Eleventh Circuits.[52] In virtually all appeals, the courts have held that the transactions had neither economic substance nor business purpose and disallowed the benefits.

A landmark series of four cases involving contingent installment sales ("CINS") transactions was decided in the late 1990s and the early 2000s. In a typical CINS transaction, an American and a foreign entity form a partnership to acquire

48. Glass v. Comm'r, 87 T.C. 1087, 1153 (1986).

49. *Id.* at 1141.

50. *Id.* at 1174.

51. *Id.* at 1175-76.

52. Dewees v. Comm'r, 870 F.2d 21 (1st Cir. 1989); Friedman v. Comm'r, 869 F.2d 785 (4th Cir. 1989); Killingsworth v. Comm'r, 864 F.2d 1214 (5th Cir. 1989); Herrington v. Comm'r, 854 F.2d 755 (5th Cir. 1988); Ratliff v. Comm'r, 865 F.2d 97 (6th Cir. 1989); *Yosha*, 861 F.2d 494 (7th Cir. 1988); Kielmar v. Comm'r, 884 F.2d 959 (7th Cir. 1989); Lee v. Comm'r, 897 F.2d 915 (8th Cir. 1989); Keane v. Comm'r, 865 F.2d 1088 (9th Cir. 1989); Bohrer v. Comm'r, 945 F.2d 344 (10th Cir. 1991); *Kirchman*, 862 F.2d 1486 (11th Cir. 1989).

non-readily-marketable property and sell it in exchange for a large fixed payment plus small contingent payments. The resulting gain for the year of the sale is allocated to the foreign partner, while the later years' corresponding losses are allocated to the U.S. partner. The transaction is specifically designed to accelerate gain for the foreign partner and provide, through the partnership agreement, a distributive share of most of the losses to the domestic partners in later tax years.

The Tax Court in *ACM Partnership v. Commissioner* held that such a CINS transaction lacked economic substance and business purpose.[53] The Court of Appeals defined the objective test as examining "whether the transaction has any practical economic effects other than the creation of income tax losses." Applying this standard, the Third Circuit affirmed the Tax Court's decision.[54]

The D.C. Circuit followed *ACM Partnership* in three subsequent decisions involving similar facts and held for the government.[55] The taxpayer's only (temporary) victory was in *Boca Investerings v. United States* at the District Court, but on appeal, the D.C. Circuit reversed and held for the Government.[56]

Another set of cases involved taxpayers who received substantial tax savings by participating in transactions involving corporate owned life insurance policies ("COLI"). In *Winn Dixie Stores Inc. v. Commissioner*, the Tax Court held, and the Eleventh Circuit affirmed, that a taxpayer had neither economic substance nor business purpose for entering into a transaction, and denied the associated tax benefits.[57] Subsequently, in *Commissioner v. CM Holdings*, the U.S. District Court

53. ACM P'ship v. Comm'r, 73 T.C.M. 2189, 2215 (1997) ("The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.").

54. *ACM P'ship*, 157 F.3d at 248-49.

55. ASA Investerings v. Comm'r, 201 F.3d 505, 514 (D.C. Cir. 2000) (focusing primarily on the substance of the partnership); Saba P'ship v. Comm'r, 273 F.3d 1135, 1140 (D. C. Cir. 2000); Boca Investerings P'ship v. United States, 314 F.3d 625, 631 (D.C. Cir. 2003).

56. Boca Investerings P'ship v. United States, 167 F. Supp. 2d 298, 373 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003).

57. 254 F.3d 1313 (11th Cir. 2001), *aff'g* 113 T.C. 254 (1999).

(Delaware) held that the leveraged COLI program of CM Holding's subsidiary, Camelot Music, was a sham.[58] The third victory for the government was *American Electric Power Co. v. United States,* where the Tax Court not only held that a taxpayer's COLI transaction was a sham, but also that certain aspects of the transaction were shams in fact while the plan as a whole was a sham in substance.[59]

The District Court in *Dow Chemicals v. United States,* however, held that as opposed to the facts in the other three cases, the present transaction did not lack economic substance.[60] Nevertheless, subsequent to the decision in *Dow Chemicals,* the Sixth Circuit affirmed the District Court's decision in *American Electric Power Company,* and held that the COLI transaction involved was a "sham in substance" and held for the United States without ruling "whether any particular aspects. . . were in fact shams."[61] A motion for rehearing in *Dow Chemicals* was denied in August 2003.[62]

Courts have observed, however, that the application of the economic substance and similar doctrines is limited. In *Northern Indiana Public Service Company v. Commissioner* ("NIPSCO"), a taxpayer created a Netherlands Antilles subsidiary for the purpose of obtaining funds. The subsidiary issued notes in the Eurobond market with a call option guaranteed by NIPSCO, and NIPSCO received the proceeds in exchange for a $70 million note.[63] The subsidiary earned income on the spread between the interest it received from NIPSCO and the interest it paid to the holders of the notes. When NIPSCO paid off the note, the subsidiary redeemed the notes for a premium in addition to principal and interest paid to the holders of the notes. Subsequently, the subsidiary was liquidated.[64] The IRS argued that the subsidiary was merely a conduit and should be

58. *In re* CM Holdings, 301 F.3d 96, 99 (3d Cir. 2002).

59. Am. Elec. Power Co. v. United States, 136 F. Supp. 2d 762, 795 (S.D. Ohio 2001), *aff'd* 326 F.3d 737 (6th Cir. 2003).

60. *See* Dow Chemicals Co. v. United States, 250 F. Supp. 2d 748, 828 (E.D. Mich. 2003) (District Court validated a transaction utilizing both the economic substance and sham transaction doctrines).

61. Am. Elec. Power Co. v. United States, 326 F.3d 737, 745 (6th Cir. 2003).

62. *Dow Chem. Co.*, 278 F. Supp. 2d at 846.

63. 115 F.3d at 507-08, *aff'g* 105 T.C. 341 (1995).

64. N. Ind. Pub. Serv. Co. v. Comm'r, 105 T.C. 341, 346 (1995).

disregarded.[65] The Tax Court rejected the IRS's argument on the grounds that the subsidiary had a legitimate business purpose—that is, to borrow money in Europe at a favorable rate and to lend it to NIPSCO.[66]

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

> *Knetsch* and the captive insurance company cases do not dictate the outcome the Commissioner desires. Those cases allow the Commissioner to disregard transactions which are designed to manipulate the Tax Code so as to create artificial tax deductions. They do not allow the Commissioner to disregard economic transactions, such as the transactions in this case, which result in actual, non-tax-related changes in economic position.[67]

In *UPS of America v. Commissioner*, the Eleventh Circuit discussed the essence of the business purpose doctrine.[68] In general, UPS collected excess value charges ("EVCs") for packages with a value of more than $100. In 1983, UPS formed an offshore Bermuda subsidiary (OPL) and distributed the subsidiary's stock to its employee-shareholders. UPS also entered into an agreement with a domestic insurer (NUF) pursuant to which UPS would collect and remit the premiums to NUF. In December 1983, NUF and OPL entered into a reinsurance contract pursuant to which NUF would remit to OPL the EVCs received from UPS less certain commissions and expenses. Prior to the disputed restructuring, UPS reported the EVCs as income and deducted expenses actually paid for damaged packages. Because the EVC income earned by OPL was not subject to U.S. tax until the income was repatriated back into the United States (i.e., as a dividend to its shareholders) the transaction would have resulted in a deferral of tax on the income attributable to the premiums.[69]

The Tax Court found that the formation of OPL lacked economic substance and business purpose; therefore, OPL's participation in the arrangement should be ignored and its in-

65. *Id.* at 348.
66. *Id.* at 358.
67. *N. Ind. Pub. Serv. Co.*, 115 F.3d at 512.
68. *United Parcel Serv. of Am., Inc.*, 254 F.3d at 1019.
69. *Id.* at 1016-17.

come should be taxed to UPS.[70] The Eleventh Circuit, however, reversed and remanded the Tax Court's decision. The Eleventh Circuit applied the two-prong test, and although it observed that the transaction was "more sophisticated and complex than the usual tax-influenced form-of-business," it found that the transaction had economic substance. The Court of Appeals continued to the subjective prong and observed that a transaction has "a 'business purpose' when we are talking about a going concern like UPS, as long as it figures in a bona-fide, profit seeking business."[71] The Eleventh Circuit also acknowledged that choosing one form over another solely for tax purposes may still satisfy the business purposes test.[72]

During the same period, two cases, factually identical to each other, were decided for the taxpayer on appeal. Both *IES Industries, Inc. v. United States* and *Compaq Computer Corp. v. Commissioner* involved the purchase of American Depository Receipts ("ADR") "*cum dividend*"—and their virtually immediate sale "*ex dividend.*"[73]

The Tax Court in *Compaq Computer Corp* and the United States District Court of the Northern District of Iowa in *IES Industries* disallowed the losses and tax credits claimed on the grounds that the disputed ADR transactions lacked both economic substance and business purpose.[74] The Eighth Circuit reversed *IES Industries* in July 2001 and the Fifth Circuit reversed *Compaq Computer Corp.* in December 2001. Both appellate courts reversed on the grounds that the ADR transactions had both economic substance and business purpose.[75] Both circuit courts focused on the profit potential from the transactions, and acknowledged that in calculating the profit potential, the foreign (Dutch) tax should *not* be treated as a cost.

---

70. United Parcel Serv. of Am., Inc. v. Comm'r, T.C.M. (CCH) 262 (1999).

71. *United Parcel Serv. of Am.*, 254 F.3d at 1019.

72. *Id.*

73. IES Indus., Inc. v. United States, 253 F.3d 350, 352 (8th Cir. 2001); Compaq Computer Corp. v. Comm'r, 113 T.C. 214 (1999).

74. Compaq Computer Corp. v. Comm'r, 113 T.C. 214; *IES Indus., Inc.*, 253 F.3d at 351.

75. Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 788 (5th Cir. 2001); *IES Indus., Inc.*, 253 F.3d at 356.

II.
THE ECONOMIC SUBSTANCE DOCTRINE

The Role of the Economic Substance Doctrine

A taxpayer should be entitled to rely on the current law in planning her business decisions. Given that the taxpayer—not the IRS—chooses the form of the transactions, however, there must be limits on the taxpayer's ability to enter into tax-motivated transactions. Otherwise taxes would be easy to evade.[76]

The Commissioner currently has three major means of disallowing tax benefits that arise from a tax-motivated transaction: (i) statutory anti-abuse rules, including rules governing the treatment of partnerships, consolidated returns, debt instruments issued at a discount, contingent debt instruments, interest-rate, equity and commodity swaps, net operating loss limitations, sourcing of losses, etc;[77] (ii) re-characterization of the form of the transaction under the substance-over-form or "step transaction" doctrines;[78] and (iii) the economic substance doctrine.[79]

According to David Hariton, the economic substance doctrine is the most efficient way of the above three, since it "offers a more coherent balance between objective results and subjective limitations than does the re-characterization doctrine and. . . it is a direct and honest application of subjective scrutiny applied under a limited set of circumstances."[80]

Hariton wrote his article in 1999 in response to Judge McKee's dissenting opinion in the *ACM Partnership* appeal. Judge McKee argued that "the majority's conclusion to the contrary is, in its essence, something akin to a 'smell test.'"[81] Mr. Hariton rejects the idea that the economic substance test is a 'smell test,' and sets forth the following observations pertaining to the nature of the economic substance doctrine:

> The economic substance doctrine is not just a smell test, because it only applies to transactions, which lack economic substance. The doctrine permits tax-

76. Hariton, *supra* note 5, at 239.
77. *Id.*
78. Comm'r v. Clark, 489 U.S. 726, 738 (1989).
79. *See supra* notes 20-75 and accompanying text.
80. Hariton, *supra* note 5, at 241.
81. *ACM P'ship*, 157 F.3d at 265.

> payers to retain even the most egregious tax benefits if they arise from transactions with meaningful economic consequences . . .
> Tax benefits will not be disallowed merely because they arise from transactions, which lack economic substance. Rather, if the transactions lack economic substance, then the court may overturn the formalistic results . . .
> Economic substance is not about profit potential. Any transaction with significant net equity will produce a significant profit. A transaction has economic substance if it alters the taxpayer's economic position in a meaningful way . . .
> A more complex, tax-advantaged way of executing a transaction should not lack economic substance if the transaction itself has economic substance.[82]

Professor Bankman observes that "the economic substance doctrine, like the other common law tax doctrines, can. . . be thought of as a method of statutory interpretation."[83] Furthermore, the doctrine also resembles, to some extent, "a substantive canon of interpretation; it has been part of the tax law for so long that it is accepted by jurists who would otherwise hew more closely to a textual reading of the applicable statute."[84]

As discussed in greater detail below, litigation involving the economic substance doctrine frequently involves disputes over the text, intent, and purpose of the relevant statute.[85] Generally, the taxpayer will defend its position by arguing that the disputed transaction is supported by the statute's text, and in addition, by some combination of intent and purpose.[86] According to Professor Bankman, a transaction that is clearly supported by the text, intent, and purpose will withstand judicial scrutiny regardless of whether it otherwise meets the eco-

---

82. Hariton, *supra* note 5, at 235-36 (1999).

83. Bankman, *supra* note 2, at 11.

84. *Id.* at 11.

85. *Id. See, e.g., Coltec Indus. Inc.*, 62 Fed. Cl. 716 (2004).

86. Bankman, *supra* note 2, at 11. *See, e.g.*, Neb. Dept. of Revenue v. Lowenstein, 513 U.S. 123 (1994); *Clark*, 489 U.S. at 737; *Knetsch*, 364 U.S. at 367; Lerman v. Comm'r, 939 F.2d 44, 52 (3d Cir. 1991); *ACM P'ship*, 157 F.3d at 261.

nomic substance test.[87] On the other hand, if the text is inconsistent with intent and/or purpose, the result might be different.[88]

The government's determination, followed by the Tax Court's decision, to disallow the losses in *Santa Monica Pictures,* was based solely on common law grounds.[89] Thus, the government effectively used the economic substance doctrine as the primary weapon instead of the intended purpose of all common law doctrines, which is as a mere backstop to the statutory rules. In my view, this approach is inconsistent with the court's assertion in *Coltec Industries,*[90] 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.

General Application of the Economic Substance Doctrine

Under the general application of the judicial economic substance doctrine, the tax benefits of transactions lacking such attributes may be denied.[91] A transaction that would oth-

87. Bankman, *supra* note 2, at 11-12. Professor Bankman illustrates with the case of a corporate taxpayer investing in housing subject to low-income tax credit. The tax credit was enacted to stimulate investment in low-income housing. A taxpayer who makes the investment solely because of tax reasons is presumably doing just what the lawmakers who enacted the legislation would have wished. Thus, according to Bankman, the IRS cannot argue that the benefits should be denied even though the transaction was designed in a way to achieve a tax benefit; the economic substance doctrine should not be applicable to such investments, which the government wishes to encourage by providing tax incentives. *Id.*

88. *See ACM P'ship,* 73 T.C.M. (CCH) at 2215.

89. T.C. Memo. 2005-104.

90. 62 Fed. Cl. 716 (2004).

91. *Killingsworth,* 864 F.2d at 1216 ("Since *Gregory* was decided, courts have consistently held that although a transaction may, on its face, satisfy applicable Internal Revenue Code criteria, it will nevertheless remain unrecognized for tax purposes if it is lacking in economic substance."); *Karr,* 924 F.2d at 1023 ("expenses incurred in connection with a sham transaction are not deductible."); U.S. Dep't of the Treasury, *The Problem of Corporate Tax Shelters: Discussion Analysis, and Legislative Problems* 56 (1999) ("The third, and final, way the IRS can use non-statutory standards to challenge the tax benefits of a particular tax-advantaged transaction is through the application of the economic substance doctrine. This doctrine allows the IRS to deny tax benefits if the economic substance of a transaction is insignificant relative to

erwise result in beneficial tax treatment to a taxpayer will be disregarded if the transaction lacks economic substance.[92]

In determining whether a certain benefit ought to be disallowed under the economic substance doctrine, "the relevant legal inquiry is 'whether *the transaction* that generated the claimed deductions. . . had economic substance.'"[93] Thus, a taxpayer may not combine a valid transaction with a disputed transaction to assert that the overall position had economic substance.[94]

Under the two-prong test, the economic substance doctrine is based on an objective and subjective determination of whether a transaction has real, non-tax economic benefit.[95] Courts have applied various tests to evaluate whether a transaction lacks such non-tax economic benefits.[96] For example, a

---

the tax benefits obtained."); Horn v. Comm'r, 968 F.2d 1219, 1236 (D.C. Cir. 1992) ("The economic sham doctrine generally works to prevent taxpayers from claiming the tax benefits of transactions, which, although they may be within the language of the Code, are not the type of transaction Congress intended to favor."); *Yosha*, 861 F.2d at 497 ("There is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer [a tax] advantage."); *Ferguson v. Commissioner*, 29 F.3d 98, 101 (2d Cir. 1994) (*per curiam*) ("An activity will not provide the basis for deductions if it lacks economic substance.").

92. United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994) ("The general rule on sham transactions in [the Third] circuit is well-established: 'If a transaction is devoid of economic substance . . . it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot be the basis for a deductible loss.'"). *See also Killingsworth*, 864 F.2d at 1216 ("It is a well settled rule of law that transactions that lack economic substance will not be recognized for tax purposes."); Boynton v. Comm'r, 649 F.2d 1168, 1172 (5th Cir. 1981) ("Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized.")

93. *See Long Term Capital Holding*, 330 F. Supp. 2d at 183 (emphasis added) (quoting *Nicole Rose Corp. v. Comm'r*, 320 F.3d 282, 284 (2d Cir. 2002).

94. *ACM P'ship*, 157 F.3d at 256 n.48.

95. *Frank Lyon Co.*, 435 U.S. at 583-84; *Rice's Toyota World, Inc.*, 752 F.2d at 91 (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."). *See also ACM P'ship*, 157 F.3d at 248.

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

few courts have compared the disputed transaction with transactions that might normally be expected to occur in bona fide business settings.[97] Other courts have applied a cost-benefit analysis to determine the existence of an economic rationale.[98] A minority of courts have applied the opportunity costs analysis pursuant to which a transaction is deemed to have no business purpose if the taxpayer could have earned the same benefit without the disputed complex structure.[99]

Generally, the taxpayer carries the burden of proof to show that he or she has not been acting to avoid taxes.[100] Courts have found a business purpose in several cases even though the taxpayer may have been primarily or predominantly motivated by tax benefits.[101] Under this approach, a transaction lacks a business purpose only if the taxpayer's *sole*

---

97. Merryman v. Comm'r, 873 F.2d 879, 881 (5th Cir. 1989) ("Courts . . . compare the transaction in question with transactions that might usually be expected to occur in bona fide business settings."); *CM Holdings, Inc.*, 254 B.R. at 600 (to satisfy the sham transaction standard the taxpayer, "must prove the purported transaction actually took place in a manner which did not deviate from relevant commercial norms."); *CM Holdings*, 301 F.3d at 108 (affirming that a transaction may be viewed as a factual sham if it is inconsistent with the industry practice); Andantech L.L.C. v. Comm'r, 83 T.C.M. (CCH) 1476, 1505 (2002) ("In order to maintain this objectivity and ensure the steps have independent significance, it is useful to compare the transactions in question with those usually expected to occur in otherwise bona fide business settings.").

98. *E.g.*, *ACM P'ship*, 157 F.3d at 252-53.

99. *Boca Investerings P'ship*, 314 F.3d at 631, *cited in Long Term Capital Holding*, 330 F. Supp. 2d at 183 ("defies common sense from an economic standpoint" to execute an investment indirectly through a partnership and not directly where indirect method diminishes profits by adding millions in transaction costs). This standard was not accepted in the recent JOBS Act of 2004, as discussed below.

100. *CM Holdings*, 301 F.3d at 102 ("The taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible."); *Merryman*, 873 F.2d at 882 ("the Commissioner's determination that the partnership lacked economic substance was presumptively correct and the taxpayers bore the burden of proving the determination erroneous."); Estate of Baron v. Comm'r, 798 F.2d 65, 72 (2d. Cir. 1986) ("It was Baron's burden to 'represent and demonstrate that [he] expected to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions.'"); Robertson v. Comm'r, T.C. M. (CCH) 540, 552 (1995) ("Petitioners bear the burden of proving that the transactions at issue are not shams. Rule 142(a).").

101. *N. Ind. Pub. Serv. Co.*, 115 F.3d at 511 ("A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his

motivation is tax avoidance.[102] As the Eleventh Circuit indicated in *UPS*, "no-business-purpose cases concern tax-shelter transactions or investments by a business or investor that would not have occurred, *in any form*, but for tax-avoidance reasons."[103]

The Two-Prong Test

1. *Overview*

In *Frank Lyon Co.*, the Supreme Court held that a transaction will be recognized for tax purposes only if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached. . . ."[104]

Frank Lyon has been construed to create the two-prong test for determining whether a transaction is a "sham" to be disregarded for tax purposes entirely: "has the taxpayer shown that it had a business purpose for engaging in the transaction other than tax avoidance? [And] has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?"[105] The business purpose standard focuses on the motives of the taxpayer for entering into the transaction,

---

business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes.").

102. Zmuda v. Comm'r, 731 F.2d 1417, 1421 (9th Cir. 1984) ("Although the taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation."); *Friedman*, 869 F.2d at 792 ("this prong [business purpose] requires a showing that the *only* purpose for entering into the transaction was the tax consequences."); Ockels v. Comm'r, 54 T.C.M. (CCH) 785, 796 (1987) ("Where a transaction is entered into without any purpose other than to obtain tax benefits, the form of the transaction will be disregarded and the tax benefits denied . . . However, the fact that a transaction generates tax benefits for investor does not necessarily mean that the transaction lacks economic substance."); *United Parcel Serv. of Am.*, 254 F.3d at 1019 ("A 'business purpose' does not mean a reason for a transaction that is free of tax considerations.").

103. *United Parcel Serv. of Am.*, 254 F.3d at 1020. *Cf. Kirchman*, 862 F.2d at 1490-92; *Karr*, 924 F.2d at 1023; *Rice's Toyota World, Inc.*, 752 F.2d at 91.

104. *Frank Lyon Co.*, 435 U.S. at 583-84.

105. Bail Bonds by Marvin Nelson, Inc. v. Comm'r, 820 F.2d 1543, 1549 (9th Cir. 1987). *Cf. Rice's Toyota World, Inc.*, 752 F.2d at 91-95. *See also* Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990).

while the economic substance standard involves an objective analysis of the taxpayer's economic position before and after the transaction.[106]

Circuits are divided, however, on how to apply the two-prong test.[107] 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.[108] Other circuits have determined that the existence of *either* economic substance or business purpose (*i.e.*, a disjunctive test) validates a transaction.[109] In addition, some courts have given more weight to one prong than the other, and in several cases, focused primarily on one prong and disregarded the other.[110] For example, in applying the two-prong test, several courts have focused primarily on the objective prong in determining the validity of a transaction, and give no or minimal weight to the subjective prong.[111] Finally, some courts have applied a

106. *See Sochin*, 843 F.2d at 354 (stating that the application of the business purpose prong is a subjective test, whereas the application of the 'economic substance' prong is an objective test).

107. *E.g.*, *Collins*, 857 F.2d at 1386 ("The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.").

108. *E.g.*, Pasternak v. Comm'r, 990 F.2d 893, 898 (6th Cir. 1993).

109. *Rice's Toyota World, Inc.*, 752 F.2d at 91-92 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *Black & Decker Corp.*, 340 F. Supp. 2d at 623; *IES Industries*, 253 F.3d at 353; Sanderson v. Comm'r, T.C. Memo 1985-477 ("This Court has interpreted this language to mean that, to uphold the validity of a sale-leaseback transaction, the transaction must either satisfy a subjective 'business purpose' test, or satisfy an objective 'economic substance' test.").

110. *Cf. ACM P'ship*, 157 F.3d at 248, n.31 ("Where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations.") *with CM Holdings*, 301 F.3d at 102 ("Although [the Third Circuit] has hinted that the objective analysis may be more important than the subjective, the latter analysis remains important.").

111. *Lee*, 155 F.3d at 586 ("In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of intent."); *TIFD III-E Inc.*, 342 F. Supp. 2d at 111 ("In evaluating the economic substance of a transaction, courts are cautioned to give more weight to objective facts than self- serving testimony."). *See also* Jacobson v. Comm'r, 915 F.2d at 838; Saba P'ship, 78 T.C.M. (CCH) 684 (1999)

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.[112]

2. *Objective or Subjective Test?*

Courts are divided on what each prong means; although it is clear that one is objective and the other subjective, several variations have emerged for each prong. Regardless of whether the rigid two-prong or the unitary test is applied, however, most courts agree that the objective economic substance and subjective business purposes are two different standards.[113]

("[A] transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a non-tax business purpose"); Rose v. Comm'r, 868 F.2d 851, 854 (6th Cir. 1989) (focusing on "whether the transaction had any practicable economic effect other than the creation of economic tax losses"); *Kirchman*, 862 F.2d at 1492 ("It is clear that transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer."). *Cf. Karr*, 924 F.2d at 1023 (noting that subjective intent is not irrelevant, despite *Kirchman*'s statement of the doctrine).

112. *See ACM P'ship*, 157 F.3d at 247 ("[The objective and subjective] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes."); James v. Comm'r, 899 F.2d 905, 908-09 (10th Cir. 1990) ("The better approach, in our view, holds that 'the consideration of business purpose and economic substance are simply more precise factors to consider in the [determination of] whether the transaction had any practical economic effects other than the creation of income tax losses.'"); *Long Term Capital Holding*, 330 F. Supp. 2d at 171.

113. Cherin v. Comm'r, 89 T.C. 986, 993 (1987) ("The economic substance of a business transaction and the intent, purpose, or motive of an individual investor, while sometimes equated, are not identical.") *But see Zmuda*, 731 F.2d at 1420 ("There is no real difference between the business purpose and the economic substance rules. Both simply state that the Commissioner may look beyond the form of an action to discover its substance.").

A. The Objective Prong

There are several views regarding the application of the objective prong of the economic substance test.[114] As the Third Circuit recently summarized in *CM Holdings*:

> There are several different formulations of the objective portion of the economic substance inquiry. *Knetsch* voided a transaction because it "did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax . . . In *United States v. Wexler* we held that "where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes" . . . . In *ACM Partnership* we required a "net economic effect on the taxpayer's economic position."[115]

Under this view, economic substance is determined by an *objective* evaluation of the changes in the taxpayer's economic position, aside from tax benefits.[116] Specifically, a transaction would be viewed as satisfying the objective prong of the economic substance doctrine if the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position.[117]

---

114. *E.g., ACM P'ship*, 157 F.3d at 248 ("In assessing the economic substance of a taxpayer's transactions, the courts have examined 'whether the transaction has any practical economic effects other than the creation of income tax losses'"); *Sochin*, 843 F.2d at 354 (articulating the objective analysis as whether "the transaction had 'economic substance' beyond the generation of tax benefits"); *Rice's Toyota World, Inc.*, 752 F.2d at 94 (stating that the economic substance inquiry is an objective inquiry into whether the transaction produced any non-tax benefit).

115. *CM Holdings, Inc.*, 301 F.3d at 103 (internal citations omitted). The Third Circuit set forth its own formulations of the objective test: "The main question these different formulations address is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way." *Id.*

116. *See* Winn-Dixie Stores, Inc. v. Comm'r, 113 T.C. 254, 284 (1999); *Knetsch*,, 364 U.S. at 366 (disallowing the deduction on the grounds that they "did not appreciably affect his beneficial interest except to reduce his tax."); *N. Ind. Pub. Serv. Co.*, 115 F.3d at 512; *ACM P'ship*, 157 F.3d at 248, n.31. *Cf. Long Term Capital Holding*, 330 F. Supp. 2d at 185-86 (rejecting this test and applying the cost v. reasonably expected profit instead).

117. *See* 150 CONG. REC. S3591 at §11 (Proposed § 7701(n)(1)(B)(i)(I) and (II)).

A narrower view would focus on the taxpayer's expected *benefits* from the transaction.[118] In other words, under this approach, not only the taxpayer's position must change, that it must be a change providing a benefit to the taxpayer. For example, sometimes a taxpayer derives a profit from the form of entity, incorporation (limited liability), or accounting and other benefits not specifically translated into "profit."[119]

Finally, the narrowest view would focus on the taxpayer's reasonably-expected *profits* from the transaction.[120] In contrast to the previous views, this approach would require a quantification of benefits in the form of an economic profit.[121] Thus, this standard is narrower than the previous ones, because a meaningful change in the taxpayer's economic positions will include potential profit, but may also include other elements that are not reflected in the profit potential test.

In *Johnson v. United States*, the Court of Federal Claims applied a cost vs. reasonably expected profit formula to conclude that the disputed transaction had no objective economic substance.[122] A similar view was earlier expressed in *Gilman v. Commissioner*, where the Second Circuit affirmed the Tax Court's economic substance analysis, which was approached from "the standpoint of a prudent investor."[123]

---

118. *Bail Bonds by Marvin Nelson, Inc.*, 820 F.2d at 1549 ("The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction."); *Winn-Dixie Stores, Inc.*, 113 T.C. at 285 (economic substance depends on whether the transaction "was likely to produce" non-tax economic benefits).

119. *See, e.g., TIFD III-E Inc.*, 342 F. Supp. 2d at 111 (taxpayer claimed, and the court agreed, that a company was motivated by other benefits, such as to raise capital and to demonstrate to investors, rating agencies, and its senior management, that it *could* raise capital).

120. Johnson v. United States, 32 Fed. Cl. 709, 716-17 (1995).

121. *E.g., Compaq Computer Corp.*, 113 T.C. at 221-223.

122. The court elaborated that "[t]he determination of whether a transaction has economic substance is essentially a two part analysis: (1) whether the substance of the transaction is reflected in its form, and (2) whether the transaction had a reasonable objective possibility of providing a profit aside from tax benefits." *Johnson*, 32 Fed. Cl. 709 (1995). *See also Cherin*, 89 T.C. at 993 ("A business transaction by its very nature must have economic substance, that is, a realistic potential for profit.")

123. *Gilman*, 933 F.2d at 146-47.

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

B. The Subjective Prong

The inquiry into whether there was "a legitimate business purpose" for a "transaction "involves a *subjective* analysis of the taxpayer's intent."[124] To satisfy this prong, the taxpayer must demonstrate a non-tax purpose.[125] In contrast, in the context of a business deduction under § 162 or the standard of § 183, courts have held that the taxpayer's business purpose must be primary, *i.e.*, of greater importance than potential tax benefits.[126] As the Fifth Circuit indicated in *Shriver v. Commissioner*, subjective intent may be demonstrated by the existence of a *general* non-tax motive (including business and regulatory con-

---

124. Shriver v. Comm'r, 899 F.2d 724, 726 (8th Cir. 1990) (emphasis added). *Accord* 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, Inc.*, 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."); *Lee*, 155 F.3d at 587; *Wexler*, 31 F.3d at 125.

125. *Friedman*, 869 F.2d at 792 ("[the subjective] prong requires a showing that the *only* purpose for entering into the transaction was the tax consequences." (emphasis in original)); *ACM P'ship*, 73 T.C.M. (CCH) at 2217 (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.")

126. Ramsay v. Comm'r, 83 T.C. 793, 810 (1984) ("The standard for determining whether an individual or a partnership is carrying on a trade or business so that expenses are deductible under section 162 is whether the individual or partnership is engaged in the activity with the predominant purpose and intention of making a profit."); Surloff v. Comm'r, 81 T.C. 210, 232 (1983) ("In order to constitute the carrying on of a trade or business, the partnerships must have entered into the coal venture, in good faith, with the dominant hope and intent of realizing a profit. . ."); Brannen v. Comm'r, 722 F.2d 695, 704 (11th Cir. 1984) ("Before any deduction is allowed under Section 162(a), it must be shown that the activity was entered into with the dominant hope and intent of realizing a profit.").

siderations) *or* an objective pre-tax profit potential expected at the time the transactions were entered into.[127]

The fact that the *principal* (but not the only) purpose of a transaction is to obtain a favorable tax treatment is not a reason for disallowing such favorable treatment.[128] In *UPS of America*, the Eleventh Circuit held that:

> [a] 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business.[129]

By contrast, the D.C. Circuit acknowledged in both *Boca Investerings* and *ASA Investerings* that while taxpayers are allowed to structure their business transactions in such a way as to minimize their tax, these transactions must have a legitimate non-tax avoidance business purpose to be recognized as legitimate for tax purposes.[130]

---

127. *See Shriver*, 899 F.2d at 726; Andantech LLC v. Comm'r, T.C. Memo 2002-97, at 131.

128. *Frank Lyon Co.*, 435 U.S. at 580; *Goldstein*, 364 F.2d at 741 (a tax benefit should be permitted whenever it can be said that the taxpayer's desire to secure such benefit "is only one of mixed motives that prompts the taxpayer," while a tax benefit should be denied where the transaction "has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit"); *N. Ind. Pub. Serv. Co.*, 115 F.3d at 511 ("A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what otherwise would be his taxes."); *Yosha*, 861 F.2d at 497 ("There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes."). *See also Aiken Indus., Inc.*, 56 T.C. at 933, *acq.*, 1972-2 C.B. 1 ("The fact that the actions taken by the parties in this case were taken to minimize their tax burden may not by itself be utilized to deny a benefit to which the parties are otherwise entitled under the convention."); *Bass*, 50 T.C. at 600 ("a taxpayer may adopt any form he desires for the conduct of his business, and . . . the chosen form cannot be ignored merely because it results in a tax saving.")

129. *United Parcel Serv. of Am., Inc.*, 254 F.3d at 1019.

130. *Boca Investerings*, 314 F.3d at 631 ("A tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated—in every respect except for differing investments in tax avoidance."). *See also ASA Investerings P'ship.*, 201 F.3d at 505.

In *Long Term Capital Holding*, the District Court added another factor to the business purpose analysis—the reasonable means factor. The court observed that "[t]aking fee-generating investments was Long Term's core business and was regularly executed without either complex machinations related to OTC's contributions or the attendant millions in transaction costs."[131] Thus, under this test, a court can disregard a valid non-tax business purpose if the taxpayer could have achieved the same result by entering into a more simple transaction, which is consistent with the taxpayer's core business.[132] This approach, however, has been adopted only a by a few courts, and is not the prevailing standard.

Courts frequently focus on the profit motive of the taxpayer in applying the subjective test.[133] "The 'business purpose' test involves the consideration whether a taxpayer had an 'actual and honest profit objective' in engaging in the transactions at issue."[134] Thus, many taxpayers have attempted to prove that they entered into the disputed transaction to make a profit, in order to satisfy this prong.[135] In other cases, such as *TIFD III-E Inc.*, however, the court did not have to apply the profit motive test, and found that the transaction had a legitimate business purpose.[136] Specifically, the District Court accepted the taxpayer's argument that it entered into the partnership agreement to raise capital and, more importantly, to demonstrate to investors, rating agencies, and its senior management, that it *could* raise capital.[137]

Similarly, in *Coltec Industries Inc.*, the taxpayer's business purpose was to insulate itself from potential liability in connection with asbestos lawsuits. The court accepted the taxpayer's

131. *Long Term Capital Holding*, 330 F. Supp. 2d at 186-87.

132. Pursuant to proposed § 7701(n)(1)(B)(i)(I) and (II), a transaction will have economic substance only if (i) the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a *reasonable means* of accomplishing such purpose. *See* 150 CONG. REC. S3591 at § 11.

133. *E.g.*, *ACM P'ship*, T.C. Memo 1997-115, at 120-138.

134. Coffey v. Comm'r, T.C. Memo 1991-516, 62 TCM 1021.

135. *See, e.g.*, *IES Industries, Inc.*, 253 F.3d at 350; *Compaq Computer Corp.*, 277 F.3d at 778.

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

137. *Id.* at 111.

business purpose even though it observed that the taxpayer also had tax motivation in structuring the transaction.[138]

"How significant must the non-tax purpose be?" Professor Joseph Bankman asks this question, and proposes that the most reasonable rule would peg the required expectations to the required return or business purpose in the objective leg of the doctrine.[139] Bankman, however, criticizes the subjective business purpose by arguing that it is impossible to know the taxpayer's intentions. Furthermore, he argues that this test encourages taxpayers and promoters to provide false documents.[140]

The Conjunctive Test

Under the conjunctive standard, if a court finds the lack of either of the prongs, it presumably is not required to examine the other prong, and may invalidate the transaction.[141] In other words, a taxpayer is required to establish the presence of both prongs for the transaction to withstand court scrutiny. While some courts begin with the subjective prong (usually by evaluating the profit motive)[142] other courts have first tested the objective standard and if it were found that the transaction lacked objective economic substance, the court would stop and invalidate the transaction.[143] As the Eleventh Circuit indi-

138. *Coltec Indus.*, 62 Fed. Cl. at 754.

139. Bankman, supra note 2, at 27. *See also generally*, Yoram Keinan, *The Profit Requirement Under the Economic Substance Doctrine*, 21 J. TAX'N INV. 81 (2003).

140. *Id.*

141. Illes v. Comm'r, 982 F.2d 163, 165 (6th Cir. 1992) ("To be valid, an asserted deduction must satisfy both components of a two-part test. The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."). *See also Pasternak*, 990 F.2d at 898 ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction. . . If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made.").

142. *ACM P'ship*, 73 T.C.M. (CCH) at 2217.

143. *Kirchman*, 862 F.2d at 1492 ("The analysis of whether a transaction is a substantive sham, however, addresses whether a transaction's substance is that which its form represents. That does not necessarily require an analysis of a taxpayer's subjective intent. Once a court determines a transaction is a sham, no further inquiry into intent is necessary."); *Lee*, 155 F.3d at 586 (*cit-*

cated in *UPS of America*, "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance."[144]

Accordingly, under the conjunctive test, if the court begins with the objective prong and finds that the transaction had economic substance, it will next examine if the transaction had business purpose.[145] In *Ferguson v. Commissioner*, the court, finding the transaction to lack substance, found it unnecessary to analyze the taxpayer's motives.[146] As the Tax Court indicated in *Cherin v. Commissioner:*

> Subjective intent cannot supply economic substance to a business transaction. Where, as in the case at bar, we examine the transaction and conclude as we do in this case that Southern Star's herd investment

---

ing Jacobson v. Comm'r, 915 F.2d 832, 839 (2d Cir. 1990)); *Gilman*, 933 F.2d at 148 n. 5 ("[S]ection 183 applies after a transaction has been determined to have economic substance."); Mahoney, 808 F.2d at 1220 ("Here, the Tax Court in a lengthy and well-reasoned opinion decided the transactions were a sham, thus making it unnecessary to directly reach the 'entered for profit issue.'").

144. *United Parcel Serv. of Am., Inc.*, 254 F.3d at 1018. *See also* Gardner v. Comm'r, 954 F.2d 836, 839 (2d Cir. 1992) ("Since the taxpayers concede that their straddle transactions lacked economic substance, and since it is well established that a subjective profit motive can not save a transaction that objectively lacks economic substance . . . we agree with the Tax Court and the Third Circuit that the straddle transactions did not create any recognizable losses."). *Accord Dow Chem. Co.*, 250 F. Supp. 2d at 799 ("[C]ourts have held that a proper business purpose alone will not 'breathe substance' into a transaction that objectively has no reasonable prospect of profitability absent tax considerations.").

145. *See Ferguson*, 29 F.3d at 102 ("Having concluded that the partnerships' Koppelman Process activities lacked economic substance, those activities must be disregarded for tax purposes and cannot form the basis of any deductions. It is unnecessary, therefore, for us to analyze the tax court's findings with respect to the partnerships' profit motive."); *Pasternak*, 990 F.2d at 898 ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction."); *Dow Chem.*, 250 F. Supp. 2d at 800 ("If the transaction is objectively economically viable, the Court must determine whether the taxpayer had a legitimate profit motive in entering into the transaction. However, the subjective component does not become determinative unless the transaction has satisfied the objective requirement of the sham test.").

146. *Ferguson*, 29 F.3d at 102.

> packages lack any realistic potential for profit, we need not examine the investor's state of mind.[147]

The Tax Courts in *Sheldon* and *ACM Partnership* also started with the subjective standard, which was basically a profit motive test.[148] In *Sheldon*, the Tax Court began with the following analysis: "We first address whether the transactions involving the purported T-Bill and repo transactions were fictitious or real."[149]

The Tax Court applied a comprehensive profit potential analysis and observed that "having found that 10 of the 11 repos and related transactions were not fictitious, we must now consider whether, within the meaning of *Goldstein*, any of the transactions had economic substance."[150] The Tax Court concluded that ". . . the 11 repo transactions, although 10 of them are not fictitious, lacked tax-independent purpose."[151]

In *ACM Partnership*, the Tax Court also acknowledged that "the CINS transaction was not a sham in the sense that it was fictitious but it was a sham in the sense that the [section] 453 investment strategy lacked economic substance."[152] The Tax Court first examined the profit potential and concluded that there was no profit potential from the transaction.[153] Subsequently, the Tax Court dismissed the taxpayer's second argument that the LIBOR notes served as a hedging tool.[154] Accordingly, the Tax Court concluded that "[b]ut for the $100

147. *Cherin*, 89 T.C. at 994. *See also Kirchman*, 862 F.2d at 1492 ("It is clear that transactions whose sole function is to produce tax deductions are substantive shams, *regardless of the motive* of the taxpayer." (emphasis added)).

148. Sheldon v. Comm'r, 94 T.C. 738, 735 (1990); *ACM P'ship*, 73 T.C.M at 2217-21.

149. *Sheldon*, 94 T.C. at 753. The Tax Court explained that "Although fictitious transactions or those lacking in economic substance have, in different cases, been alternately labeled as a 'sham', in this opinion the term 'fictitious' will refer to nonexistent transactions and transactions lacking economic substance will be so described." *Id.* at 752 n.8.

150. *Id.* at 760.

151. *Id.* at 762.

152. *ACM P'ship*, 73 T.C.M. (CCH) at 2216 n. 21.

153. *Id.* at 2221 ("Considering the high costs of the financial engineering it required and ABN's unwillingness to have Kannex share any of these costs or be exposed to any of the entrepreneurial risks it entailed, the section 453 investment strategy would not have been consistent with rational profit-motivated behavior in the absence of the expected tax benefits.").

154. *Id.*

million of tax losses it generated for Colgate, the section 453 investment strategy would not have been consistent with rational economic behavior. The section 453 investment strategy lacked economic substance. It served no useful nontax purpose."[155]

In both of these cases, the Tax Court considered the profit potential to be probative of the taxpayer's motivation. Because the courts found the potential for profit to be insignificant, the Tax Court concluded that the taxpayer was motivated solely by tax benefits. In general, if the court applies the conjunctive test, begins with the profit potential standard, and finds it to be no more than *de minimis*, the court can end its examination and hold that the transaction should be invalidated and tax benefits be denied. Nevertheless, in these two cases as well as in many others, the courts also performed the objective analysis.

Finally, as set forth in greater detail below, recent legislative proposals to codify the economic substance doctrine would apply the conjunctive test.[156]

Applying only the Objective Test

In several cases, the objective prong has been the primary or even sole basis for the courts in disregarding the form of the transaction where the taxpayer's only claimed business purpose was to earn a profit. Some courts completely disregarded the subjective standard and focused primarily on the objective standard.[157] A similar view was expressed by both the Treasury and the Joint Committee of Taxation in 1999, in their lengthy reports on tax shelters. Specifically, the Treasury suggested to codify the economic substance doctrine, and suggested that:

---

155. *Id.* at 2229.

156. *See* 150 CONG. REC. S3591 at §11 (Proposed § 7701(n)(1)(B)(i)(I) & (II)).

157. *Saba P'ship*, 78 T.C.M. (CCH) at 722; *Kirchman*, 862 F.2d at 1492; *Rose*, 868 F.2d at 854. *But see Karr*, 924 F.2d at 1023 (noting that subjective intent is not irrelevant, despite *Kirchman*'s statement of the doctrine); McCrary v. Comm'r, 92 T.C. 827, 845 (1989) ("A taxpayer's subjective intent, however, is a factor to be considered in determining whether the transaction had economic substance.").

> [a] tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction are insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income.[158]

Pursuant to the Treasury's proposed definition, the subjective motives of the taxpayer are not taken into account. Rather, the motives of the taxpayer are analyzed objectively based on whether the taxpayer reasonably expects an economic profit from the transaction in question. In the report, the Treasury explained its rationale behind this standard and asserted that a subjective test would likely prove inadequate for several reasons. First, the Treasury argued that corporations exist to make a profit, and therefore "will be presumed to satisfy the potential for profit test even if its expectation of profit is unreasonable. Second, permitting corporate taxpayers to enter into transactions with unreasonable expectations of profit would permit corporations to engage in transactions solely for tax benefits."[159]

In some cases, the objective economic substance may be dispositive and the transaction will be validated if the amount of economic substance is significant enough, even in the ab-

---

158. U.S. Dep't of the Treasury, *The Problem of Corporate Tax Shelters: Discussion Analysis, and Legislative Problems* at 157 (1999), *available at* http://www.treas.gov/press/releases/reports/ctswhite.pdf.

159. *Id.* at 160-61. Similarly, the Joint Committee on Taxation issued in 1999 its own report pertaining to tax shelters, and also suggested to codify the economic substance doctrine. According to the Joint Committee, a transaction will not be recognized for tax purposes if "[t]he reasonably expected pretax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits." STAFF OF THE J. COMM. ON TAXATION, STUDY OF PRESENT LAW PENALTY AND INTEREST PROVISIONS, AS REQUIRED BY SECTION 3801 OF THE INTERNAL SERVICE RESTRUCTURING AND REFORM ACT OF 1998, JCS-3-99 at 229 (July 22, 1999), *available at* http://www.house.gov/jct/pubs99.html.

sence of non-tax business purpose.[160] Several courts have followed the same view. As the Second Circuit indicated in *Rosenfeld v. Commissioner*:

> [W]e decline appellant's invitation to adopt a business purpose standard of review. Rather, we believe our inquiry should focus on whether there has been a change in the economic interests of the relevant parties. If their legal rights and beneficial interests have changed, there is no basis for labeling a transaction a 'sham' and ignoring it for tax purposes. Indeed, our prior decisions have indicated that this is the relevant inquiry.[161]

This standard of review may be viewed as a variation of the disjunctive test, because the existence of one prong, namely the objective prong, would validate a transaction.[162] Even

---

160. *Saba P'ship*, 78 T.C.M. (CCH) at 718 ("A transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a nontax business purpose"); *N. Ind. Pub. Serv. Co.*, 115 F.3d at 512 (economic substance doctrine "do[es] not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax-related changes in economic position.")

161. 706 F.2d 1277, 1282 (1983). In another decision, the Tax Court indicated that:

> [W]e are not unaware of the proposition that where a taxpayer mistakenly believes there existed a potential for profit, a transaction devoid of economic substance may not be disregarded entirely (sometimes called the subjective business purpose test). Under the circumstances of this case, however, [the taxpayer] should have known that the transaction at issue could not achieve a non-tax profit. . . . We refuse to allow a sophisticated businessman who has not taken adequate steps to form a reasoned assessment of an investment to rely on his failure to take such steps and on his resulting ignorance. To do so would encourage "tax shelter charlatans," and discourage taxpayers from independently evaluating transactions and making informed business judgments, thereby putting a premium on gullibility.

Carlson v. Comm'r, T.C.M (CCH) 1176 (1987).

162. *See* Friendship Dairies, Inc. v. Comm'r, 90 T.C. 1054 (1988). The court noted that:

> A two-pronged test has emerged. Under this test, we must disregard such transactions if we find "that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists. Petitioner does not seriously contend that the transaction had a pur-

though, technically, the disjunctive test discussed in the next section would allow a taxpayer to demonstrate either economic substance or business purpose, as a practical matter, most taxpayers would focus on showing objective substance under the disjunctive test.[163]

On the other hand, in *CM Holdings*, on appeal, the taxpayer argued that subjective intent is irrelevant for purposes of the economic substance test.[164] The Third Circuit disagreed, however, and held that "[f]rom the time of Gregory's analysis of the 'rational business purpose,' courts have evaluated taxpayers' purposes when determining whether a transaction has economic substance."[165] Thus, the Third Circuit concluded that the objective prong alone is insufficient for satisfying the economic substance test.

The rationale behind applying only the objective prong is that if the claimed business purpose of the taxpayer is to earn a profit by entering into the transaction—unlike the transaction in *Frank Lyon*, which was also guided by accounting and regulatory concerns—the two prongs of the test overlap to a large extent.[166] As discussed above, subjective intent is frequently demonstrated by the existence of an objective pre-tax profit potential expected at the time the transactions were entered into and other business and regulatory considerations. In *IES Industries*, the Eighth Circuit observed that "the business purpose test is a subjective economic substance test."[167] Thus,

---

> pose apart from tax savings. Petitioner's witnesses all protested that tax considerations were not a major or primary factor in petitioner's decision to invest in the equipment. They did not, however, identify any other motivating consideration that can be given credence. Thus we give greater weight to objective factors and conclude that petitioner's tax objective was the only real purpose of the transaction."

Id. at 1062-63 (internal citations omitted).

163. *Cf. Black & Decker Corp.*, 340 F. Supp. 2d at 623 (the taxpayer and Government stipulated that there was no business purpose, because the taxpayer relied on the prevailing disjunctive test in the Fourth Circuit).

164. 301 F.3d at 105-06.

165. *Id.* at 106.

166. Hines v. United States, 912 F.2d 736, 739 (4th Cir. 1990); Faulcolner v. Comm'r, 748 F.2d 890, 894 (4th Cir. 1984).

167. 253 F.3d. at 355. *See also Compaq Computers Corp.*, 277 F.3d 778 (5th Cir. 2001) (the Fifth Circuit relied on the profit requirement test for establishing both economic substance and business purposes).

as a practical matter, the court applies objective analysis under both prongs.

The Disjunctive Test

A standard applied by several circuits and several Tax Courts is a disjunctive test pursuant to which the economic substance doctrine will apply to disallow a tax benefit only after a decision that the transaction lacked *both* a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).[168]

Generally, in the Fourth Circuit, a transaction will be treated as a sham (or having no economic substance) if the court finds "that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no reasonable possibility of profit exists."[169] Nevertheless, in *Hines v. Commissioner,* the Fourth Circuit implied that a mere subjective belief that a transaction can generate non-tax profit may not suffice.[170] The subjective prong is tested on an objective basis, so there is some overlap between both prongs:

> [T]he ultimate determination of whether an activity is engaged in for profit is to be made. . . by reference

168. Horn v. Comm'r, 968 F.2d 1229, 1237-38 (D.C. Cir. 1992) (holding that the economic substance of a transaction can be established if the transaction at issue had objective economic substance or if there was a subjective non-tax business purpose); *Cf. Friendship Dairies, Inc.*, 90 T.C. at 1062-63 (1988) (finding a disjunctive test, but giving "greater weight to objective factors.").

169. *Rice's Toyota*, 752 F.2d at 91 (emphasis added); *Hines*, 912 F.2d at 740 ("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."); *Black & Decker*, 340 F. Supp. 2d at 623 (confirming *Rice's Toyota* and *Hines* disjunctive test as the test in the Fourth Circuit). For other cases in the Fourth Circuit applying the disjunctive test, *see Friedman*, 869 F.2d at 792; Georgetowne Sound v. United States, 856 F. Supp. 1056, 1057 (D. Md. 1993) *aff'd*, 1994 U.S. App. Lexis 4126 (4th Cir. 1994); Duke Energy Corp. v. United States, 49 F. Supp. 2d 837, 842 (W.D.N.C. 1999).

170. 912 F.2d at 740 ("[t]he mere assertion of such a belief, particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham.").

> 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.[171]

This assertion is inconsistent with the court's decision in *Black & Decker Corp.*, where it was stipulated from the beginning that there was no business purpose, but the court held for the taxpayer on the grounds that the Fourth Circuit's standard is disjunctive and the transaction had objective economic substance.[172]

In general, the D.C. Circuit has also adopted the disjunctive standard.[173] In *Horn v. Commissioner*,[174] the D.C. Circuit cited *United States v. Consumer Life Ins. Co.*,[175] where the Supreme Court affirmed the lower courts' decisions that two types of reinsurance arrangements were not shams because they "served [other] valid and substantial non-tax purposes," specifically, risk allocation.[176] Thus, the court held that establishing that the transaction was undertaken for profit (presumably under the objective prong) or any legitimate non-tax business purpose (under the subjective prong) will validate the transaction.[177]

In *Boca Investerings Partnership*, the Federal District Court followed *Horn*, applied a disjunctive test, and held for the taxpayer.[178] Although the Court of Appeals reversed, the deci-

---

171. *Id.* (quoting *Faulconer*, 748 F.2d at 894).

172. *Black & Decker*, 340 F. Supp. 2d at 623.

173. *Horn*, 968 F.2d 1229; *Boca Investerings P'ship*, 314 F.3d 625 (D.C. Cir. 2003); *Saba P'ship*, 273 F.3d 1135 (D.C. Cir. 2000), *vac'g and rem'g* T.C. Memo 1999-359; Andantech L.L.C. v. Comm'r, 83 T.C.M. (CCH) 1476, *aff'd* 331 F.3d 972 (D.C. Cir. 2003).

174. 968 F.2d at 1238 ("a transaction will not be considered a sham if it is undertaken for profit *or* for other legitimate non-tax business purposes."). The court also cited Kent N. Schneider & Ted D. Englebrecht, *The Tax Court's Unified Approach to Analyzing Generic Tax Shelters*, 6 J. TAX'N INVESTMENTS 308, 309-10 (1989); Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 670 (1989).

175. United States v. Consumer Life Ins. Co., 430 U.S. 725, 736-39 (1977).

176. *Id.* at 739.

177. *Horn*, 968 F.2d at 1238.

178. *Boca Investerings P'ship*,, 167 F. Supp 2d. at 376, *rev'd* 314 F.3d 625 (D.C. Cir. 2003) ("A transaction is not a sham and will be recognized for tax purposes if the taxpayer satisfies *either* part of the test for economic substance—if either (1) using a subjective analysis, the transaction has a non-tax

sion was not based on the disjunctive standard applied by the District Court but rather on the grounds that the partnership had neither business purpose nor economic substance.[179]

In *Andantech,* in evaluating the economic substance of sale leaseback transactions, the Tax Court also followed *Horn* and concluded that: "the sale-leaseback should not be respected for tax purposes because (1) no reasonable possibility for profit existed, and (2) [the transaction] was not motivated by any business purpose other than obtaining tax benefits."[180] The Court of Appeals for the D.C. Circuit affirmed the decision only with respect to the validity of the partnership, and it did not conduct a separate economic substance analysis with respect to the sale-leaseback transactions.[181]

Similarly, in *Coltec Industries Inc.,* the Court of Federal Claims indicated that the economic substance test is disjunctive:

> In any event, the court already has considered and held that Coltec satisfied the tax avoidance and business purpose tests in Section 357(b), therefore, ipso facto, the 'economic substance' doctrine is satisfied, since that doctrine requires proof of at least one of these tests.[182]

Frequently, other circuits have applied the disjunctive test even though it may not be the prevailing standard in the circuit. For example, in *Shriver,* the Eighth Circuit observed that:

> For the reasons set out above, we determine that the tax court found *both* a lack of business purpose and a

---

business purpose, or (2) using an objective analysis, the transaction has a reasonable possibility of generating a profit, ex-ante."). *See also* Thomas A. Humphreys, James A. Gouwar & J. Brandon Holder, *Boca Investerings and the Future of the Economic Substance Doctrine,* DERIVATIVES REPORT (Vol. 3(5) 2001), at 9-10.

179. *Boca Investerings P'ship,* 314 F.3d at 632. *See also Saba P'ship,* 273 F.3d 1135.

180. *Andantech,* 83 T.C.M. (CCH) at 1507. *See also Friedman,* 869 F.2d at 792 ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists.") (quoting *Rice's Toyota*).

181. *Andantech,* 331 F.3d at 981-82.

182. 62 Fed. Cl. 716, 754 *(2004). See also Johnson,* 32 Fed. Cl. at 716-717 (following the disjunctive test).

> lack of economic substance, thereby performing the necessary analysis to determine that the transaction was actually a sham under *Rice's Toyota.*[183]

The Eighth Circuit, however, applied the unitary analysis and affirmed the Tax Court's decision.[184] Similarly, in *IES Industries,* the Eighth Circuit acknowledged that it generally follows *Rice*'s *Toyota* standard,[185] but:

> As in *Shriver,* we do not decide whether the *Rice's Toyota World* test requires a two-part analysis because we conclude that the ADR trades here had both economic substance and business purpose.[186]

Thus, it is unclear what standard prevails in the Eighth Circuit. The prevailing standard in the Second Circuit is also unclear. As discussed above, in *Long Term Capital Holding,* the

---

183. Shriver, 899 F.2d at 726.

184. *Id.* at 727 ("[W]e do not read *Frank Lyon* to say anything that mandates a two-part analysis. And although *Rice's Toyota World* seems to conclude a two-part test is consistent with *Frank Lyon,* the Fourth Circuit opinion does not appear to hold that such a test is essential.").

185. *IES Industries, Inc.,* 253 F.3d 350 (8th Cir. 2001). The court noted that:

> In determining whether a transaction is a sham for tax purposes, the Eighth Circuit has applied a two-part test set forth in *Rice's Toyota* . . . which the Fourth Circuit ostensibly found in the Supreme Court's opinion in *Frank Lyon Co.* Shriver v. Comm'r, 899 F.2d 724, 725-26 (8th Cir. 1990). Applying that test, a transaction will be characterized as a sham if 'it is not motivated by any economic purpose outside of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit exists' (the economic substance test).

Id. at 353.

186. *Id.* at 353-54. *See also Compaq Computer Corp.,* 277 F.3d 778 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999). In *Compaq Computer Corp.,* the court held that:

> In *Rice's Toyota World,* the court held that after *Frank Lyon Co.,* it is appropriate for a court to engage in a two-part inquiry to determine whether a transaction has economic substance or is a sham that should not be recognized for income tax purposes. . . . Other courts have said that business purpose and reasonable possibility of profit are merely factors to be considered in determining whether a transaction is a sham. . . . Because we conclude that the ADR transaction in this case had both economic substance and a business purpose, we do not need to decide today which of these views to adopt.

Id. at 781-82.

taxpayer claimed that under the Second Circuit's test, a transaction is valid if it has *either* economic substance or business purposes.[187] The District Court, however, dismissed this argument[188] and indicated that "[t]he nature of the economic substance analysis is flexible . . . thereby giving rise to alternative formulations in the Second Circuit, including both subjective and objective inquiries."[189] Thus, the District Court applied the unitary test, contrary to the taxpayer's argument that the disjunctive test should apply in the Second Circuit.[190]

In contrast, in *TIFD III-E Inc.*, the court was not as clear with respect to which standard is predominant in the Second Circuit.[191] The taxpayer asked the court to apply the disjunctive test, while the government asked it to apply the unitary test. The court applied a two-prong analysis and held that the taxpayer had both business purpose and economic substance. Thus, the court concluded that it did not have to decide which standard to apply.[192]' The court, however, implied that the disjunctive test may also be applicable in the Second Circuit (although it held that it does not matter for the particular case because the taxpayer satisfied both prongs).

Support for the taxpayers' arguments in each case is found in the Second Circuit's decision in *Gilman*, which dealt with a sale and leaseback arrangement.[193] In that case, the Tax Court applied the *Rice*'s *Toyota* disjunctive test, examined each prong separately, and concluded that the disputed transaction lacked both business purpose and economic substance.[194] On appeal, the taxpayer challenged the Tax Court's use of the disjunctive test and argued that the "relevant standard for determining economic substance is 'whether the transaction may cause any change in the economic positions of the parties

187. 330 F. Supp. 2d 122, 171 n.68.

188. *Id.* (quoting *Ferguson*, 29 F.3d at 102 (2d Cir. 1994) ("'Having concluded that the partnerships' . . . activities lacked economic substance, those activities must be disregarded for tax purposes and cannot form the basis of any deductions. It is unnecessary, therefore, for us to analyze the tax court's findings with respect to the partnerships' profit motive.").

189. *Id.* at 171 (citing *Gilman*, 933 F.2d at 148; *Lee*, 155 F.3d at 586).

190. *Id.*

191. 342 F. Supp. 2d at 108-09.

192. *Id.*

193. 933 F.2d at 147-49, *aff'g* 58 T.C.M. (CCH) 1075 (1989).

194. *Gilman*, 58 T.C.M. (CCH) at 1078-84.

(other than tax savings),'" and that the "'profit motive/business purpose' inquiry should be based on the criteria in the regulations under section 183."[195]

The Second Circuit supported the *Rice's Toyota* disjunctive test, rejected the taxpayer's argument, and held that:

> [T]he Tax Court did not demand that the taxpayer demonstrate both business purpose and economic substance. Rather, the Court examined each prong separately and concluded that Gilman lacked a business purpose and that the transaction lacked economic substance.[196]

By contrast, the Second Circuit in *Ferguson v. Commissioner* clearly applied a different test, stating that: "Having concluded that the partnerships' Koppelman Process activities lacked economic substance, those activities must be disregarded for tax purposes and cannot form the basis of any deductions. It is unnecessary, therefore, for us to analyze the tax court's findings with respect to the partnerships' profit motive."[197]

In *United States v. Wexler*,[198] the Third Circuit cited *Jacobson v. Comm'r* with approval.[199] In *Wexler*, the taxpayer, a managing partner of a limited partnership engaged in securities trading, entered into numerous repo-to-maturity transactions that paid out more in market interest than they received in coupon interest. The Government filed criminal charges against the taxpayer. The taxpayer argued—without quarrel from the Government—that the disjunctive test should apply. Specifically, as the Third Circuit observed:

---

195. *Gilman*, 933 F.2d at 147.

196. *Id.* at 148. *See also Jacobson*, 915 F.2d at 840 ("Even if the motive for a transaction is to avoid taxes, interest incurred therein may still be deductible if it relates to economically substantive indebtedness."). *Cf.* DeMartino v. Comm'r, 862 F. 2d 400, 406 (2d Cir. 1988) ("A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions.").

197. 29 F.3d at 102.

198. 31 F.3d at 126.

199. 915 F.2d at 840. *See also* Lieber v. Comm'r, 66 T.C.M. (CCH) 722, 33-34 (1993) (following *Jacobson*). *Cf. Lee*, 155 F.3d at 586-87 (rejecting the taxpayer's interpretation of *Jacobson* as a disjunctive test and stating, "had the *Jacobson* court concluded that the underlying transaction in the case before it was devoid of economic substance, the question of whether the interest expenses at issue were deductible would have been answered in the negative without any need to inquire into the reality of the debt itself.").

> [T]he two-part definition of a sham transaction proposed by the government and adopted by the district court [in Wexler] would require the jury, in order to "find the transactions were sham transactions," to "determine two things beyond a reasonable doubt:" First, that MBM had no business purpose for entering into the transactions other than to obtain tax benefits; and [s]econd, that there was no economic substance to the transaction, that is there was no reasonable possibility that MBM could earn a profit on the transactions apart from tax benefits. Thus, what Jacobson holds is that interest will be deductible where the government proves lack of business purpose, but cannot prove lack of economic substance—i.e. if the underlying transaction is not a "sham" as defined by the district court's order in Wexler's case.[200]

Finally, the Third Circuit acknowledged in *ACM Partnership* that even though it applied the unitary analysis, "it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations."[201]

Several Tax Court cases followed the disjunctive test, generally quoting *Rice's Toyota* and *Frank Lyon.* In *Packard v. Commissioner,* the Tax Court cited these two cases and held as follows:

> A taxpayer's failure to establish that a transaction was motivated by a business purpose rather than by tax avoidance is not conclusive, however, that the transaction was a sham. Rather, if an objective analysis of the transaction indicates that a reasonable possibility

200. *Wexler,* 31 F.3d at 126.

201. *ACM P'ship,* 157 F.3d at 298 n.24 (citing *N. Ind. Pub. Serv. Co.,* 115 F.3d at 512 ("Gregory and its progeny 'do not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax-related changes in economic position' regardless of 'tax-avoidance motive' and refusing to disregard role of taxpayer's foreign subsidiary which performed a 'recognizable business activity' of securing loans and processing payments for parent in foreign markets in exchange for legitimate profit.")).

> of profit existed apart from tax benefits, the transaction will not be classified as a sham.[202]

The Tax Court in *Torres v. Comm'r* followed the same standard two years later in a sale and leaseback case and held that under the *Rice's Toyota* standard, "a finding of lack of economic substance is inappropriate if either a business purpose or a reasonable possibility of profit apart from expected tax benefits is found to have been present."[203]

Because the disjunctive standard only requires the taxpayer to satisfy one prong, even if a court finds that the taxpayer had no or little non-tax motivation, it would validate a transaction if it finds the transaction had objective economic substance. In *Sanderson v. Comm'r*, the Tax Court held that ". . .while we have little doubt that tax benefits were a significant aspect of this transaction, the record establishes the fact that the investment in the buildings provided a realistic opportunity for economic profit apart from tax benefits."[204]

Similarly, the Tax Court in *Saba Partnership v. Comm'r* relied on *Horn* and asserted that "a transaction imbued with economic substance normally will be recognized for tax purposes even in the absence of a non-tax business purpose."[205] The court in *Saba* cited *Larsen v. Comm'r* for this proposition. In *Larsen'*, four different lease transactions were reviewed by the court. The Tax Court said it was "satisfied that petitioner did not manifest the requisite business purpose necessary to justify the form of the transaction."[206] Nevertheless, reviewing the objective economic substance of the transactions, it held that:

---

202. 85 T.C. at 417.

203. 88 T.C. 702, 718-19 (1987), citing *Packard.* 85 T.C. at 417. *See also Friendship Dairies, Inc.*, 90 T.C. at 1062-63 ("A two-pronged test has emerged. Under this test, we must disregard such transactions if we find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."); Estate of Thomas v. Comm'r, 84 T.C. 412, 438-39 (1985) (following the disjunctive test, in a decision subsequent to the Tax Court's decision in *Rice's Toyota*, and concluding that the transaction had neither business purpose nor economic substance); *McCrary*, 92 T.C. at 845 ("A transaction that has a business purpose or profit objective will survive the *Rose* analysis of economic substance.").

204. 50 T.C.M. (CCH) 1033, 1037 (1985).

205. 78 T.C.M. at 718.

206. Larsen v. Comm'r, 89 T.C. 1229, 1253 (1987).

> the four transactions were not motivated by a business purpose, and that the Hon and Anaconda transactions were devoid of economic substance and are to be disregarded for Federal income tax purposes. We further find that the record provides sufficient evidence that the Irving transactions were transactions imbued with economic substance. Consequently, the Irving transactions are accorded recognition for Federal income tax purposes.[207]

Although in most cases in which the court applied the disjunctive test taxpayers prevailed by showing objective economic substance, a taxpayer may still prevail on the grounds of having subjective business purpose without having to show objective economic substance. Citing *Rice's Toyota,* the Tax Court indicated in *Mukerji v. Comm'r* that:

> Once business purpose is established, the transaction should not be classified a 'sham.' A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some modicum of economic substance. Conversely, transactions devoid of economic substance are not always shams such as where a taxpayer mistakenly believes there existed a potential for profit. But when there is a finding that the taxpayer entered into the transaction for tax reasons only, then it is proper to subject the transaction to an objective economic analysis to determine whether there could have been an opportunity for profit.[208]

To conclude, the disjunctive test is clearly more favorable to taxpayers than the conjunctive test. Taxpayers, therefore, generally attempt to convince the court that it should apply the disjunctive test, while the government, naturally, attempts to convince the court that either the conjunctive test or the

207. *Id. See also Black & Decker,* 340 F. Supp. 2d at 624 ("The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes.").

208. 87 T.C. 926, 960 (1987). *But see Hines,* 912 F.2d at 740 ("The mere assertion of such a belief, particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham.").

unitary analysis is appropriate.[209] As set forth above, in some circuits, it is clear enough which standard prevails (Fourth, D.C. and Federal), while in others, it is up to the taxpayer to convince the court (Eighth and Second). Courts may begin with the subjective prong and if they have enough evidence to validate a transaction on the grounds that the taxpayer honestly and reasonably expected an actual profit, there is no need to utilize an additional objective test. The latter test would be necessary, however, when the taxpayer cannot prove by clear evidence its honest pursuit for profit. In most cases, the court would have to apply the objective test. If the court begins with the objective analysis, it may not need to examine subjective intention if it finds that the transaction had objective economic substance.

The Unitary Analysis

The origins of the unitary analysis are found in *Zmuda v. Comm'r*, where the Ninth Circuit indicated that there is no real distinction between the objective and subjective prongs, and that "[b]oth simply state that the Commissioner may look beyond the form of an action to discover its substance."[210] The court elaborated that "[t]he terminology of one rule may appear in the context of the other because they share the same rationale. Both rules elevate the substance of an action over its form."[211] The court observed, however, that the rule established in *Moline Properties*[212] and the economic-substance doctrine "share the same rationale."[213]

Under this approach, "[a] taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to [the sham transaction] inquiry."[214] Thus, the two prongs are no more than potentially relevant factors.[215] Nevertheless, courts that apply the unitary analysis

209. *See, e.g., Long Term Capital Holding*, 330 F. Supp. 2d at 171 n.68; *TIFD III-E Inc.*, 342 F. Supp. 2d at 108-09.

210. 731 F.2d at 1420.

211. *Id.* at 1421.

212. 63 S. Ct. 1132, 1133-34 (1943).

213. *Zmuda*, 731 F.2d. at 1421.

214. *Rose*, 868 F.2d at 853.

215. *ACM Partnership*, 157 F.3d at 247. The court noted that:

> The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both

often apply it similarly to the two-prong test[216] or as an alternative test.[217] In *ACM Partnership*, for example, both the Tax Court and Third Circuit examined each prong separately to reach the conclusion that the transaction had neither economic substance nor business purpose.

The flexible, or unitary, test has been adopted by the Second, Sixth, Eighth, Ninth, Tenth and Eleventh Circuits as well as in several Tax Court opinions.[218] As discussed above, however, in some circuits, such as the Second and Eighth, it is not

---

> the "objective economic substance of the transactions" and the "subjective business motivation" behind them. . . . However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.

Id.

216. *See, e.g.*, *Friedman*, 869 F.2d at 792 (holding that although tax court did not apply the "exact test" of *Rice's Toyota*, there was nevertheless ample support for the court's finding of a sham transaction). *See also Hines*, 912 F.2d at 739 ("While it is important to examine both the subjective motivations of the taxpayer and the objective reasonableness of the investment, in both instances our inquiry is directed to the same question: whether the transaction contained economic substance aside from the tax consequences.").

217. *Shriver*, 899 F.2d at 726-27 ("Although we elect also to address the question of whether the two-part test applied in *Rice's Toyota World* is mandated by the *Frank Lyon* sham-transaction analysis, the following discussion only provides an alternative basis for our holding.").

218. Second Circuit: Gardner v. Comm'r, 954 F.2d 836, 838-39 (2d Cir. 1992), *aff'g* Fox v. Comm'r, 56 T.C.M. (CCH) 863 (1988); *Gilman*, 933 F.2d at 148; Rosenfeld, 706 F.2d at 1281-82. Sixth Circuit: Provizer v. Comm'r, 996 F.2d 1216, 1993 WL 245799 at **2 (6th Cir. July 7, 1993) (stating *Rice's Toyota* test but citing *Rose* as authority), *aff'g per curiam* 63 T.C.M. (CCH) 2531, 2548 (1992); Smith v. Comm'r, 937 F.2d 1089, 1096 (6th Cir. 1991); Bryant v. Comm'r, 928 F.2d 745, 748-49 (6th Cir. 1991); *Rose*, 868 F.2d at 853; *Mahoney*, 808 F.2d at 1220, *aff'g* Forseth v Comm'r, 85 T.C. 127 (1985). Eighth Circuit: *Shriver*, 899 F.2d at 726. Ninth Circuit: Sacks v. Comm'r, 69 F.3d 982, 986-88 (9th Cir. 1995), *rev'g* 64 T.C.M. (CCH) 1003 (1992); *Casebeer*, 909 F.2d at 1363; *Collins*, 857 at 1385; *Sochin*, 843 F.2d at 354; *Zmuda*, 731 F.2d at 1421. Tenth Circuit: Jackson v. Comm'r, 966 F.2d 598, 601 (10th Cir. 1992); James v. Comm'r, 899 F.2d 905, 908-09 (10th Cir. 1990). Eleventh Circuit: *Karr*, 924 F.2d at 1022-23; *Kirchman*, 862 F.2d at 1492. Cases in other circuits have also adopted the unitary approach. *See, e.g.*, Lerman v. Comm'r, 939 F.2d 44, 53-55 (3d Cir. 1991), *aff'g Fox*; Forseth v. Comm'r, 845 F.2d 746, 748-49 (7th Cir. 1988), *aff'g* 85 T.C. 127 (1985).

that clear that the unitary test is the prevailing standard.[219] In addition, due to the flexible nature of the unitary standard, different versions have emerged.[220]

A court applying the unitary analysis would, generally, discuss both prongs, and would make a decision based on its findings as to these prongs; however, the decision will be made based on the transaction's overall effect (in particular, the presence of any practical effect other than tax effect), and not on the precise findings for each prong.[221]

The unitary analysis allows the court to be more flexible with respect to the weight given to each prong, and, in fact, it also allows the court to completely ignore one prong, if the court views it unnecessary to apply such prong.[222] As set forth above, in many cases, courts have presented the two alternative tests, the disjunctive and unitary, and concluded, generally,

---

219. *See, e.g., Shriver*, 899 F.2d at 726; *IES Industries, Inc.*, 253 F.3d at 353; *Gilman*, 933 F.2d at 147-48.

220. For examples of the different standards applied by different courts under the unitary test, see *Zmuda*, 731 F.2d at 1420 (finding no real difference between the business purpose and the economic substance tests since both allow the Commissioner to look past a transaction's form to its substance); *Lee*, 155 F.3d at 586 (a transaction lacks economic substance if it "can not with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequences." (quoting *Goldstein*, 364 F.2d at 740)); *Mahoney*, 808 F.2d at 1220 n.2 (finding no practical economic effects beyond the creation of tax benefits); Boynton v. Comm'r, 649 F.2d 1168, 1172 (5th Cir. 1981) ("Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized."); Tolwinsky v. Comm'r, 86 T.C. 1009, 1037 (1986) ("[W]here transactions serve no 'purpose, substance, or utility apart from their anticipated tax consequences' they are disregarded for tax purposes." (quoting *Goldstein*, 364 F.2d at 740)); *Cherin*, 89 T.C. 986 (1987) (disavowing the existence of a two-prong test and determining that the taxpayer's investment in a cattle breeding program lacked a realistic potential for profit and should be disregarded as a sham).

221. *See Zmuda*, 731 F.2d at 1421. *See also Sochin*, 843 F.2d at 354. In that the latter case, the court held that:

> [W]e did not intend our decision in *Bail Bonds* to outline a rigid two-step analysis. Instead, the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses.

Id.

222. *ACM Partnership*, 157 F.3d at 248 n.31.

that under either test they would have reached the same conclusion.[223]

In my view, there is little practical difference between the unitary and the conjunctive standards, because a court applying the former test would examine both prongs to reach a conclusion, and would not validate a transaction if only one of them is satisfied.[224]

III.
RECENT ECONOMIC-SUBSTANCE COURT CASES

During the fall of 2004, taxpayers had three victories in *Black & Decker*,[225] *Coltec Industries*,[226] and *TIFD III-E Inc.*"",[227] the last following the government win in *Long Term Capital Holding*[228] by a different District of Connecticut judge. The pendulum has shifted back, however, in 2005, with the government's two recent victories in *CMA Consolidated Inc.*[229] and *Santa Monica Pictures*.[230] Those latest two victories were at the Tax Court, while the taxpayers' three previous victories were at different district courts.

Long Term Capital Holding v. United States

A U.S. district court held that a transaction involving the contribution of stock with a built-in loss to a partnership lacked economic substance and had been entered into without any business purpose other than tax avoidance. Alternatively, the court held that the transaction could be recast under the

223. *See, e.g.*, *Shriver*, 899 F.2d at 726; *IES Industries*, 253 F.3d at 353-54; *Compaq Computer Corp.*, 113 T.C. 214 (1999); *TIFD III-E Inc.*, 342 F. Supp. 2d at 108-09.

224. CM Holdings, Inc., 254 B.R. at 621 ("Although [the economic substance and business purpose] inquiries do not constitute two distinct prongs of analysis, the Court will address these component inquiries in turn."). *See also* Sacks, 69 F.3d at 987 ("We stated that although the proper test to apply to a sham question is not a 'rigid two step analysis,' we typically focus on the subjective aspect of whether the taxpayer intended to do anything other than acquire tax deductions, and the objective aspect of whether the transaction had any economic substance other than creation of tax benefits.").

225. Black & Decker Corp., 340 F. Supp. 2d 621 (D. Md. 2004).

226. Coltec Indus., 62 Fed. Cl. 716 (2004).

227. TIFD III-E Inc., 342 F. Supp. 2d 94 (D. Conn. 2004).

228. *Long Term Capital Holding*, 330 F. Supp. 2d at 122.

229. T.C. Memo. 2005-16 (Jan. 31, 2005).

230. T.C. Memo. 2005-104 (May 11, 2005).

step-transaction doctrine as a taxable transfer of a loss stock from the contributing partner to the general partner, followed by a sale of the stock by the general partner. The court also upheld accuracy-related penalties assessed by the IRS despite the taxpayer's argument that it had obtained and relied on two separate law firm "should" level opinions supporting its position.[231]

1. *Facts*

The essence of the transaction was to allow loss duplication through the contribution by Onslow Trading & Commercial LLC ("OTC") of stock with a built-in loss to a partnership, the sale of the contributor's partnership interest to the general partner, and the subsequent sale of the loss stock by the partnership. The stock with the built-in loss (i.e., stock with low value but high tax basis) was created by contributing cash subject to a pre-paid lease obligation to two different corporations in a § 351 transaction.[232]

During 1996, OTC contributed cash and the loss stock to Long-Term Capital Partners LP ("LTCP"), a hedge fund, in exchange for a partnership interest in LTCP. OTC borrowed the cash component of its contribution from Long-Term Capital Management UK, a UK entity related to Long-Term Capital Management LP ("LTCM"), the general partner of LTCP. In addition, OTC purchased from LTCM a "liquidity put" and a "downside put" with respect to its interest in LTCP.[233] In December 1997, LTCP sold some of the preferred stock with a basis of $107 million for approximately $1 million, producing

231. *Long Term Capital Holding*, 330 F. Supp. 2d at 196.

232. The key was that the lease obligations were not treated as a liabilities under § 357 (2004), so the basis in the preferred stock was amount of cash contributed, even though its value was much lower (because it reflected the liabilities). *Id.* at 135-36.

233. In general, these puts, each of which could only be exercised on or between October 27, 1997 and October 31, 1997, gave OTC the right to put its interest in LTCP to LTCM for an amount equal to the greater of the value of such interest at the date of the put or OTC's original capital investment in LTCP. OTC exercised its liquidity put on October 28, 1997, selling its entire interest in LTCP to LTCM for $12,614,188, representing approximately a 22% return on OTC's investment. *Id.* at 136-38. Of course, no § 754 election was made (§ 754 of the tax code allows a partnership to adjust the basis of partnership property, subject to other limitations within the tax code). I.R.C. § 754 (2004).

a loss of $106 million, which was allocated to LTCM under § 704(c).

Babcock & Brown, which designed the transaction, received a partnership interest in LTCP and a 12-month consulting arrangement for which it was paid $1.2 million. Turlington also claimed he had earned a fee for his role in the transaction. This claim was settled by Long Term paying Turlington $1.25 million and B&B paying $550,000.[234] As manager of the underlying portfolio, LTCM earned fees for assets under management, proportional to the return achieved for the investors. Long Term relied on the additional fees it would earn from both the OTC and the B&B investment to justify its ability to earn a pre-tax profit.

2. *Economic Substance Analysis*

As set forth above, the taxpayer first argued that the standard in the Second Circuit is a disjunctive test.[235] The court, however, held that the prevailing standard in the Second Circuit is the unitary test.[236] Nevertheless, even if the court would have accepted the disjunctive test, it would reach the same result because, it found, the transaction lacked objective economic substance *and* the taxpayer entered into the transaction without any business purpose other than tax avoidance.

A. Objective Economic Substance

The taxpayer argued that the objective economic substance test ought to be whether there was a meaningful change in the taxpayer's economic position. The court rejected this argument.[237] Applying a cost/benefit analysis similar to the one in *Goldstein*, the court held that LTCM had no realistic expectation of economic profit after taking into account fees.[238] 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

234. *Long Term Capital Holding*, 330 F. Supp. 2d at 159.
235. *Id.* at 171 n.68.
236. *Id.* at 171-72 n.68.
237. *Id.* at 185-86.
238. *Id.* at 173-74.

considering these costs and fees.[239] With respect to the potential profit, the court considered only the management fees LTCM could earn on the OTC investment, not the B&B/UBS investment, because the latter didn't contribute to the obtaining of the tax benefits.[240] As a result, the maximum reasonably expected gross earnings were estimated at $2 million.[241]

B. Subjective Business Purpose

The court found that the transaction was purely tax-motivated, notwithstanding the parties' efforts to imbue it with a business purpose (earning fees). Most notably, the court asserted that the transaction was brought to the taxpayer as a tax product.[242]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.[243] The court elaborated with respect to the business purpose subjective standard that Long Term did not carry out the transaction in a way that indicated it had any motive other than tax savings.

3. *Step Transactions Analysis*

Alternatively, the court held that under the "end result" test of the step transaction doctrine, the court collapsed the several steps taken by the taxpayer and held that OTC ought to be viewed as if it sold its preferred stock to LTCM, so LTCM had a cost basis in the stock.[244]

---

239. In particular, the costs included legal fees of $1 million, the B&B fee of $1.2 million, the Turlington settlement of $1.25 million, and various internal allocations and bonuses paid to Long Term principals. *Id.* at 175-82.

240. *Id.* at 178.

241. *Id.* at 182.

242. *Id.* at 187.

243. "[T]he construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees points to Long Term's true motivation, tax avoidance." Id. at 186.

244. *Id.* at 191-96. *See also generally,* Greene v. United States, 13 F.3d 577, 583 (2d Cir. 1994) ("Under the end result test, the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result."); Cornfeld v. Commissioner, 137 F.3d 1231, 1235 (10th Cir. 1998) *affg.* T.C. Memo 1996-472 (citing Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1523 (10th Cir. 1991) ("The 'end result'

4. *Penalties*

The court found the taxpayers liable for valuation overstatement[245] and substantial understatement penalties.[246] The court held that the S&S and K&S opinions did not allow the taxpayers to qualify for the "reasonable cause/good faith" exception to the penalties[247] for several reasons. First, the K&S written opinion was delivered late, and the record did not establish that Long Term had reasonably relied on K&S's oral advice. Second, there was no evidence that any of the Long Term partners other than Myron Scholes actually read the K&S opinion. Third, the favorable authorities cited in the K&S opinion were based on facts materially different from those found by the court, so could not be relied upon. Fourth, the K&S opinion did not adequately address Second Circuit

---

test amalgamates into a single transaction separate events which appear to be component parts of something undertaken to reach a particular result.")).

245. *Id.* at 199. A 20-percent accuracy-related penalty applies to the extent that any portion of an underpayment is attributable to any "substantial valuation misstatement". I.R.C. §§ 6662(a) & (b)(3). There is a "substantial valuation misstatement" if "the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed . . . is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)". § 6662(e)(1)(A). In the case of a "gross valuation misstatement", the penalty increases from 20 to 40 percent. There is a "gross valuation misstatement" if the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed is 400 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be). *Id.* §§ 6662(e)(1) & (h)(2).

246. *Id.* at 200. A "substantial understatement" exists when the "correct" tax liability exceeds the tax liability actually reported by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations). The rate of penalty is equal to 20 percent of the underpayment. I.R.C. § 6662. 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 imposed which is shown on the return. I.R.C. § 6662(d)(2)(A).

247. *Id.* at 205-12. *See also* I.R.C. § 6662(d)(2)(C)(i)(I) & (II). A taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer reasonably relies in good faith on the opinion of a professional tax adviser; and if the opinion is based on the tax adviser's analysis of the pertinent facts and authorities and unambiguously states that the tax adviser concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS. Reg. § 1.6662-4(g)(4)(B).

precedent, nor the "end result" variation of the step-transaction doctrine; and finally, Long Term lacked good faith, as evidenced by the steps it took to conceal the preferred stock losses on its tax return.[248] The court's primary reason for sustaining the penalties asserted by the IRS appeared to be that the transaction lacked economic substance and business purpose. But the opinion also suggests that the opinion did not protect the taxpayer because it was deficient in its legal analysis and because at most one of the partners in LTCM had read the opinion.

The decision thoughtfully analyzed the law on economic substance and business purpose, especially Second Circuit precedent, but the court offered no new doctrine. The case essentially says that a transaction driven exclusively by tax benefits cannot be dressed up with a thin layer of economic substance and business purpose. In this respect, it differs little from *ACM Partnership* and similar cases. Finally, footnote 89 distinguishes the pro-taxpayer decision of the Eleventh Circuit in *UPS*, which, as explained by the District Court, involved the restructuring of a taxpayer's business operation to derive a tax advantage, as opposed to *Long Term Capital Holding*, which involved a unique transaction having nothing to do with a taxpayer's business.[249]

Black & Decker Corp. v. United States

A district court in Maryland granted Black & Decker Corp.'s ("B&D") motion for summary judgment in a refund suit for over $57 million in federal taxes arising from a contingent liability transaction.[250]

1. *Facts*

In 1998, B&D created Black & Decker Healthcare Management Inc. ("BDHMI") and transferred approximately $561 million to BDHMI along with $560 million in contingent employee healthcare claims in exchange for newly issued stock in BDHMI, in a § 351 transaction. Subsequently, B&D sold its stock in BDHMI to a third party for $1 million. B&D argued

248. *Id.* at 205-12.
249. *Id.* at 190-91 n.89.
250. *Black & Decker Corp.*, 340 F. Supp. 2d 621 (D. Md. 2004).

that its basis in the BDHMI stock was $561 million (i.e., equal to the value of the property it had transferred to BDHMI). Thus, B&D claimed approximately $560 million in capital losses on the stock sale[251]

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

2. *Analysis*

As set forth above, 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.[252] For purposes of its motion for summary judgment, B&D conceded that tax evasion was its sole motivation, and focused on establishing objective economic substance. The District Court applied a combination of the *Moline Properties* doctrine and objective economic substance analysis to conclude that a corporation *and its transactions* are objectively valid, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions.[253]

> The Court looked at the facts and noted that BDHMI: (1) "assumed the responsibility for the management, servicing, and administration of plaintiff's employee and retiree health plans;" (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

251. Note that in Notice 2001-17, 2001-9 IRB 730, the IRS identified as "listed transactions" such transactions involving a loss on the sale of stock acquired in a purported § 351 transfer of a high basis asset to a corporation and the corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes. The transaction in the present case occurred prior to the issuance of Notice 2001-17.

252. *Black & Decker*, 340 F. Supp. 2d at 624 ("The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes.") (citing *Rice's Toyota*, 752 F.2d at 96).

253. *Id.* at 623-24 (citing *N. Indiana Public Serv. Co.*, 115 F.3d at 512; *Moline Properties*, 319 U.S. at 438-39; *Frank Lyon Co.*, 435 U.S. at 583-84).

> 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.[254]

As a result, the court held that "[t]he BDHMI transaction, therefore, had very real economic implications for every beneficiary of B&D's employee benefits program, as well as for the parties to the transaction."[255]

TIFD III Inc. v. United States

The District of Connecticut ordered the IRS to refund $62 million to the tax-matters partner of Castle Harbour-I LLC, finding that the LLC's creation was not a sham designed solely to avoid taxes.[256]

1. *Facts*

TIFD III-E is a wholly owned subsidiary of the General Electric Capital Corporation ("GECC"), a subsidiary of the General Electric Company ("GE"). GECC leased commercial aircrafts. In 1992, at least partially in response to concerns about the number of airlines going into bankruptcy, GECC decided to create a separate entity to which it would contribute a number of aircrafts.[257] First, three GECC subsidiaries formed an LLC ("Summer Street") and transferred to it aircraft, nonrecourse debt, rents receivable, cash, and all the stock of GECC subsidiary TIFD VI (stock value: $0).[258] Second, the GECC subsidiaries sold $50 million of their interest in Summer Street to two Dutch banks. The Dutch banks also contributed an additional $67.5 million, bringing their total investment to $117.5 million. Summer Street then changed its name to Castle Harbour-I Limited Liability Company ("Castle Harbour"), and TIFD VI changed its name to Castle Harbour Leasing, Inc. ("CHLI").

---

254. *Id.* at 624 (footnotes omitted).

255. *Id.*

256. *TIFD III-E Inc.*, 342 F. Supp. 2d at 121.

257. The result would be that GECC would trade some of the risks and returns of those aircraft to the outside foreign (tax-neutral) investors in exchange for a cash contribution to the newly created entity. The plan was implemented in two stages. *Id.* at 96-98.

258. *Id.* at 97.

The partnership allocations under the operating agreement were as follows: each year the Dutch banks were to have their capital accounts debited or credited, depending on whether the partnership had received a gain or suffered a loss, and each year the Dutch banks were to have a significant portion of their ownership interest bought out by the partnership. At the end of eight years, if the Dutch banks' capital accounts had actually earned a rate of return of 9.03587%, the Dutch banks' capital accounts, i.e., ownership interests, would be decreased to near zero, but if the Dutch banks' capital accounts were credited at a rate less than 9.03587%, the accounts would be negative after eight years, and if the accounts were credited at a rate greater than 9.03587%, the capital accounts would be positive. Positive capital accounts would result in payments to the banks when the partnership wound up, and negative accounts would mean the banks owed money to the partnership. If the banks' interests were not liquidated after eight years, the banks would still have their capital accounts credited or debited by allocations of income or loss in successive years.

Castle Harbour was required to maintain "investment accounts" for the Dutch banks. No cash was paid into these accounts; they merely kept track of a hypothetical balance. The opening balance of these accounts was the initial investment made by the Dutch Banks, which was to be recalculated at the time the Dutch banks exited the partnership as if every year the balance had been increased by a defined applicable rate but also reduced by the payments described above. If, when the Dutch banks exited Castle Harbour, the investment account sum exceeded a specific allocation formula, that amount would be paid to the Dutch banks, instead of the amount in their capital accounts.

The operating agreement defined two categories of income: operating income and disposition gains/losses.[259] Once operating income had been calculated, it was allocated to the capital accounts as follows: if operating income was posi-

259. Operating income was comprised of income less expenses. Income was rent and interest on investments. Expenses consisted of normal administrative expenses, interest owed on aircraft debt, depreciation of the aircraft, and guaranteed payments to GECC entities. A disposition gain or loss was the result of the difference between the sale price of an asset, usually an aircraft, and its book value. *Id.* at 100-01.

tive—i.e., an operating gain—it was allocated 98% to the Dutch banks and 2% to the GECC entities. If operating income was negative—i.e., an operating loss—then it was first allocated in an amount sufficient to offset the cumulative disposition gains allocated to any of the partners in previous years, and the remainder was then allocated 98% to the Dutch banks until they had been allocated, cumulatively, $3,854,493 of operating losses. The remained after this was allocated 99% to the GECC entities and 1% to the Dutch banks.

Disposition gains and losses were allocated much like operating losses. First, disposition gains were allocated to offset prior disposition losses and prior operating losses; disposition losses offset prior disposition gains. The remainder was then allocated 90% to the Dutch banks until they had been allocated, $2,854,493 of either disposition gains or losses, and the remainder after this was allocated 99% to the GECC entities and 1% to the Dutch banks.

2. *Economic Substance of the Transaction*

As the court indicated:

> [A] transaction will be deemed a 'sham' and disregarded when calculating taxes if it has no business purpose or economic effect other than the creation of tax benefits. 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.[260]

The court continued to discuss the two-prong test: "[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."[261]

The taxpayer argued that the court must apply the disjunctive test. The Government, however, urged the court to apply the unitary standard. The court asserted that the decisions in the Second Circuit are inconsistent with respect to

260. *Id.* at 108 (citing *Jacobson*, 915 F.2d at 837; Newman v. Comm'r, 902 F.2d 159, 163 (2d Cir. 1990)).

261. *Id.* at 108-09 (citing *Gilman*, 933 F.2d at 148).

which test to apply; it also cited *Long Term Capital Holding* as an example for applying the unitary analysis.[262] The court, however, asserted that it did not have to decide which standard to apply, because "under either reading. . . the Castle Harbour transaction was not a 'sham.'"[263] The court held that 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.

A. Economic Substance

The government argued that because the return earned by the Dutch banks was essentially guaranteed, it had no risk with respect to the transaction, and that there was no economic effect. The court dismissed this argument. "In return for a significant portion of Castle Harbour's Operating Income," stated the court, "the Dutch Banks contributed approximately $117 million dollars, which was used by Castle Harbour's subsidiary CHLI either to purchase aircraft or to retire GECC debt."[264] Although the investment accounts provided the Dutch Banks with some guarantee of return, the court held that:

> A *lack of risk* is not enough to make a transaction economically meaningless. Even with an 8.5% guaranteed return, the Dutch banks still participated in the—economically real—upside of the leasing business . . . Participating in upside potential, even with some guarantee against loss, is economically substantial.[265]

Finally, the court observed that the Government's premise that a guarantee of a positive return indicates no risk, is simplistic; whether an investment is risky to the investor depends on a number of factors, including the investor's cost of capital and opportunity costs. The court concluded that "[t]he economic reality of such a transaction is hard to dispute."[266]

---

262. *Id.* at 109 (citing *Long Term Capital Holding*, 330 F. Supp. 2d 122 (D. Conn. 2004)).

263. *Id.* at 109.

264. *Id.*

265. *Id.* at 110 (emphasis added).

266. *Id.* at 109.

B. Business Purpose

The court started, "[i]n evaluating the economic substance of a transaction, courts are cautioned to give more weight to objective facts than self-serving testimony."[267] The court found that the transaction had a legitimate business purpose; specifically, that GECC entered into the transaction "to raise capital and, more importantly, to demonstrate to investors, rating agencies, and GECC senior management, that it *could* raise capital on its fleet of aging Stage II aircraft."[268] In light of the economic reality of the Castle Harbour transaction, the court found persuasive the testimony of five GECC executives, who all swore that "demonstrating liquidity" and "monetizing" Stage II aircraft were important motivations. The court found the testimony of GECC's executives persuasive. Consequently, it held that GECC was subjectively motivated to enter into the Castle Harbour transaction at least in part by a desire to raise capital and a desire to demonstrate its ability to do so.

3. *Economic Substance of the Partnership*

Alternatively, the government argued that even if the "transaction as a whole had economic substance, for tax purposes the Dutch Banks were not partners of the GECC entities but rather were their creditors."[269] The court identified "two circumstances under which the Dutch banks would not be considered partners: (1) if there was no economic reality to the label 'partner;' and (2) if, regardless of the economics of the situation, the Code would simply classify them as something else."[270] The court applied a separate economic substance analysis to the first circumstance, but, rather than examining the substance of the entire transaction, it focused on "whether there was any economic reality to the choice of the partnership form."[271] As to the second circumstance, the court held that there is no current authority for it to reclassify an interest in a partnership as something else.

First, the court found:

267. *Id.* at 111 (citing *Lee*, 155 F.3d at 586).
268. *Id.* (emphasis in original).
269. *Id.*
270. *Id.*
271. *Id.*

> The 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 Banks came together to form Castle Harbour, i.e., there was economic substance in not only the actions, but also the formation, of the partnership.[272]

The decision to form a partnership, noted the court, may be economically insubstantial, even though the partnership undertakes a legitimate business. The court distinguished this case from the situations in *ASA Partnership*, mainly on the grounds that in *ASA Partnership*, the foreign partners were entirely indifferent to the partnership's activities (because their return was 100% guaranteed), while in the present case the Dutch Banks could have suffered some downside (albeit limited) and could have earned more profit than the guaranteed return.[273] In the present case, "[t]he Dutch Banks had a very real stake in the transaction because their return was tied directly to the performance of the aircraft leasing business."[274]

Coltec Industries Inc. v. United States

In *Coltec Industries*, the Court of Federal Claims ordered the IRS to refund $82.8 million in federal taxes arising from a contingent liability transaction.[275] The first paragraph of the decision provided a clear indication of what the decision was going to be. The court also quoted the following passage from *Atlantic Coast Line v. Phillips*, which in turn was quoting prior decisions of Justice Holmes and Judge Learned Hand:

> As to the astuteness of taxpayers in ordering their affairs so as to minimize taxes we have said that 'the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it.' This is so because [there is no] 'public duty to pay

272. *Id.* at 113.

273. *Id.* at 113-14 (contrasting *ASA Investerings P'ship*, 201 F.3d 505 (D.C. Cir. 2000)).

274. *Id.* at 113.

275. *Coltec Indus.*, 62 Fed. Cl. at 756).

more than the law demands: taxes are enforced exactions, not voluntary contributions.'[276]

1. *Facts*

Coltec Industries, Inc. ("Coltec"), a publicly-traded holding company, owns Garlock, Inc. ("Garlock"). Garlock's companies include Garlock Mechanical Packing Company, Stemco, Inc., and Anchor Packing ("Anchor"). Anchor utilized asbestos in manufacturing its products. In 1993, Coltec decided to discontinue Anchor's business operations and by 1996, Anchor's only assets were nearly depleted insurance coverage and a small building in Louisiana. By the early 1990's, Anchor and Garlock were or had been defendants in approximately 100,000 asbestos cases.

In 1996, Coltec established Garrison, a "case management subsidiary," to handle the asbestos cases. Garrison authorized the issuance of 300,000 shares of common stock and 1,500,000 shares of Class A stock. Coltec contributed $998,000 to Garrison in exchange for 99,800 shares of Garrison common stock and $13,000,000 in exchange for 1,300,000 shares of Garrison Class A stock.

To effect capitalization of Garrison, Garlock caused Stemco to issue a promissory note to Garlock in the amount of $375 million. Garlock contributed to Garrison the Stemco note, the outstanding stock of Anchor, the rights to any future asbestos insurance recoveries, furniture, fixtures, and equipment, and all of the files, records, and data of the Asbestos Litigation Department. In exchange, Garrison issued 100,000 shares of Garrison common stock to Garlock and assumed defense and payment of Garlock's and Anchor's contingent asbestos liabilities.

In December 1996, several banks' subsidiaries purchased 50,000 shares of Garrison common stock for $250,000 or 100,000 shares for a total of $500,000 or $5 per share. In return, Coltec agreed to indemnify the banks for any asbestos-related claims that may arise in the future. An exit strategy was set forth in a separate agreement wherein the banks were granted the right to "put" the Garrison shares to Coltec at fair

276. Atlantic Coast Line v. Phillips, 332 U.S. 168, 172-73 (1947) (quoted in *Coltec Indus.*, 62 Fed. Cl. at 718).

market value, and Coltec had the right to "call" or buy back the shares at a fixed price; each option right was executable after five years. The banks have not exercised their put rights and Coltec has not exercised its call options.

2. *Substantive Analysis*

The court examined the transaction using a three-step analysis. First, it held that the contribution of the stock and the promissory notes to Garrison satisfied § 351 because (1) Coltec and Garlock transferred qualifying "property" (i.e., the stock and notes) to Garrison; (2) Coltec and Garlock received only stock from Garrison (Coltec received 93% of the equity of Garrison and Garlock received 7% of the equity of Garrison); and (3) immediately after the exchange, Coltec and Garlock owned and controlled 100% of the total combined voting power of all classes of Garrison stock entitled to vote.

Second, the court held that the asbestos liabilities assumed by Garrison were contingent, since both of the events necessary to establish the fact of the liability had not occurred—namely, the filing of a lawsuit asserting a claim and an adjudication of liability.[277]

Finally, the court concluded that the sale of the stock should be respected as a true sale. The court restated the principle that a sale occurs if the benefits and burdens of ownership have passed from the seller to the buyer. The government attempted to show that the purchasers of the Garrison stock did not obtain such burdens and benefits of ownership of the stock. The court, however, rejected the government's arguments on the following grounds: first, the stock entitled

277. Pursuant to § 358(d)(1), in a stock exchange to which § 351 applies, the assumption of liabilities by another party to the stock exchange is treated as money received by the distributee upon the exchange, and, therefore, the distributee's basis in the stock received ought to be reduced to the extent of the amount of the liabilities assumed. *See* § 358. Treas. Reg. § 1.461-1(a)(2)(i) provides that, for an accrual method taxpayer, a liability "is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability [and] the amount of the liability can be determined with reasonable accuracy." Note that because § 358(h) was enacted only in 1999 and did not apply to the transaction, the court held that Garlock will reduce its basis in the Garrison stock if and when the liabilities accrue and are satisfied by Garrison. *See Coltec Indus.*, 62 Fed. Cl. at 757.

the banks to a proportionate distribution upon liquidation—similar to the stock—but were only required to provide Coltec with notice on such a sale. Second, regarding the control issue, the Banks acquired a minority position in Garrison, and their rights were typical to any minority interest in a company (i.e., they could not expected to control the company). Third, the banks had stakes in Garrison through the life of the venture; and finally, the banks were concerned about veil piercing and they too formed separate corporations to insulate their main businesses and required further indemnification from Coltec.[278] The court also concluded that the transaction was made at arm's length.

3. *Section 357(b): The Tax Avoidance (or Business Purpose) Test*

The court tested to see whether Garrison's assumption of the Garlock liabilities were not undertaken for "the principal purpose. . . to avoid federal income tax" under § 357(b).[279] In addition, the court required Coltec to demonstrate that assumption of such liabilities also had a "bona fide business purpose." Both of these "tests" must be established by a "clear preponderance of the evidence."[280]

The court reviewed several cases discussing § 357(b) and set forth the following prevailing principles:

> Business purpose is to be examined narrowly to a purpose with respect to the assumption of a liability and to a purpose to avoid income tax on the exchange . . .
>
> The closer the nature of the liabilities to the customary business of the transferee and its continued viability, the more likely that Section 357(b)'s principle 'business purpose' test will be satisfied . . .
>
> 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 . . .
>
> The longer the life span of the corporate vehicle utilized and term of any promissory notes issued, the

278. *Coltec Indus.*, 62 Fed. Cl. at 750.
279. *Id.* at 733.
280. *Id.* (citing 26 U.S.C. § 357(c)).

> more likely a court will find the transaction to have been undertaken for a business purpose.[281]

The court concluded that the taxpayer satisfied these tests:

> The contingent . . . liabilities assumed clearly were related to Anchor's, Garlock's, and Garrison's ordinary business, and the management and minimization of such liabilities was essential to the continued viability of Anchor and potentially Garlock . . . The events that gave rise to these contingent liabilities . . . took place well before the Garrison transaction. In addition, the facts that the Stemco promissory note had a 15-year term and that Garlock, Stemco, and Garrison continue to function today—eight years after the formation of Garrison also weighs in favor of the Garrison transaction being viewed as having a bona fide business purpose. And, the separate Garrison structure became an important factor in Coltec's ability to sell the company to B.F. Goodrich Corporation in 1999.[282]

The court concluded, "the record in this case establishes that Garrison's assumption of Garlock's contingent asbestos liabilities had a '*bona fide*' business purpose that satisfied Section 357(b) by a clear preponderance of the evidence."[283]

4. *Economic Substance Analysis*

The court began by stating the principle that the economic substance doctrine is "a composite of the 'business purpose,' 'substance over form,' and 'sham transaction' doctrines."[284] In one sentence, the court collapsed all four common law doctrines into a single standard. The government provided the court with the usual list of "binding precedent," including *Gregory v. Helvering* and *Comm'r v. Court Holding Co.*, that "support the principle that economic substance, and not mere formal compliance with the Code, must inform the interpretation and application of the tax law."[285] The court coun-

281. *Id.* at 743 (citations omitted).
282. *Id.*
283. *Id.*
284. *Id.* at 752.
285. *Id.* at 753.

tered that "[a] careful reading of other cases cited by the Government, however, reveals that the Court resolved the tax question at issue first by looking to the Code and utilized doctrinal language only to further support its conclusion."[286] Thus, the court will apply common law doctrines only where the statute is unclear and open to several interpretations.[287]

Furthermore, the court reviewed the three Federal Circuit cases cited by the government from the Federal Circuit to conclude that none endorsed the economic substance doctrine.[288]

The court, however, found that even if it was required to apply the economic substance test, Coltec has satisfied the test because it satisfied the business purpose of § 357(b), and, therefore "the 'economic substance' doctrine is satisfied, since that doctrine requires proof of at least one of these tests."[289]

Finally, the court supported its conclusion that the transaction had economic substance on the grounds that "from the 'standpoint of the prudent investor,' the Garrison transaction not only appeared to place one more barrier in the way of veil piercing claims, but it provided the B.F. Goodrich Corporation with a sufficient comfort level to purchase all of the Coltec Group in 1999."[290]

---

286. *Id.*

287. *Cf. Santa Monica Pictures, LLC,* T.C. Memo 2005-104 (discussed below)

288. *Coltec Indus.*, 62 Fed. Cl. at 753-54 (citing Holiday Village Shopping Ctr. v. United States, 773 F.2d 276 (Fed. Cir. 1985) (asserting that "[i]n light of the fact that the federal appellate court undertook no analysis of the 'economic realities' attributed to Gregory and clearly limited its holding to the facts of the case, the court does not discern any directive requiring it to resolve the instant case under the economic substance doctrine."). The court also cited Executive Jet Aviation, Inc. v. United States, 125 F.3d 1463 (Fed. Cir. 1997), for the proposition that "where the language of the Code is clear, the 'substance rather than form' doctrine is irrelevant." *See also* Rubin v. Comm'r, 429 F.2d 650, 653 (2d Cir. 1970) ("Resort to 'common law' doctrines of taxation . . . have no place where, as here, there is a statutory provision adequate to deal with the problem presented.").

289. *Id.* at 754.

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

The court cited Professor Bankman 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."[291]

Thus, the court concluded:

> Under our time-tested system of separation of powers, it is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare . . . . Accordingly, the court has determined that where a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the economic substance doctrine to trump "'mere compliance with the Code would violate the separation of powers."'[292]

CMA Consolidated Inc. v. Commissioner[293]

The Tax Court held that lease stripping transactions structured using tax-indifferent parties had no economic substance or profit potential aside from the tax benefits, disallowed the claimed deductions, and imposed penalties on the participant for negligence and for a gross undervaluation of certain notes. This basic transaction was similar to the transaction in *Andantech*,[294] which was a case of first impression in which the Tax Court rejected a lease stripping transaction and the District of Columbia Circuit Court affirmed.[295]

---

291. *Id.* at 755-56 (quoting Bankman, *The Economic Substance Doctrine*, *supra* note 2, at 29-30).

292. *Id.* at 756.

293. T.C. Memo. 2005-16 (January 31, 2005).

294. T.C. Memo. 2002-97.

295. In *Andantech*, the Tax Court disallowed losses from a lease stripping transaction. In a series of cascading holdings, the court found that the transaction lacked economic substance under a number of theories. 83 T.C.M. at 1507. The D.C. Circuit agreed with the Tax Court that the record established that the parties never intended to join together as partners to run a business and that the partnership had no legitimate non-tax purpose. 331 F.3d at 981-82. The appellate court's opinion, however, did not address the remaining Tax Court holdings invalidating the entire transaction on economic substance and similar grounds. Rather, the D.C. Circuit remanded

1. *Facts*

Similar to the analysis in *Andantech*, the factual circumstances in this case consisted of a "Byzantine labyrinth of complex transactions," the Tax Court said.[296] The Tax Court further noted that most of the transactions were undertaken solely to achieve a tax effect.[297] The taxpayer was generally involved in equipment leasing transactions and the structuring of equipment financing. During the early 1990s, the taxpayer began to arrange deals designed to separate equipment rental income from the related rental expenses. In those deals, the rental income was allocated to a tax-indifferent or tax-neutral party in order to allow another party to claim a greatly disproportionate share of the related tax benefits. The specific lease stripping transaction in this case involved computer and photo processing equipment which was subject to two existing end-user leases and a prior lease stripping arrangement. An "upper lease" interest was created between the equipment owner and the existing head lease and user lease. The arrangement involved the purchase of the lease by a partnership where 99% of the taxable income resulting from a rent sale to finance the purchase was allocated to a tax-exempt Indian nation and then the property was transferred to the taxpayer in exchange for preferred stock of minor value. As structured, the lease strip interest was intended to generate over $4.2 million of potential tax deductions at an out-of-pocket cost of $40,000.

2. *Economic Substance Analysis*

The Tax Court held that any deductions claimed by a promoter of lease stripping transactions, who acquired a position in an arrangement that it had tried to market to other investors, should be treated as a sham lacking economic substance. In evaluating whether the transaction lacked economic substance, the court applied the two-pronged inquiry: (1) a subjective inquiry as to whether the transaction was carried out for a valid business purpose; and (2) an objective inquiry concern-

---

the case to the Tax Court to determine whether the Tax Court had jurisdiction to decide the tax consequences of the individual "partners" on a separate taxpayer basis. *Id.*

296. T.C. Memo 2005-16, at 65.

297. *Id.*

ing the non-tax economic effect of the transaction.[298] The court noted, however, that "the two tests have much in common and are not necessarily discrete prongs of a 'rigid two-step analysis'" (*i.e.*, the "unitary" or flexible analysis).[299] Similar to cases like *ACM Partnership, Sheldon,* and *Rice's Toyota World,* the Tax Court focused on the profit test in applying both prongs. 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."[300]

With regard to the subjective prong, the taxpayer argued that it expected to earn a pretax profit from the equipment rental income or the income produced from disposition of the residual interests.[301] The court found that the taxpayer's behavior was "inconsistent with a genuine pretax profit motive for entering into the second lease strip deal."[302] The court further held that the lease strip deals in this case were "mere tax-avoidance devices or subterfuges mimicking a leasing transaction." The court further noted that the obvious purpose was to obtain unwarranted and substantial tax benefits.[303] The court observed that the taxpayer could only enjoy a return from the lease rentals after expiration of the user leases and prior to the ultimate equipment return but the documents were incorrectly drafted with incorrect dates that eliminated this period entirely. Thus even though the taxpayer argued that this should be corrected, the court concluded that the fact that no attention was paid to the error, which was never corrected, is evidence that the taxpayer had no interest in the underlying leasehold interest.[304] Accordingly, the court held that petitioner had neither profit motive nor valid non-tax business purpose for entering into the lease strip deal apart from tax benefits.

---

298. *Id.* at 69 (citing *ACM P'ship,* 157 F.3d at 247-248; *Casebeer,* 909 F.2d at 1363; *Kirchman,* 862 F.2d at 1490-1491).

299. *Id.* (citing *Casebeer,* 909 F.2d at 1363).

300. *Id.* at 71 (citing *ACM P'ship,* 157 F.3d at 257; *Sheldon* 94 T.C. at 767-68).

301. *Id.* at 79.

302. *Id.* at 84-6.

303. *Id.*

304. *Id.*

With regard to the objective prong, the court stated that it must "examine the potential for economic profit" from the disputed transaction.[305] Obviously, the taxpayer's expert attempted to prove that the taxpayer could have reasonably expected a profit from the transaction, while the government's expert argued that there was no realistic profit potential.[306] The court concluded that the IRS's appraisal expert was correct in determining that there was no expectation of any residual value even if the drafting error were corrected, thus there could be no reasonable expectation of a more than *de minimis* pre-tax return.[307] Furthermore, in reaching the conclusion that the transaction "did not have any objectively demonstrable, practical economic profit potential" for the taxpayer, the court also observed that the disputed transaction was consummated through various entities, a number of which either were related to, or were owned and/or controlled by others who regularly cooperated with the taxpayer.[308] The court also noted that the other participants involved in the lease strip deals, in most instances, were not acting at arm's length and shared a common interest in inflating the values of the underlying equipment and the values of the leases and residual interests to generate substantial potential tax benefits for the ultimate beneficiaries/customers.[309] As such, the court held that the second lease strip lacked objective economic substance.

Santa Monica Pictures, LLC v. Commissioner

The Tax Court denied capital losses stemming from the 1996 sale of certain assets of the parent company of Metro-Goldwyn-Mayer ("MGM"), holding that a number of the transactions lacked economic substance and business purpose and imposed accuracy-related penalties.[310]

305. *Id.* at 86.

306. *Id.* at 91-102.

307. *Id.* at 104-05.

308. *Id.* at 106-07.

309. *Id.*

310. *See generally* T.C. Memo 2005-104 at 10-16.

1. *Facts*

Similar to *Long Term Capital Holding*, at the heart of this case were high-basis, low-value assets, which the Tax Court described as having "tantalizing tax attributes."[311] The taxpayers entered into partnership transactions designed to allow the tax losses from these assets to be deducted by parties that had not suffered the losses and, to some extent, to allow the same economic losses to be deducted twice. To achieve this result, the owners of the high-basis assets transferred them to a partnership in exchange for partnership interests while the taxpayer contributed cash to the same partnership. Within the same month, the high-basis partnership interests were sold to another partner, and no election was made under § 754 to step down the basis of the assets to their fair market value. Shortly thereafter, some of the high-basis, low-value assets were sold, with the loss being allocated to the partner that had purchased the partnership interest of the original owner of the assets.[312]

2. *Economic Substance Analysis*

Applying the unitary standard, the Tax Court held that a number of the transactions involved lacked economic substance.[313] The facts in this case were even more extreme than in *Long Term Capital Holding*, particularly because three weeks after the formation of the partnership, some of the partners exited it to facilitate the losses to the other partners.[314]

The substantive question discussed by the Tax Court was whether the claimed losses ought to be disallowed even though the taxpayer literally satisfied the relevant partnership basis and loss provisions.[315] Applying the economic substance doctrine—and alternatively, the step transaction doctrine—the Tax Court rejected the taxpayer's argument that formalistic compliance with statutory provisions necessarily entitles it to the tax benefits provided therein, and held that, "[n]otwithstanding its form, the transaction did not, in substance, represent contributions of property in exchange for

311. *Id.* at 10.

312. *See id.* at 103-04 (discussion of the technical application of the partnership rules to the transaction).

313. *Id.* at 153-55.

314. *Id.*

315. *Id.* at 284.

partnership interests."[316] The Tax Court concluded that none of the parties to the transaction had business purpose or economic substance and denied the claimed losses solely on those grounds.

3. *Accuracy-Related Penalties*

Similar to *Long Term Capital Holding*, the Tax Court upheld that the forty percent penalty for gross valuation misstatements applied to the underpayments that result from adjustments to the tax bases that the partnership reported on its tax returns for the relevant years. The Tax Court observed that the gross valuation misstatement penalty applied to the inflation of the basis and was not limited to cases of overvaluation of property, as argued by the taxpayer.[317] Furthermore, the Tax Court refused to allow the taxpayer to rely on the "reasonable cause" exception by virtue of obtaining several opinions from tax professionals.[318]

IV.
LEGISLATIVE PROPOSALS TO CODIFY THE ECONOMIC SUBSTANCE DOCTRINE

In recent years, several legislative proposals to "codify and clarify" the economic substance doctrine have been made.[319] Not only scholars—but also government officials—have criticized these proposals.[320] Some commentators have indicated that rather than codifying or clarifying a common law doctrine, the proposed legislation would set forth a new and

316. *Id.* at 287.

317. *Id.* at 343-44.

318. *Id.* at 360-99.

319. *See, e.g.*, Office of Tax Policy, Dept. of Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* (2000), at 126, *available at* http://www.treas.gov/offices/tax-policy/library/grnbk00.pdf.

320. Samuel C. Thompson Jr. & Robert Allen Clary II, *Coming In From The 'Cold': The Case For ESD Codification* (May 23, 2003), *available at* LEXIS 2003 TNT 102-33 (citing Assistant Secretary of the Treasury for Tax Policy Pamela Olson's statement in her nomination hearings before the Senate Finance Committee: "I do not think that codification of the Economic Substance Doctrine will help."). For recent comments by the IRS Chief Counsel, Donald L. Korb, opposing codification, *see* Allen Kenney, *Korb Speculates on Codification of Economic Doctrine* (Nov. 9, 2004), *available at* LEXIS 2004 TNT 217-2 (IRS Chief Counsel Donald Korb is reported as being opposed to the efforts on Capitol Hill to codify the economic substance doctrine).

higher standard, which has not been adopted by the vast majority of courts.[321] For example, with respect to the profit requirement, one proposed bill would change the objective standard from "reasonable possibility of profit" to "reasonably-expected pretax profit,"[322] a change that is inconsistent with the vast majority of cases.[323] The proposed legislation could apply to common tax structuring and otherwise clearly permissible transactions.[324] For example, certain types of financial trans-

---

321. *See* Kevin D. Dolan, *Notice 98-5 Foreign Tax Credit Arbitrage*, 455 PLI/TAX 1029, 1047-1050 (1999).

322. *See* CHARLES E. GRASSLEY, CARE ACT OF 2003, S. REP. NO. 108-11, at 80 n. 140 (2003) (discussing 108 S. 476 and stating that "a 'reasonable possibility of profit' will not be sufficient to establish that a transaction has economic substance.").

323. The Tax Court confirmed that the standard should be whether the taxpayer had "realistic potential to earn a meaningful profit." *See Andantech LLC*, T.C.M. (CCH) at 1510. For a similar argument, *see* Herbert N. Biller, *ABA Tax Section Offers Comments, Concerns Regarding Care Act Provisions* (Apr. 24, 2003), *available at* LEXIS 2003 TNT 81-74. Biller argued that:

> This proposal goes beyond present law in that it evaluates the taxpayer's "reasonably expected" pre-tax profit rather than the potential for profit. Measured by this standard, a short sale of a security arguably would have no economic substance because the market expectation of positive returns on stocks and bonds means that the reasonably expected rate of return on a short sale is negative. Thus, at a minimum, it should be clarified that "reasonably expected profit" should not be a simple weighted average of the profit that could be realized under all possible market scenarios but should encompass the case where the taxpayer had a significant profit objective and there was a reasonable possibility that that objective could be achieved.

The Joint Committee on Taxation candidly acknowledged a similar concern:

> requiring a pre-tax profit test as part of an economic substance analysis could raise concerns with respect to certain customary leveraged lease transactions, financing arrangements in general, and transactions where the tax benefits are both intended by Congress and significant, but the transaction itself is expected to yield little (if any) profit.

See STAFF OF THE J. COMM. ON TAXATION, 107TH CONG., TECHNICAL EXPLANATION OF H.R. 5095 (THE "AMERICAN COMPETITIVENESS ACT OF 2002"), JCX-78-02 (July 19, 2002), at 6-8, *available at* http://www.house.gov/jct/x-78-02.pdf.

324. James M. Peaslee, *Economic Substance Codification Gets Worse* (May 20, 2003), *available at* LEXIS 2003 TNT 97-28 ("The profit test will be failed by many transactions that should be found to have economic substance."); Terrill A. Hyde & Glen Arlen Kohl, *The Shelter Problem Is Too Serious Not To Change The Law* (July 3, 2003), *available at* LEXIS 2003 TNT 130-44.

actions such as swaps might be treated as lacking economic substance even if clearly entered into for business reasons.

History

As set forth above, in 1999, both the Treasury and the Joint Committee on Taxation released comprehensive reports discussing corporate tax shelters and suggesting alternative routes to fight such transactions. Both reports officially suggested, for the first time, the possibility of "codifying" the common law doctrine of economic substance. In its July 1999 Report on Tax Shelters, the Treasury recommended codifying the economic substance doctrine, generally as a one-prong objective test.[325] It declared that a substantive change is necessary to address corporate tax shelters. Particularly, it decided that the centerpiece of the substantive law change should be the codification of the economic substance doctrine. It also repeated the goals of the doctrine, that is, a comparison of the present values of expected pre-tax profits and expected tax benefits.

The Joint Committee on Taxation proposed a similar standard in its July 1999 report. Finally, a similar proposal was included in the Clinton Administration's Budget Proposal for Fiscal Year ("FY") 2001.[326] The FY 2000 Administration proposal for corporate tax shelters legislature was reviewed by three major commentators: the American Bar Association ("ABA"),[327] the American Institute of Certified Public Accountants ("AICPA"),[328] and the New York State Bar Associa-

325. *See generally* U.S. DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION ANALYSIS, AND LEGISLATIVE PROBLEMS (1999).

326. *See* OFFICE OF TAX POLICY, DEPT. OF TREASURY, GEN. EXPLANATIONS OF THE ADMIN.'S FISCAL YEAR 2001 REVENUE PROPOSALS 124-26 (Feb. 2000) *available at* http://www.treas.gov/offices/tax-policy/library/grnbk00.pdf.

327. Statement of Stefan F. Tucker, on behalf of the Section of Taxation, American Bar Association, before the Committee on Finance (Apr. 27, 1999). The ABA generally followed the Administration's proposal to codify and expand the economic substance doctrine. However, it proposed a narrower reform, and suggested that the doctrine would apply only it currently applies under current doctrine, and suggested not to apply the present value examination proposed by the Administration.

328. Statement of David A. Lifson, on behalf of the Tax Division, American Institute of Certified Public Accountants, before the Committee on Finance (Apr. 27, 1999). The AICPA disagrees with the need to expand the scope of the economic substance doctrine, or disallowance of benefits.

tion ("NYSBA").[329] Out of these three commentators, only the ABA supported a codification of the economic substance doctrine, and to a limited extent. The ABA generally followed the Administration's proposal to codify and expand the economic substance doctrine. However, it proposed a narrower reform, and suggested that the doctrine would apply only as it currently applies, and suggested not to apply the present value examination proposed by the Administration.

Also in 1999, Congressman Lloyd Doggett introduced a bill to curb tax abuses by disallowing tax benefits claimed to arise from transactions without substantial economic substance and increasing the understatement penalty with respect to such transactions.[330] The proposal reflected the comments made by the ABA on the FY 2000 Administration proposal.

In particular, the proposal contains three major elements: first, section 3 of the bill proposed to amend § 7701, to disallow non-economic tax benefits, including deductions, losses, or credits arising from a corporate tax shelter.[331] Second, the exception to the disallowance would be when the transaction changed meaningfully the taxpayer's economic position, and when the non-tax benefits are significant relative to the tax benefits. Third, with respect to financing transactions, deductions would be disallowed if such benefits are significantly in

329. New York State Bar Association, Tax Section, Report on Corporate Tax Shelters of New York State Bar Association Tax Section, 83 Tax Notes 879 (1999).

330. Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong. (1st Sess. June 17, 1999).

331. *Id.* § 3. The deductions, losses, and credits referred to in the Act are classified as non-economic tax attributes, defined as: "Any deduction, loss, or credit claimed to result from any transaction unless:

> the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the present value of the reasonably expected potential income from the transaction (and the taxpayer's risk of loss from the transaction) are substantial in relationship to the present value of the tax benefits claimed, or in the case of a transaction [involving] the borrowing of money or the acquisition of financial capital, the deductions claimed with respect to the transaction for any period are not significantly in excess of the economic return for such period realized by the person lending the money or providing the financial capital.

See id.

excess of the economic return of the other party to the transaction.

During 2001-2002, two bills were proposed to codify the economic substance doctrine as part of § 7701.[332] Under proposed § 7701(m)(B):

> [A] transaction has economic substance only if—
> (i) the transaction changes in a meaningful way (apart from Federal Income Tax effects) the taxpayer's economic position, and
> (ii) the taxpayer has a substantial nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[333]

House Committee on Ways & Means Chairman Bill Thomas proposed to codify economic substance as part of his international reform bill that was introduced for mark-up by the Committee on July 11, 2002,[334] but the Senate Finance Committee had not included codification in any of its tax shelter legislation. The Committees subsequently switched positions on the issue. During 2003, the attempts to codify or clarify the doctrines continued with the introduction of two almost identical proposed provisions in the Jobs and Growth Reconciliation Tax Act of 2003,[335] and the Care Act of 2003.[336]

---

332. H.R. 2520, 107th Cong. (1st Sess. July 17, 2001) (also proposed by House Ways & Means member Lloyd Doggett); American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. (2d Sess. 2002) (proposed by Houses Ways & Means Chair William Thomas).

333. H.R. 5095, § 101. This quoted section adopts the rigid two-prong conjunctive test.

334. *Id.*

335. Jobs and Growth Reconciliation Tax Act of 2003, Pub. L. No. 108-27, S. 1054, 108th Cong. (reported by the Senate Finance Committee on May 8, 2003, passed by the Senate on May 16, 2003). *See* J. COMM. ON TAXATION, SUMMARY OF CONFERENCE AGREEMENT ON H.R. 2, THE JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003, JCS-54-03 (May 22, 2003), *available at* http://www.house.gov/jct/x-54-03.pdf.

336. Care Act of 2003, S. 476, 108th Cong. §701, "Clarification of Economic Substance Doctrine" (passed by the Senate on April 9, 2003). Many similar proposals were introduced. *E.g.*, 149 CONG. REC. S96-S98 (daily ed. Jan. 9, 2003) (statement of Sen. Mark Dayton); H.R. 2286, 108th Cong. (1st Sess. 2003) (Rep. Charles B. Rangel); H.R. 2286, 108 Cong. (1st Sess. June 22, 2003); Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003, H.R. 1555, 108th Cong. (1st Sess. 2003) (Rep. Lloyd Doggett); Rebuild America Act of 2003, S. 1409, 108th Cong. §1101 (1st Sess. 2003); Sales

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

On September 18, 2003, Senators Grassley and Baucus, the chair and ranking minority member of the Senate Finance Committee, introduced the Jumpstart Our Business Strength (JOBS) Act of 2003. Section 401 of the JOBS Act would codify the economic substance doctrine, consistent with the Charity, Aid, Recovery, and Empowerment (CARE) Act.

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

The Latest Version: The Jobs Act of 2004[337]

The following is a summary of the important elements of the proposed codification of the doctrine in the Jobs Act of 2004, which, as set forth above, was rejected by the conferees.

Tax Equity Act of 2003, S. 1436, 108th Cong. § 201 (1st Sess. 2003); Tax Shelter Transparency and Enforcement Act, S. 1937, H.R. 3560, 108th Cong. (1st Sess. 2003); Progressive Tax Act of 2003, H.R. 3655, 108th Cong. (1st Sess. 2003); Highway Reauthorization And Excise Tax Simplification Act, S. 1072, 108th Cong. § 5611 (proposing codification of the economic substance doctrine in new § 7701(n), to be effective for transactions entered into after February 2, 2004), § 5614 (proposing new § 6662B, the strict liability economic substance penalty, effective for transactions entered into after February 2, 2004) (2d Sess. 2004); S. Amendment No. 2645 to S.1637, the Jumpstart Our Business Strength (JOBS) Act § 401 (Mar. 3, 2004); Substitute amendment to S. 1637, the JOBS Act, § 401, 2004 TNT 57-19 (Mar. 23, 2004); Substitute for S. 1637, the JOBS Act, § 401 (Apr. 5, 2004), 2004 TNT 67-38; Tax Shelter and Tax Haven Reform Act, S.2210, § 301 (codification of economic substance doctrine), § 303 (economic substance strict liability penalty), 2004 TNT 51-15 (Mar. 12, 2004) (Sen. Carl Levin, Ranking Democrat on the Senate Permanent Subcomm. on Investigations).

337. Jumpstart Our Business Strength (JOBS) Act. S. 1637, 108th Cong. (1st Sess., Nov. 7, 2003). *See also* S. REP. No. 108-192 (2003) (reporting on JOBS Act).

A similar version was re-proposed in H.R. 3, the Highway Reauthorization and Excise Tax Simplification Act of 2005 (§ 5521). As this article concludes, the current version should not be adopted not only because it is questionable whether codification of common law doctrines is the right answer, but also because the current proposal is inconsistent with the majority of court decisions on economic substance.

1. *Scope of the Doctrine*

The proposed standard would apply only if a court determines that the economic substance doctrine is relevant for the disputed transaction.[338] If the court determines that the doctrine is relevant, the transaction will be validated only if the proposed two-prong standard discussed below would be met.[339] Thus, a court may simply decide that there is no need to apply the doctrine on a transaction. Courts frequently refuse to apply common law doctrines when a taxpayer clearly satisfies the applicable statutory requirements.

Pursuant to proposed § 7701(n)(3)(A), the term "economic substance doctrine" means "the common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." Thus, the proposed test is *conjunctive.* The proposed codification only applies to businesses. For individuals, the doctrine applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.[340] The proposed legislation specifies that other common law doctrines are not affected.[341]

---

338. Proposed § 7701(n)(1)(a) would set forth that: "[i]n any case in which a court determines that the economic substance doctrine is relevant for purposes of this title to a transaction (or series of transactions), such transaction (or series of transactions) shall have economic substance only if the requirements of this paragraph are met." 150 CONG. REC. S3591 at §11 (daily ed. Apr. 1, 2001) (S. Amendment 3009, submission of Sens. Rockefeller and Nelson).

339. *Id.* Thus, a court may choose not to apply the new proposed statutory standard. *See* Monte A. Jackel, *For Better or For Worse: Codification of Economic Substance,* 103 TAX NOTES 1069 (2004); James M. Peaslee, *Dover Done In By Senate ETI Bill; Don't Be The Last To Know,* 103 TAX NOTES 1412 (2004).

340. 150 CONG. REC. S3591, § 11 (Proposed § 7701(n)(3)(C)).

341. *Id.* (Proposed § 7701(n)(4)).

2. *A Conjunctive Two-Prong Test*

A transaction would have economic substance only if the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer's economic position, *and* the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[342]

In my view, there are two main problems with this proposed conjunctive standard. First, as set forth above, courts are divided with respect to how to apply the two-prong test, and, certainly, several recent cases have indicated that it is not so common to apply the conjunctive two-prong test.[343] Second, the proposed prongs do not reflect the prevailing authorities on economic substance. With respect to the objective prong, various courts have applied a reasonable expectation for profit test rather than the broader test suggested in the proposed legislation. Third, and more significantly, the second requirement of the subjective test implies a requirement not only that the taxpayer has significant non-tax purpose, but also that the taxpayer is not free to choose how to get there (i.e., a "reasonable means" test).[344] As set forth above, this standard is also inconsistent with the vast majority of courts' decisions.

3. *Relying on Potential for Profit*

As stated above, many taxpayers have attempted to assert that their transactions have economic substance by virtue of having potential for profit. As the Senate Report for the Jobs Act of 2004 indicates, many courts denied tax benefits on the grounds that the questioned transactions lacked more than *de minimis* profit potential.[345] The Senate Report also indicates that some courts have applied the profit requirement in a more rigid way and disallowed tax benefits even when the tax-

342. *See id.* (Proposed § 7701(n)(1)(B)(i)(I)&(II)).

343. *Cf. Horn*, 968 F.2d at 1235 (the economic substance of a transaction can be established if the transaction at issue had objective economic substance or if there was a subjective non-tax business purpose); *Sanderson*, T.C. Memo 1985-477 at 2136.

344. *Long Term Capital Holding*, 330 F. Supp. 2d at 183.

345. S. REP. No. 108-192 at 85 (2003) (citing Knetsch, 364 U.S. 361 (1960); Goldstein, 364 F.2d 734 (2d Cir. 1966); Ginsburg v. Comm'r, 35 T.C.M. (CCH) 860 (1976)).

payer was exposed to risk and the transaction had a profit potential, but the economic risks and profit potential were insignificant when compared to the tax benefits.[346]

Under Proposed § 7701(n)(1)(B)(ii), if a taxpayer attempts to rely on potential for profit:

> A transaction shall not be treated as having economic substance by reason of having a potential for profit unless:
>
> (i) the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected, *and*
>
> (ii) the reasonably expected pre-tax profit from the transaction exceeds a risk-free rate of return.[347]

The first part of the proposed rule requires that the potential profit be not only more than *de minimis*, but also significant in relation to the expected net tax benefits from the disputed transaction. This standard has been accepted only by a few courts,[348] and is clearly inconsistent with decisions across all circuits and courts. Furthermore, the requirement of at least a risk-free rate of return imposes another burden on the taxpayer, which is, once again, inconsistent with the majority view. Commentators have criticized the comparison with the tax benefits approach[349] and the risk-free minimum return approach.[350]

Note that pursuant to § 7701(n)(1)(C), for purposes of the profit-potential test, "[f]ees and other transaction ex-

---

346. *Id.* (citing *Goldstein*, 364 F.2d at 739-40; Sheldon, 94 T.C. at 768). Note that in *Sheldon*, the taxpayer argued that *Goldstein* supports the proposition that any gain will suffice. *Sheldon*, 94 T.C. at 767-68.

347. 150 CONG. REC. S3591.

348. *E.g.*, *Sheldon*, 94 T.C. at 768.

349. Bankman, *The Economic Substance Doctrine* supra note 2, 23 n.33 ("This passage suggests that the court [in *Saba*] favored an approach that compared tax benefits to pretax profits—an approach consistent with the Treasury Department's shelter proposals but inconsistent with most case law on point.").

350. *See NYSBA Objects To Codification Of Economic Substance Provisions*, 2003 TNT 102-19 (May 21, 2003). *See also* Warren, *supra* note 29 at 989 (stating that while "a dollar's worth of economic profit" is insufficient to validate a transaction, a requirement of a full market return is "incoherent.").

penses and foreign taxes shall be taken into account as expenses in determining pre-tax profit." This provision responds to the *Compaq* and *IES* cases.

A Criticism of the Proposed Codification

As set forth above, the proposal to codify the economic substance doctrine has been widely criticized. An exchange between the Chairman of the Senate Committee on Finance, Senator Charles E. Grassley, and the Acting Assistant Secretary of the Treasury for Tax Policy, Pamela F. Olson, at a Finance Committee hearing during August 2004 describes the Treasury's rationale for NOT codifying the economic substance doctrine:

> Senator Grassley. Let us go back to this committee's effort to crack down on tax shelters . . . Do you believe that codification of the Economic Substance Doctrine will help or hinder our goal of combating tax shelters?
>
> Ms. Olson. I do not think that codification of the Economic Substance Doctrine will help. I do not think it will help for several reasons, but I would like to maybe mention a couple of them . . . . One, is that the doctrine right now is a very flexible doctrine that is applied by the courts as needed. I think any codification of it, even if in codifying it we say that we do not intend to override any other doctrines, I think it is going to make it more wooden and less flexible than it currently is. If that happens, then it has the potential for being both too broad and too narrow. So, that is a real danger. . . . A more serious danger I see with it, is I think it adds to the complexity for the IRS in its enforcement of the laws and assertion of penalties in appropriate cases because it is yet another set of things that they need to consider, work through, and look at in doing an audit of a taxpayer. . . . So I think that it has the potential to slow IRS audits, and anything that slows IRS audits is not a good thing. I think that what we need at this point is

more enforcement, and the IRS being able to complete more audits as rapidly as possible.[351]

Nevertheless, despite the lack of support for the codification of the doctrine and its rejection by the House of Representatives in the Jobs Act of 2004,[352] as set forth above, the 109th Congress is about to reconsider the codification, as a part of the Highway Bill in the near future. There are two main reasons for my view that even if the current version is not adopted in the Highway Bill, codification of the economic substance will be back on the table soon. First, as estimated by the Joint Committee on Taxation in 2004, the revenue associated with the provision (estimated at more than $13 billion over 10 years)[353] are more than significant.[354] Second, the recent taxpayer victories in the three different courts (discussed above) that rejected the government's reliance on the economic substance doctrine to deny tax benefits from structured transactions may motivate the government to support the codification.[355]

V.
CONCLUSION AND PROPOSAL

Since *Frank Lyon*, circuits have been divided on how to apply the two-prong test. As set forth above, the inconsistency is reflected in several ways. First, each circuit has chosen a different path pertaining to the test; some circuits apply the conjunctive test, others apply a disjunctive test, and the rest apply a unitary analysis. In addition, some circuits— such as the Sec-

351. *See* Cummings & Hanson, *supra* note 7, at 4-5 (quoting *Nomination of Pamela F. Olson to be Assistant Secretary of the Treasury: Hearing before the S. Comm. on Fin.*, 107th Cong., S. Hrg. 107-742, 8-9 (Aug. 1, 2002)). For recent comments by the IRS Chief Counsel, Donald L. Korb, opposing codification, *see Korb Speculates on Codification of Economic Substance Doctrine*, 2004 TNT 217-2 (Nov. 9, 2004) (reporting IRS Chief Counsel Donald Korb as being opposed to the efforts on Capitol Hill to codify the economic substance doctrine).

352. Title VIII, Subtitle B of the Act, entitled "Provisions Relating to Tax Shelters", includes 49 separate provisions. *See generally* H.R. 4520.

353. J. COMM. ON TAXATION, ESTIMATED REVENUE EFFECTS OF S.1637, JCX-36-04, at 4 (May 20, 2004), *available at* http://www.house.gov/jct/x-36-04.pdf (estimating $13.315 billion of revenue over ten years from the codification of economic substance).

354. *See* Cummings & Hanson, *supra* note 7, at 4-6.

355. *Id.*

ond and the Eighth—are internally inconsistent. Finally, almost every circuit has applied the disjunctive test at least once. Tax Courts also do not follow a uniform standard.

Recent year has shown that the confusion is about to grow. The recent cases discussed in this article illustrate not only inconsistent application of the economic substance doctrine, but also inconsistent application of the two-prong test within a given circuit. For example, while the court in *Long Term Capital Holding* seemed convinced that the prevailing standard in the Second Circuit is the unitary analysis,[356] the court in *TIFD III-E Inc.* did not dismiss the taxpayer's assertion that the Second Circuit could apply the disjunctive test.[357] As set forth above, most circuits have considered applying the disjunctive test at some point. The Court of Federal Claims in *Coltec Industries* not only held that the disjunctive test is the relevant one, but also decided that a § 357(b) business purpose analysis is adequate for purposes of satisfying the two-prong test.[358] By contrast, in the equivalent situation in *Black & Decker*, the parties stipulated that the taxpayer had no business purpose as a factual matter, and the court only focused on economic substance.[359] *Black & Decker* applied the Fourth Circuit's disjunctive test,[360] using a unique combination of *Rice*'s *Toyota* (the prevailing authority in the Fourth Circuit) and *Moline Properties.*

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

---

356. 330 F. Supp. 2d at 199 n.99 (rejecting the taxpayer's attempted reliance on Gilman v. Comm'r).

357. 342 F. Supp. 2d at 109.

358. 62 Fed. Cl. 716, 754 (2004).

359. 340 F. Supp. 2d at 623-624.

360. *Id.*

In the absence of codification, it is up to the courts and the IRS to search for uniformity. Having reviewed numerous cases involving economic substance analysis across all circuits and courts, I believe that a possible solution, acceptable by all circuits, would be to transform the two-prong test into a single, flexible, objective standard. Such a standard would revive the original substance-over-form analysis conducted by the Supreme Court in *Gregory v. Helvering* without contradicting the current standard applied by all circuits.

Specifically, the standard would be whether the transaction had any economic effect on the taxpayer, apart from tax benefits. In particular, where potential profit from the transaction is measurable, the test should be whether the reasonably expected profit from the transaction exceeded the expected costs. This is, the reader will observe, the prevailing standard for the objective prong of the two-prong test. The question is what to do with the subjective prong; for example, how do we reconcile it with the view in the Fourth Circuit? The answer is that in the vast majority of cases, even ones applying the two-prong test, the subjective intent has been incorporated into the objective analysis, either by examining the subjective intent on an objective basis, or simply by inferring business purpose in cases where the court found objective economic substance. Put broadly, it is much more likely that a court would first find economic substance and then infer business purpose than the converse, where the court would infer economic substance from a subjective analysis of the taxpayer's intent. In addition, it is very unlikely that a court, even in the Fourth Circuit, would validate a transaction on the grounds that it had business purpose but not economic substance,[361] but much more likely that a court applying the disjunctive test would first find objective economic substance and validate the transaction with no need to examine business purpose. For those who still view the subjective prong as essential, the subjective test could remain relevant, but only as one factor among others in the overall determination of economic substance.

Adoption of such a standard, therefore, should not be inconsistent with the prevailing disjunctive test, because courts

361. *See, e.g., Hines*, 912 F.2d at 741.

would simply collapse the two prongs into a single test that reflects the standard such courts have been applying.

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

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

In addition, the subjective prong is generally mute in cases involving business entities, because, business entities generally are created and operate to make a profit. Thus, it is implicit that a business entity will have a business purpose for any transaction the expected benefits of which exceed the expected costs.[362] With respect to individuals, various statutory rules—including §§ 108, 165 and 183—contain subjective business purpose requirements (usually in the form of a "primarily-for-profit" requirement) for purposes of validating a deduction, and such rules ought to govern in the applicable cases.[363]

In addition, I suggest that the comparison between tax benefits and non-tax benefits would not be followed, not only because it is inconsistent with the vast majority of cases across all circuits, but also because it is unfair to a taxpayer entering into a transaction with expectations for a more than *de minimis* profit and potential risk of loss. From *Gregory v. Helvering* to *Compaq*, courts have clearly stated that a taxpayer may have significant tax motivation, as long as it has some non-tax purpose, and as long as the motivation is meaningful. Neither the court nor the IRS can establish a higher standard.[364]

---

362. For a similar view, *see* Department of the Treasury, *The Problem of Corporate Tax Shelters* (July 1999), *available at* http://www.treas.gov/press/releases/reports/ctswhite.pdf

363. *See* §§ 108, 165, 183 (2004).

364. Gregory v. Helvering, 293 U.S. 465 (1935); *Compaq Computer Corp.*, 277 F.3d at 788.

Lastly, for the same reasons, a requirement that the taxpayer earns at least a risk-free return should not be adopted. There are no legal grounds for requiring the taxpayer to make at least a certain return on a transaction in order to be eligible for the tax benefits associated with the transaction.