The Corporate Counselor®

Volume 19, Number 8 • January 2005

ALM

The Role Of Economic Substance In Tax Shelter Controversies

Three Recent Cases Give Taxpayers Hope That The Courts Will Be Discriminating In Their Use Of The Doctrine

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In its assault on corporate tax shelters, the Internal Revenue Service (IRS) — with considerable help from Treasury and Congress — has added new weapons to its arsenal and has honed its existing weaponry.

Tax Shelter Enforcement: The Current Climate and the Role of the Economic Substance Doctrine

With mandatory disclosure requirements for reportable transactions, registration and list maintenance requirements for tax shelter promoters, summons enforcement actions against promoters, targeted audit inquiries, and new, tougher penalties for those who fail to disclose, the IRS has become better equipped at identifying tax-aggressive transactions.

The IRS also is taking an increasingly coordinated and hardened stance in the audit and administrative appeals process. For widely used tax shelters, the IRS is adopting tough settlement guidelines, which require participating taxpayers to concede most if not all of the taxes and even some of the penalties. With respect to penalties, the IRS is making greater use of the 40% gross valuation misstatement penalty and toughening the requirements that corporate tax shelter participants must satisfy if they are to fall within the "reasonable cause and good faith" exception to accuracy-related penalties.

Coupled with the IRS's efforts to list and categorize transactions that are potentially abusive is a tendency to lump together transactions that share certain structural features and slap the "tax shelter" label on all of them. Once that label has been affixed, taxpayers are finding that the IRS often is entrenched in its position and unable or unwilling to objectively view the unique facts of a specific transaction. Rather than settling on the IRS's stark terms and even if it means risking penalties, some intrepid taxpayers are taking their transaction to the courts for a second look.

Here the Government brandishes its cherished conventional weapon against corporate tax shelters — the economic substance doctrine. Most tax shelters transactions comply with the technical requirements of the Internal Revenue Code. In fact, the hallmark of a tax shelter is not that it is technically defective, but that it lacks a non-tax economic substance or a non-tax business purpose, or both. Because its statutory or regulatory arguments against the transaction often will be unavailing, the Government relies heavily on the judicial, common law, economic substance doctrine to deny the taxpayer the tax benefits of a transaction that would otherwise work under a literal interpretation of the tax law.

In three recent decisions, the courts reminded the Government that the economic substance doctrine is not a blunt-force instrument to be used indiscriminately without regard to the particular factual nuances of a given transaction, but rather must be used selectively and with some care. In each of the cases, the courts rejected the Government's efforts to use the economic substance doctrine to disregard the taxpayer's restructuring of its on-going business activities. The decisions, issued within a few weeks of each other, all held for the taxpayer despite the Government's allegations that the transactions at issue were tax avoidance vehicles. *Black & Decker Corp. v. United States*, 340 F.Supp.2d 621, (D. Md. Oct. 22, 2004); *Coltec Indus. Inc. v. United States*, 62 Fed. Cl. 716, (Oct. 29, 2004); *TIFD III-E Inc.* (*Castle Harbour*) *v.*

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United States, ___ F.Supp.2d ___, 2004 94 A.F.T.R.2d 2004-6635, 2004-2 USTC P 50,401, (D. Conn. Nov. 1, 2004).

Black & Decker

In 1998, Black & Decker decided that it could more proactively manage liabilities arising under its health care benefit plans by outsourcing the liabilities to a joint venture company named Black & Decker HealthCare Management, Inc. (BDHMI). At the end of 1998, Black & Decker transferred $561 million to BDHMI in exchange for a class of BDHMI stock and BDHMI's assumption of Black & Decker's contingent health care liabilities for 1999 through 2007, actuarially estimated and present valued at $560 million. The stock was later sold to an independent, third-party investor for a fair market value of $1 million, resulting in a $560 million capital loss.

In the Fourth Circuit, to which an appeal of the *Black & Decker* decision would lie, the sham transaction doctrine does not apply if the taxpayer can show either that it had a non-tax business purpose for the transaction or that the transaction has economic substance. *See, Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985). Solely for purposes of the summary judgment motion, Black & Decker conceded for the sake of argument that the sole motive for the transaction was tax avoidance. Relying on *Moline Properties v. Comm'r*, 319 U.S. 436 (1943); *United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001); and *N. Ind. Pub. Serv. Co. v. Comm'r*, 115 F.3d 506 (7th Cir. 1997), Black & Decker argued that the transaction could not be disregarded under a sham theory because the health care liability management subsidiary created in the transaction engaged in bona fide and substantial business activities.

The court had no difficulty finding that the transaction had "very real economic implications." The health care liability management subsidiary has assumed the responsibility for the management, servicing, and administration of plaintiff's employee and retiree health plans; has considered and proposed numerous health care cost containment strategies since its inception in 1998, many of which have been implemented by Black & Decker; and has always maintained salaried employees. Moreover, as a result of the transaction, the subsidiary became responsible for paying the health care claims of Black & Decker employees with its own assets.

Deciding for Black & Decker, the court held that a "corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide, economically-based business transactions." Accordingly, the court concluded that it "may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes."

Coltec

Like Black & Decker, Coltec claimed a capital loss arising from the sale of stock in a subsidiary set up to manage contingent liabilities. While *Black & Decker* involved the company's efforts to manage rapidly escalating employee and retiree health care benefits costs, Coltec was struggling with asbestos liabilities of two companies owned by Garlock, Inc., which Coltec acquired in 1976. In September 1996, Coltec created Garrison Litigation Management Group. In a §351 exchange, Garlock transferred a $375 million note, stock, rights to future asbestos insurance recoveries, and the assets and records of the Asbestos Litigation Department in exchange for stock in Garrison and Garrison's assumption of Garlock's asbestos liability. Garlock later sold the high basis, low value Garrison stock to third parties at a loss. The Government argued that the transaction was designed to generate a capital loss that could be used to offset Coltec's $283 million gain on the sale of one of its subsidiaries earlier that year.

After rejecting the Government's technical, statutory challenges to the transaction, the court turned to the Government's argument that the transaction lacked economic substance. Observing that the economic substance doctrine is "dizzyingly complex," Judge Braden explained that the "public must be able to rely on clear and understandable rules established by Congress to ascertain their federal tax obligations." Judge Braden further cautioned: "If federal tax laws are applied in an unpredictable and arbitrary manner, albeit by federal judges for the 'right' reasons in the 'right case,' public confidence in the Code and tax enforcement system surely will be further eroded."

Judge Braden also emphasized that Congress has debated and rejected several proposals to codify the economic substance doctrine. After citing Justice Scalia on the dangers of judge-made law, Judge Braden then held 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."

Castle Harbour

General Electric Capital Corp. (GECC) was in the airplane leasing business. GECC created a limited liability company (Castle Harbour), which was owned by three GECC subs. Through the subs, GECC contributed to Castle Harbour some airplanes, rents due on the airplanes, and additional cash. The GECC subs then sold a portion of their interest in Castle Harbour to two Dutch banks, and the Dutch banks also contributed additional cash. Castle Harbour was a self-liquidating partnership. Over eight years, the Dutch banks' ownership interest was to be almost entirely bought out with the income of the partnership, giving the banks a 9% return on their investment. The tax benefits resulted from the way the operating income

was allocated between the GECC subs and the Dutch banks.

Addressing the Government's economic substance argument, the court noted that the cases in the Second Circuit were not "perfectly explicit" regarding whether the court should require the taxpayer to meet both the subjective business purpose test and the objective "economic effect" test, only one of them, or a "flexible standard that considers both factors but makes neither dispositive." The court was able to avoid resolving this issue by concluding that the "transaction had both a non-tax economic effect and a non-tax business motivation, satisfying both tests and requiring that it be given effect under any reading of the law."

According to the court, the Dutch banks had an economic stake in the partnership and there was a valid business reason to form a separate entity to engage in the underlying transaction. The Dutch banks' return on their investment was directly tied to the partnership's performance in the aircraft leasing business. Although the Dutch banks were protected against loss, the banks participated in the upside. The better the leasing business did, the greater their return on their investment. Addressing GE Capital's reason for forming the partnership, the court observed that "given that [GE Capital] wanted to raise money against its aircraft, and given that it could not borrow against them, it is difficult to see what else it could have done other than create a separate entity and seek investments in that entity."

The court acknowledged that the Government is "understandably concerned that the Castle Harbour transaction deprived the public fisc of some $62 million in tax revenue," especially because it "appears likely that one of GECC's principal motivations in entering into this transaction … was to avoid that substantial tax burden." Although the transaction "sheltered a great deal of income from taxes," the court emphasized that the transaction was "legally permissible" and was an "economically real transaction, undertaken, at least in part, for a non-tax business purpose." Given these circumstances, the court bluntly directed the IRS to "address its concerns to those who write the tax laws." Indeed, the government's recent losses have led to speculation that Congress may revisit codifying the economic substance doctrine.

Conclusions

The courts are by no means uniform or consistent in their approach to the economic substance doctrine. Legal standards vary from jurisdiction to jurisdiction and, even within a single jurisdiction, the courts apply different levels of scrutiny depending on the facts of the case. Some courts engage in a lengthy analysis of whether the taxpayers had a reasonable expectation of pre-tax profit, while others require only that the restructured entity engaged in meaningful economic activity. The three recent cases suggest that courts are willing to apply the less rigorous form of the economic substance test to taxpayers who have engaged in a bona fide restructuring of an on-going business activity.

In each of the three recent cases, the taxpayers were confronted with a widely recognized threat to their bottom line. Black & Decker was faced with double-digit increases in health care benefits costs; Coltec was trying to protect itself from incurring staggering asbestos liability under a piercing-the-corporate veil theory; and GE Capital Corp. was responding to a substantial downturn in the airplane leasing business. In each case, the taxpayer created a separate entity to restructure its management of these risks and liabilities.

Although the last chapter to this story has yet to be written, a discernable plotline is developing: where real business activities are being conducted and the taxpayer has satisfied the relevant statutory requirements, the courts are not going to deprive taxpayers of the benefits the Internal Revenue Code provides merely because the Government raises the specter of economic substance every time tax avoidance is a motivating force in the transaction.

While it may not be possible to avoid IRS challenges to tax aggressive transactions, particularly those the IRS deems to be so-called "cookie cutter" deals marketed by third-parties, at least the outcomes of these cases may cause the government to rethink whether it can continue to employ a "one size fits all" strategy against taxpayers or whether it would be better served by evaluating each taxpayer's case on its own merits. To that end, and given the importance of the factual record in these types of cases, it remains prudent for corporate counsel to remind transaction participants — including third parties — at the outset of any discussions about a potential transaction that they can expect exhaustive scrutiny of the documentary record in an audit and/or litigation. Accordingly, it is imperative that appropriate protocols be established and then followed by all parties to the transaction to ensure conformity with document retention/document destruction policies as well as preservation of the attorney-client privilege that may otherwise fall victim to inadvertent waiver. When all is said and done, the time-tested maxim still applies: an ounce of prevention is worth a pound of cure. Based on the courts' latest pronouncements, that may well take taxpayers who wind up in litigation a very long way.

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