

TAX LITIGATION ISSUES

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Tax Shelters and Economic Substance Doctrine Hotly Litigated

The government's full-blown pursuit of corporate tax shelters has suffered three significant defeats in the past few months, leaving the strength of the Internal Revenue Service's (IRS) "economic substance" argument in serious question.

However, these decisions stand in contrast to the government's almost simultaneous advances in its attack on corporate tax shelters with a substantial victory in the *Long Term Capital Holdings* case and the passage of 2004 legislation,¹ which integrates sweeping changes to the tax shelter provisions of the Internal Revenue Code (code).

The essence of the economic substance argument is that a transaction cannot be used as the basis for a deduction if it lacks economic substance or a "realistic potential for profit."² This requirement is meant to ferret out "sham" or fictitious transactions that have no business purpose other than the creation of a tax deduction.

In determining whether a transaction has economic substance, a court engages in a two-pronged inquiry, evaluating (i) the subjective business purpose of the taxpayer for engaging in the transaction



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and (ii) the transaction's objective economic effect. The U.S. Court of Appeals for the Second Circuit has applied a "prudent investor standard" to this analysis to determine whether it would have been reasonable for a prudent investor to make the investment with a profit motive.³

The Government's Losses

The first of the government's recent defeats in its reliance on the economic substance doctrine came in *Black & Decker Corp. v. United States*,⁴ decided on Oct. 22, 2004 in the U.S. District Court for the District of Maryland.

In 1998, Black & Decker created a subsidiary, BDHMI, to which it transferred approximately \$561 million in assets in exchange for the subsidiary's assumption of approximately \$560 million in contingent employee health care claims and newly issued BDHMI stock. Black & Decker later sold the BDHMI stock to a third party for \$1 million and claimed a \$560 million loss on its tax return predicated upon its assertion that the \$561 million in assets that it transferred to BDHMI constituted its basis in the stock. The government argued that the BDHMI

transaction should be voided because it was a tax avoidance scheme that lacked economic substance. Although Black & Decker conceded that tax avoidance was its sole factor in conducting the BDHMI transaction, it pointed to the second prong of the economic substance test, arguing that the transaction had objective economic effect and, therefore, had economic substance.

The court concurred with Black & Decker in its analysis, stating that despite any tax avoidance motive, the transaction had real economic implications for the beneficiaries of the Black & Decker employee benefits program and for the parties involved in the transaction.⁵

A week after the Black & Decker decision, the Court of Federal Claims reached a similar decision in *Coltec Industries, Inc. v. United States*.⁶

The 'Coltec' Case

In *Coltec*, a corporate taxpayer established a subsidiary for the purpose of managing hundreds of thousands of asbestos cases in which it had been involved. The "case management subsidiary," Garrison Litigation Management Group Ltd. (Garrison), issued common stock to Coltec in exchange for totaling over \$375 million. Garrison also assumed the defense and payment of certain asbestos liabilities. After the sale of its Garrison stock for \$500,000, Coltec claimed a loss of approximately \$370 million, which disallowed the deduction.

The court rejected the government's

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contention that Coltec's loss should be disallowed because the assumption of the asbestos liabilities should reduce its basis in the stock,⁷ and found that the Garrison transaction had a bona fide business purpose, thereby giving it "economic substance." Specifically, Garrison's assumption of Coltec's liabilities served to remove the specter of asbestos liability from the parent company, making Coltec more attractive to potential buyers. The court also found that the transaction prevented asbestos litigants from piercing the corporate veil to reach Coltec's assets. Moreover, the court concluded that there was a clear relationship between the liabilities and the companies' ordinary businesses. Accordingly, the transaction had economic substance separate and apart from its tax consequences.

Finally, the court engaged in a detailed analysis of the evolution of the economic substance doctrine and its convoluted application. Questioning the vitality of the doctrine, the court noted that Congress consistently has rejected proposals to codify the economic substance doctrine. "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 [c]ode' would violate the separation of powers."⁸

Three days after the decision in *Coltec*, the government suffered a third blow in its attempts to use the economic substance doctrine to invalidate tax shelters in the U.S. District Court for the District of Connecticut's decision in *TIFD III-E v. United States (Castle Harbour)*.⁹ Castle Harbour was a Nevada limited liability company formed by General Electric Capital Corp. (GECC) for the purpose of raising cash with respect to GECC's ownership of certain older aircraft, which it could neither sell nor borrow against. GECC contributed assets to Castle Harbour including \$296 million in cash and aircraft with a net value of

\$272 million. Soon thereafter, GECC sold an interest in Castle Harbour to two Dutch banks for \$50 million. In exchange for the Dutch banks' initial and subsequent cash investments, the parties executed an operating agreement that provided that the banks were to have a significant portion of their ownership interests in Castle Harbour redeemed pursuant to payments scheduled over an eight-year period.

Pursuant to that agreement, operating income was allocated 98 percent to the Dutch banks with the remaining 2 percent to GECC for both book and tax purposes, while most of the gains and losses from the sale or disposition of the aircraft were allocated to GECC. Operating income

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was defined as rent and interest minus expenses, which included aircraft depreciation. While the aircraft had already been fully depreciated for tax purposes, there remained substantial book depreciation, which offset a significant amount of the annual rental income on the aircraft. Because of this difference between depreciation allowed for tax purposes and depreciation allowed on the books, the net book income allocated to the Dutch banks was significantly less than the banks' taxable income.

In taking the position that the taxable income under the agreement should be reallocated, the government argued that the formation of Castle Harbour was a sham and should be disregarded for tax purposes. Applying the two-prong economic substance test, the court rejected this argument. The court found

that the transaction had real economic value in that the Dutch banks received operating income under the agreement in exchange for their contribution of approximately \$117 million. Furthermore, the court found a legitimate business purpose in GECC's plan to raise capital and demonstrate liquidity.¹⁰

In analyzing the economic substance of the Castle Harbour transaction, the court noted some ambiguity among courts within the Second Circuit with respect to the application of the economic substance test. Some courts engage in a firm application of the test, finding that if there is either a subjective business purpose to the transaction or an objective economic effect aside from the tax ramifications, the transaction has economic substance and is not a sham. More recently, the decision in the *Long Term Capital* case (discussed below), adopted a flexible interpretation of the economic substance test, which considers both the subjective and objective prongs of the test, but does not make either dispositive on the issue of the economic substance of the transaction in question. The court in *Castle Harbour* held that this ambiguity did not affect its decision as the transaction satisfied both applications of the test.¹¹

Despite this series of defeats, the government can claim a significant victory from the August 2004 decision in *Long Term Capital v. United States* originating out of the U.S. District Court for the District of Connecticut (the same court that would decide *Castle Harbour* two months later). As has been noted repeatedly by journalists and tax experts, the *Long Term Capital* case is noteworthy for much more than its use of the economic substance doctrine to reject the transactions at issue. Rather, the court's rejection of the tax opinions rendered by counsel and re-lied upon by the taxpayer in engaging in the transactions in question, has had considerable impact on tax practitioners and their clients.¹² However, the decision in *Long Term Capital* does provide the government with

ammunition to argue that the economic substance argument is alive and well.

'Long Term Capital' Facts

The facts in *Long Term Capital* are unusually long and complicated, involving a series of high-basis, low-value preferred stock transactions related to the acquisition of multiple leasing agreements. The taxpayers claimed a basis of more than \$100 million in the stocks having a value of approximately \$1 million.

At issue was a long-term capital loss of \$100 million claimed upon the sale of the stock. After reviewing the facts, the court concluded that "while Long Term approached the ... transaction fully conscious of the tax law's requirement of economic substance, including consideration of pre-tax profit potential, Long Term had no business purpose for engaging in the transaction other than tax avoidance and the transaction itself did not have economic substance beyond the creation of tax benefits."¹³

Specifically, there was no "realistic expectation of profit" from the transactions. Furthermore, relying on the "prudent investor" standard, the court stated that the absence of reasonableness in the transaction — a prudent investor would not have made the deal — "shed light on Long Term's subjective motivation, particularly given the high level of sophistication possessed by Long Term's principals in matters economic."¹⁴

Tax Shelter Enforcement

Notwithstanding the decision in *Long Term Capital*, there is some doubt as to the strength of the economic substance doctrine and its application to transactions involving tax shelters. The decisions in *Black & Decker*, *Coltec* and *Castle Harbour* demonstrate the courts' wariness of the doctrine and willingness to find legitimate business purposes for or effect from the transactions even where tax avoidance is an admitted goal of the taxpayer.

Moreover, the sole fact that the expectation of profit is based on tax deductions or credits does not mandate a conclusion that a transaction is a sham if there is substance to the transaction beyond the sheltering of income. Appeals of these decisions, as well as the district court's decision in *Long Term Capital*, will be heard by three different courts of appeals. To be certain, further decisions addressing the doctrine and its application will be forthcoming.

In the interim, while the district court in *Coltec* suggested that the courts are looking to Congress to set clearer parameters around the economic substance doctrine, it is notable that Congress did not include proposed legislation that would have codified the economic substance doctrine in its recent overhaul of the rules governing tax shelters in the American Jobs Creation Act of 2004 (the Jobs Act).¹⁵

This recent trend in cases and congressional inaction with respect to the economic substance doctrine should not result in false comfort. It is clear that the government, including the IRS and the legislative branch, intend to continue their crackdown on corporate tax shelters. The Jobs Act passed by Congress in October 2004 contains new rules discouraging such transactions, including new disclosure and tax shelter registration requirements, and imposes harsh penalties for noncompliance. Furthermore, the widespread implications of the *Long Term Capital* decision signal some support from the courts for limiting perceived sham tax shelters and a willingness to hold the taxpayers accountable despite reliance on advice from counsel.

Thus, while the government's reliance on the economic substance doctrine to fight tax shelters is in question, it still has many tools at its disposal in forging these battles.



1. P.L. 108-357.

2. *Ferguson v. Comm'r*, 29 F3d 98, 101 (2d Cir. 1994) (per curiam); *Gilman v. Comm'r*, 933 F2d 143, 148 (2d

Cir. 1991).

3. *Long Term Capital Holdings v. United States*, 330 FSupp2d 122, 171-173 (D. Conn. 2004) (setting forth Second Circuit analysis requiring a "realistic expectation of economic profit").

4. 340 FSupp2d 621 (D. Md. 2004).

5. Id. at 623-24.

6. 62 Fed. Cl. 716 (2004).

7. Pursuant to §§351 and 358 of the Internal Revenue Code, Coltec calculated that its basis in the Garrison stock was equal to the amount of assets contributed to Garrison. The government argued that Garrison's assumption of the asbestos liabilities should reduce Coltec's basis in the stock. Generally, the assumption of liability does not affect the basis of the stock received by the transferor unless there is no bona fide business purpose for the assumption of the liability or its principal purpose is to avoid federal income tax. Sections 351, 358(d)(2), 357(b)(1), (c)(3). In this case, the court found neither to be the case. Rather, several factors existed which indicated that a bona fide business purpose existed for the assumption of liabilities by Garrison. Id. at 738-45.

8. Id. at 756.

9. *TIFD III-E Inc. v. United States*, 342 FSupp2d 94 (D. Conn. 2004).

10. Id. at 111. The government also argued that the allocation of income under the operating agreement violated §704(b) of the Internal Revenue Code. Section 704(b) and rules promulgated thereunder, provide that a partner's share of income is generally determined by partnership agreement, but will be determined "in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)" if the allocation to a partner under the agreement "does not have substantial economic effect." The analysis of "substantial economic effect" under this provision is similar to the two-pronged economic substance test; first, the allocation must satisfy an objective "economic effect" test which generally requires that capital accounts be properly maintained; and second, the "economic effect" must be subjectively substantial. The court rejected this argument as well, finding that agreed-upon allocation by GECC and the Dutch banks satisfied the substantial economic effect test. Id. at 113-14.

11. Id. at 109.

12. See Richard M. Lipton, "Reliance on Tax Opinions: The World Changes Due to Long Term Capital Holdings and the AJCA," *Journal of Taxation*, December 2004; Richard A. Levine, "A Tax Opinion Is Not a Bulletproof Vest," *Metropolitan Corporate Counsel*, Vol. 12, No. 11, November 2004.

13. 330 FSupp2d at 172.

14. Id. at 186.

15. S. 1637, 108th Cong., Section 402 (2004).

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