

BEING PUNISHED FOR OBEYING THE RULES:  
CORPORATE TAX PLANNING AND THE OVERLY  
BROAD ECONOMIC SUBSTANCE DOCTRINE

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INTRODUCTION

In the world of corporate transactions, the stakes are high and businesses are not the only players. The federal government also takes an interest each time a deal closes with a handshake or a signature and stands to gain millions of dollars by paying close attention to the structure of each transaction and to each tax return generated by the business players after the transaction. In 2003, the Internal Revenue Service (“IRS”) succeeded in offsetting an approximately \$191 million loss claimed on one corporate tax return, generating large tax revenues in the process.<sup>1</sup> In 2006, the IRS reaped \$62 million in taxes from the reversal of deductions claimed from a single corporate transaction.<sup>2</sup> Such good fortune for the federal treasury has not been uncommon in recent years and, at first glance, seems to signal a degree of victory over unscrupulous tax reporting by U.S. corporations. Closer inspection, however, reveals that the IRS, aided by federal appellate courts, may be playing with a stacked deck and receiving undue monetary windfalls in some cases.

For instance, suppose an enterprising tax professional devises an innovative financial transaction that consistently provides substantial tax advantages across a range of corporate taxpayers and situations. By accurately applying the provisions of the Internal Revenue Code (“I.R.C.”), the tax professional has created a transaction that can be outlined in generic terms and sold to any interested customer. The tax professional successfully recruits two corporations, Corporation A and Corporation B, to implement the transaction. Although the transactional steps followed by Corporation A and Corporation B are largely the same, there are slight modifications that serve to alter the non-tax return in each instance. Corporation A effectively eliminates upside potential and downside risk by entering into outside hedge transactions. Corporation A captures only the tax benefits of the

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<sup>1</sup> *Saba P'ship v. Comm'r*, 273 F.3d 1135, 1136 (D.C. Cir. 2001).

<sup>2</sup> *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 223 (2d Cir. 2006).

transaction, with no potential for real economic gain. Understandably, the IRS disallows the tax benefits that Corporation A has received, on the basis that the transaction was undertaken only for tax purposes. The trial and appellate courts concur. On the other hand, Corporation B welcomes both the upside potential and the downside risk, hoping that the upside potential is realized, and does not enter into any outside hedge transactions. In addition to receiving tax benefits, Corporation B has undergone a risky transaction, with a real business motive. In Corporation A's case, the IRS disallows the tax benefits, but in Corporation B's case, the trial court does not agree with the IRS, and instead recognizes the existence of a legitimate transaction and allows the tax benefits to stand. The implicit question on appeal becomes: should the mere existence of a salable tax package and Corporation A's misuse of that package serve to rationalize an appellate court's presumptive bias against Corporation B's use of the same package? Although answering yes to this question cuts against notions of allowing each case to stand or fall on its own merits, appellate courts consistently reach that conclusion.

Although the rise of tax planning packages for corporations began in the late 1980s and early 1990s,<sup>3</sup> the first cases dealing with those packages have only recently wound their way through the court system.<sup>4</sup> As the volume of case law dealing with corporate tax packages grows, one trend becomes increasingly clear: if the use of a tax package is struck down once, it will be struck down again and again, regardless of important factual differences among cases and taxpayer compliance with the letter and spirit of the I.R.C., Treasury Regulations, and IRS interpretative guidelines.<sup>5</sup> It appears many appellate courts have put on blinders, seeing only the repeated use of a tax package, without regard for important distinctions among cases.<sup>6</sup> To accomplish their exclusive goal of striking down "bad" tax packages, the appellate courts have alternately expanded and contracted the traditional

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<sup>3</sup> See DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 27 (1999) [hereinafter WHITE PAPER], available at <http://www.ustreas.gov/offices/tax-policy/library/ctswwhite.pdf>. According to the Treasury Department, the Tax Reform Act of 1986 may have had the unintended effect of increasing the supply of tax shelter experts:

[E]limination of [individual] tax shelters may have freed up a supply of knowledgeable and willing tax practitioners and shelter promoters, who have turned to corporate tax shelters as a source of employment in the 1990s. Thus, at the same time that the 1986 Act helped boost demand for corporate tax reductions, it created a supply of those who are expert in seeking out novel ways to reduce taxes.

*Id.*

<sup>4</sup> See, e.g., *Boca Investorings P'ship v. United States*, 314 F.3d 625, 626-29 (D.C. Cir. 2003) (addressing a Contingent Installment Note Sales transaction initially used in 1990); *ACM P'ship v. Comm'r*, 157 F.3d 231, 233-44 (3d Cir. 1998) (addressing a Contingent Installment Note Sales transaction initially used in the late 1980s).

<sup>5</sup> See *infra* Part II.

<sup>6</sup> See *infra* Part II.

judicial doctrines at their disposal.<sup>7</sup> Even where taxpayers have complied with the explicit, objective requirements of the I.R.C. framework, they are left uncertain as to whether the tax benefits of their transactions will pass judicial muster, as the relevant judicial doctrines are ambiguous and subject to modification without notice.<sup>8</sup>

Where Congress has provided extensive and carefully considered rules to guide behavior, it is prudent and consistent with our system of government to allow those rules to operate as written.<sup>9</sup> Where, as in tax law, those Congressional rules are additionally supplemented and clarified by extensive regulatory action, the room for judicial modification of the result of a literal application of those rules should decrease.<sup>10</sup> Although I do not advocate an abandonment of the traditional judicial doctrines related to the detection of illegal tax planning, courts, in recognition of their constitutional role, should defer to legislative procedures and outcomes. If there is to be a judicial presumption, it should operate in favor of the taxpayer, who is merely applying the law as Congress and the Treasury have stated it. In addition to deference to the legislative framework, appellate courts should exercise deference to the fact-finding of the trial courts. Prepackaged tax planning typically employs complicated transactional structures, and although two different cases may employ the same facial structure, there can be significant underlying factual differences that indicate illegality in one case, but legitimate investment with favorable tax treatment in another.<sup>11</sup> Trial courts are best suited to detect these factual differences<sup>12</sup> and, thus, are more effective at discerning legitimate tax benefits. Federal appellate courts have exhibited an inadvisable bias against tax packages, whereby each instance of the tax package's use will be disallowed if the initial use was disallowed, regardless of underlying factual differences. The effects of this apparent bias should be minimized by a reaffirmation of the foundational judicial principles of adherence to statutory law and meaningful deference to the trial court as the most effective fact finder.

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<sup>7</sup> See *infra* Part II.C.

<sup>8</sup> See *infra* Part II.C.

<sup>9</sup> See *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) ("It is quite true . . . that as the articulation of a statute increases, the room for interpretation must contract . . ."), *aff'd*, 293 U.S. 465 (1935); John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501, 1519 (1997) ("[I]n the search for congressional intent and statutory purpose, the enacted language of the statute should be the primary guide."); Daniel A. Farber, *Statutory Interpretation and Legislative Supremacy*, 78 GEO. L.J. 281, 293 (1989) ("When the court concedes that a statute is within the legislature's prerogatives under the existing scheme of constitutional government, refusal to implement that statute is in a sense a minor assault on the constitutional structure itself.").

<sup>10</sup> See 1 NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION § 3:27 (6th ed. 2002).

<sup>11</sup> See *infra* Part II.

<sup>12</sup> *United States v. Or. Med. Soc'y*, 343 U.S. 326, 339 (1952) ("[T]he original trier of the facts holds a position of advantage from which appellate judges are excluded. In doubtful cases the exercise of his power of observation often proves the most accurate method of ascertaining the truth.").

Part I of this Comment defines, through a series of examples, prepackaged tax planning, specifically focusing on corporate tax packages. This Part also provides the background of the economic substance doctrine, the primary judicial tool for examining the tax benefits of prepackaged tax planning. Part II demonstrates the judicial presumption against prepackaged tax planning through an examination of recent cases in the D.C., Second and Sixth Circuits, specifically focusing on *Boca Investering's Partnership v. United States*<sup>13</sup> in the D.C. Circuit. Part III argues for a retreat from the imposition of judicial doctrines where the taxpayer has complied with the provisions of the I.R.C. and related regulations, except in instances where there is a clear departure from acceptable tax planning. This Part also argues for meaningful appellate court deference to the fact-finding of the trial courts.

#### I. BACKGROUND—PREPACKAGED TAX PLANNING AND THE ECONOMIC SUBSTANCE DOCTRINE

To recognize the appellate bias against prepackaged corporate tax planning, one must understand prepackaged tax planning, as well as the judicial doctrines that apply to these tax packages. This section (1) provides a workable definition of prepackaged tax planning; (2) examines a series of tax packages to further outline the contours of prepackaged tax planning; and (3) examines the history of the economic substance doctrine, the primary judicial tool for striking down tax packages.

##### A. *Prepackaged Tax Planning*

The discussion contained in this Comment requires a workable definition of prepackaged tax planning or tax packages. Simply put, tax packages literally implement the provisions of the I.R.C. to create a transaction form that can be utilized consistently and with minimal variation by a multitude of similarly situated taxpayers for the purpose of minimizing their overall tax liability. The tax minimization effects of a tax package can be intended or unintended and unforeseen by the drafters of the I.R.C. For example, through the creation of Individual Retirement Accounts (“IRAs”), which allow taxpayers to make tax-deferred contributions to IRAs and allow those contributions to grow on a tax-deferred basis,<sup>14</sup> Congress intentionally allowed the time value of money to work for the taxpayer, rather than the Treasury. As such intended tax minimization is rarely questioned, this Comment will address situations where a taxpayer is able to receive tax

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<sup>13</sup> 314 F.3d 625 (D.C. Cir. 2003).

<sup>14</sup> I.R.C. § 408(e) (2000).

benefits unintended and unforeseen by Congress. Typically, these situations are recognized by an enterprising tax professional, who outlines the literal requirements for capturing these benefits and then sells his outline to receptive taxpayers, often guiding the taxpayer through the required benefit-capturing steps. The methods by which these potential tax benefits are recognized, sold, and captured is best demonstrated by an examination of real transactions.

### 1. Contingent Installment Note Sale

The most distinct example of a tax package is the Contingent Installment Note Sales (“CINS”) transaction developed and promoted by Merrill Lynch in the late 1980s and early 1990s.<sup>15</sup> In the typical case, Merrill Lynch would sell the CINS transaction to a company that was expecting large capital gains, frequently from the sale of a subsidiary.<sup>16</sup> In many cases, the CINS transaction was effective in employing the literal requirements and allowances of the I.R.C. to create large capital losses to offset large capital gains, while allowing the company utilizing the CINS transaction to avoid most or any corresponding economic loss.<sup>17</sup>

Capturing the tax benefits of CINS was possible through the utilization of specific provisions of the I.R.C. and specific regulations promulgated by the Treasury Department. Under the I.R.C. regime, the gain or loss from a financial transaction is generally realized in the year it is received or incurred.<sup>18</sup> An installment sale,<sup>19</sup> however, presents several difficulties, including the possibility of a contingent gain or loss.<sup>20</sup> In installment sale situations, Congress provides that recognized income from a property disposition in any taxable year is the proportion of the gross profit of the payments received to the total contract price.<sup>21</sup> Where the total contract value cannot be determined at the time of the contract (i.e., where the installment sale is contingent), the Secretary of the Treasury is required to issue gov-

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<sup>15</sup> See *ASA Investorings P'ship v. Comm'r*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000).

<sup>16</sup> See, e.g., *Boca*, 314 F.3d at 626-27 (describing the creation of Boca Investorings Partnership as a method of offsetting gains from the sale of a partner's subsidiary).

<sup>17</sup> See, e.g., *Saba P'ship v. Comm'r*, 273 F.3d 1135, 1136 (D.C. Cir. 2001); *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 515-16 (D.C. Cir. 2000).

<sup>18</sup> See I.R.C. § 1001.

<sup>19</sup> *Id.* § 453(b)(1) (defining installment sale as “a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs”).

<sup>20</sup> *ASA*, 201 F.3d at 506.

<sup>21</sup> I.R.C. § 453(c). Thus, if a taxpayer owns an asset with a basis of \$1,000 and sells the asset for \$5,000 to be paid in five equal installments, he realizes a gain of \$800 each year. Gross profit equals \$4,000, contract price equals \$5,000, each installment equals \$1,000 per year, the ratio of gross profit to contract price equals 4/5, and 4/5 multiplied by the amount of each installment equals \$800 per year.

erning regulations.<sup>22</sup> Under these regulations, where a sale amount is variable, but there is a definitive maximum period as to when payments may be made, the taxpayer prorates his basis in the asset equally over the years in which payments may be received and subtracts the prorated basis from his receipts each year to calculate his taxable gain for that year.<sup>23</sup> If, in any year, the prorated basis is more than the receipts for that year, a loss may only be recognized if the receipts are the final payment under the contract.<sup>24</sup>

By recruiting a foreign entity that is not taxed on income received from a partnership, a clever U.S. taxpayer could employ the contingent installment sales statutes and regulations to create a tax loss, while avoiding large economic loss.<sup>25</sup> For example, the typical CINS transaction starts with a U.S. corporation (“UC”). Suppose the UC had recently sold a subsidiary for \$10 and wished to avoid tax liability for that gain. To negate the potential tax liability, the UC would locate a foreign entity (“FE”) subject to favorable partnership taxation rules in its home country, but not subject to U.S. taxation, allowing the FE to avoid large tax bills on its portion of any partnership income. The UC and the FE would then create a partnership, with the FE initially contributing \$9 for a 90% interest and the UC contributing \$1 for a 10% interest. In the first year of the partnership’s existence, the partners would buy property worth \$10 and then turn around and sell that property for \$5 in cash and an indefinite five-year debt instrument. The sale has a basis of \$2 per year (\$10 purchase price divided by the five-year period of the indefinite debt instrument). The cash payment produces a net income of \$3 (\$5 in gross income minus \$2 in basis) in the first year, 90% allocable to the FE. In the second year, the UC would buy out a majority of the FE’s partnership interest, reallocating the interests 90% to the UC and 10% to the FE. The partnership would then sell the debt instrument for \$5 and realize a loss of \$3 (\$5 in gross income minus \$8 in remaining basis), now 90% allocable to the UC. In this manner, the UC avoids tax liability for the profit in year one and receives a tax deduction for the loss in year two, but sustains no real economic loss.

## 2. Corporate Owned Life Insurance

Unlike CINS, Corporate Owned Life Insurance (“COLI”) was developed, promoted, and sold to corporations by a multitude of tax planners,

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<sup>22</sup> *Id.* § 453(j).

<sup>23</sup> Treas. Reg. § 15a.453-1(c)(3)(i) (as amended in 1994).

<sup>24</sup> *Id.*

<sup>25</sup> *See, e.g., ASA*, 201 F.3d at 507. Although the relevant I.R.C. sections and Treasury Regulations are still on the books, it is clear that neither the IRS nor the judiciary will allow the tax benefits of the CINS transaction. *See I.R.S., Listed Abusive Tax Shelters and Transactions*, <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html> (last visited Feb. 15, 2008); *see also infra* Part II.A.

typically working for insurance companies.<sup>26</sup> COLI relied on several provisions of the I.R.C., as well as facets of common law, to derive its tax benefits.<sup>27</sup> Generally, Congress looks favorably on life insurance policies and provides several tax benefits to such policies. The primary benefit is that the proceeds of life insurance policies are not taxed,<sup>28</sup> but Congress also allows the investment component of whole life insurance, commonly referred to as “inside build-up,”<sup>29</sup> to grow on a tax-deferred basis and does not tax it at all if it is paid out as a death benefit.<sup>30</sup> Additionally, as loan proceeds are not taxable income,<sup>31</sup> beneficiaries could take out non-taxable loans secured against a life insurance policy and, prior to 1986, receive virtually limitless tax deductions for interest paid on those loans.<sup>32</sup> This highly advantageous deduction was not limited to individuals, as corporations typically have an insurable interest in “key persons,” meaning they can purchase insurance on certain highly specialized or high ranking employee’s lives, naming the corporation as beneficiary, so long as the company stands to receive pecuniary gain from the continued existence of the employee or to suffer large pecuniary loss should the employee perish.<sup>33</sup> In 1986, however, Congress limited deductible interest to interest paid on loans of \$50,000 or less.<sup>34</sup> Even with the advent of this effective \$50,000 loan limit, employers could still reap substantial tax benefits by taking advantage of an expanding definition of “key persons” and taking out loans on insurance policies purchased to cover a large number of lower level and less skilled employees.<sup>35</sup>

By utilizing the deductions for interest expenses, the tax deferral of inside build-up, and the nontaxable gains on death benefits, clever corporate taxpayers can structure their COLI to receive substantial tax benefits.<sup>36</sup> In the typical COLI transaction, a corporation would use loan proceeds to pay the insurance premiums.<sup>37</sup> The corporation would pay a high rate of interest on the loan, but the high interest rate would be offset by inside build-up

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<sup>26</sup> *Dow Chem. Co. v. United States*, 250 F. Supp. 2d 748, 757 (E.D. Mich. 2003), *rev’d*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

<sup>27</sup> *See id.*

<sup>28</sup> *See* I.R.C. §§ 72(b)(1), 101(a)(1) (2000).

<sup>29</sup> There is no similar inside build-up in term life insurance policies. Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 WASH. & LEE L. REV. 459, 481 (1993).

<sup>30</sup> *Dow*, 250 F. Supp. 2d at 756; *see also* I.R.C. §§ 72, 101(a).

<sup>31</sup> *See* I.R.C. § 61 (excluding loan proceeds as gross income).

<sup>32</sup> *See id.* § 264(a)(4), (e)(1) (allowing deductions for interest paid on any loan secured by a life insurance policy if the loan was purchased prior to June 20, 1986 and deductions for interest paid on loans of up to \$50,000 secured by a life insurance policy purchased thereafter).

<sup>33</sup> 3 COUCH ON INSURANCE § 43:13 (3d ed. 2004).

<sup>34</sup> *See* I.R.C. § 264(a)(4), (e)(1).

<sup>35</sup> *See Dow*, 250 F. Supp. 2d at 757.

<sup>36</sup> WHITE PAPER, *supra* note 3, at 144.

<sup>37</sup> *Id.*

income.<sup>38</sup> Essentially, the tax benefits received from COLI transactions resulted from the “timing mismatch” of the current deduction for interest expense, but deferred recognition of the inside build-up income.<sup>39</sup> By carefully choosing interest rates and by removing the cash value of the inside build-up as the build-up occurs, a corporation can effectively remove any risk from the transaction, while still capturing the tax benefits.<sup>40</sup>

Congress was not oblivious to the unintended tax benefits that many corporations were receiving through the COLI transaction.<sup>41</sup> In response to the substantial unintended tax benefits, Congress gradually eliminated the I.R.C. provisions that allowed the COLI transaction to receive favorable tax treatment.<sup>42</sup>

### 3. Lease Stripping

As with COLI, a variety of tax professionals promoted and sold lease stripping.<sup>43</sup> The variety of promoters is reflected in the variability of the transactional form, which can be implemented in a number of ways.<sup>44</sup> Nevertheless, the most frequently used forms share the general characteristics that form the contours of this tax savings vehicle.<sup>45</sup> Typically, as with CINS, a foreign partner not subject to partnership taxation is enlisted to participate with a U.S. corporation in a lease stripping transaction.<sup>46</sup> The partnership then acquires certain property, either from the U.S. corporation or from an outside entity, and leases that property out, either back to the U.S. corporation or to an outside entity.<sup>47</sup> The tax benefits from this process are derived from allocating the lease income to the foreign partner, who is not subject to taxation on that income, and allocating any related deductions, such as rental or depreciation expenses, to the U.S. corporation, which is able to reduce its taxable income substantially.<sup>48</sup>

For example, a partnership in which a U.S. corporation (“UC”) has a 25% interest and a foreign entity (“FE”) has a 75% interest purchases a

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<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *See Dow*, 250 F. Supp. 2d at 758.

<sup>41</sup> *See id.* at 756.

<sup>42</sup> *Id.*; *see also* I.R.C. § 264(a)(4) (2000).

<sup>43</sup> *See* TIFD III-E, Inc. v. United States, 459 F.3d 220, 225 (2d Cir. 2006) (listing Babcock & Brown as the promoter); Andantech L.L.C. v. Comm’r, 331 F.3d 972, 973 (D.C. Cir. 2003) (listing Comdisco Investment Group, Inc. as the promoter); Nicole Rose Corp. v. Comm’r, 320 F.3d 282, 283 (2d Cir. 2003) (listing the U.S. corporation involved as the transaction developer).

<sup>44</sup> I.R.S. Notice 2003-55, 2003-2 C.B. 395.

<sup>45</sup> *See id.*

<sup>46</sup> *Id.*

<sup>47</sup> *See* sources cited *supra* note 43.

<sup>48</sup> I.R.S. Notice 2003-55, 2003-2 C.B. 395.

fleet of jalopies, which the partnership then leases back to the original owner, who subleases those jalopies to his customers exactly as he had been doing before the sale.<sup>49</sup> The partnership then sells the right to receive the lease payments to an outside entity, such as a bank.<sup>50</sup> In doing so, the partnership has accelerated recognition of the entire lease income, which is 75% allocable to the FE, into the current period.<sup>51</sup> After the sale of the lease income, the UC buys out the majority of the FE's partnership interest, so that the UC now has a 98% interest.<sup>52</sup> Because the partnership still owns the jalopies, it may take depreciation deductions on those jalopies, with the deductions being 98% allocable to the UC.<sup>53</sup> In this manner, the UC has stripped the lease income from the jalopies and avoided paying taxes on that income, but has retained the majority of the depreciation deductions, thereby greatly decreasing its taxable income.<sup>54</sup>

### B. *Economic Substance Doctrine*

As a counter measure to inappropriate tax planning, which may sometimes result with the use of the tax packages discussed above, the judiciary has developed the economic substance doctrine. This doctrine serves as a tool to effect judicial modification of the tax benefits of a taxpayer's transaction if that transaction has little economic effect on the taxpayer.<sup>55</sup> If the court disallows the tax benefit of a transaction in this manner, that transaction is typically referred to as a "sham" for tax purposes.<sup>56</sup> The genesis of the economic substance doctrine is found in *Helvering v. Gregory*,<sup>57</sup> where Judge Learned Hand examined a tax planning activity entered into by Ms. Gregory, who had strictly applied the dictionary definition of the relevant

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<sup>49</sup> See *Andantech L.L.C. v. Comm'r*, 331 F.3d 972, 973 (D.C. Cir. 2003).

<sup>50</sup> See *id.*

<sup>51</sup> See *id.*

<sup>52</sup> See *id.*

<sup>53</sup> See *id.* at 974.

<sup>54</sup> See *id.*

<sup>55</sup> See Yoram Keinan, *The Many Faces of the Economic Substance's Two Prong Test: Time for Reconciliation?*, 1 N.Y.U. J.L. & BUS. 371, 388 (2005).

<sup>56</sup> See *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). It is important to note the difference between a "factual sham" and an "economic sham." Factual shams are "transactions which either did not occur, did not occur as reported or were performed in violation of some of the background assumptions of commercial dealing." *Horn v. Comm'r*, 968 F.2d 1229, 1236 n.8 (D.C. Cir. 1992); *Lerman v. Comm'r*, 939 F.2d 44, 49 n.6 (3d Cir. 1991). Economic shams are "transactions which actually occurred but which exploit a feature of the tax code without any attendant economic risk." *Horn*, 968 F.2d at 1236 n.8 (D.C. Cir. 1992); *Lerman*, 939 F.2d at 48 n.6. The economic substance doctrine is designed to detect and disallow economic shams. As the transactions discussed in this Comment were not factual shams, the doctrines developed to detect factual shams will not be discussed.

<sup>57</sup> 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

tax statutes to reap a substantial tax benefit from a corporate merger, with little corresponding actual economic activity.<sup>58</sup> In examining this transaction Judge Hand stated, “[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”<sup>59</sup> Nevertheless, Judge Hand stated:

[although a]ll the steps [undertaken by Ms. Gregory] were real, and their only defect was that they were not what the statute means by a ‘reorganization,’ because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect.<sup>60</sup>

The Supreme Court readily agreed, stating “[t]he reasoning of the court below . . . leaves little to be said.”<sup>61</sup> Ms. Gregory’s transaction was “[s]imply 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,” that is, the transfer of corporate shares, structured in such a way so as to avoid substantial tax liability.<sup>62</sup>

More than forty years after *Gregory*, the Supreme Court issued another seminal statement in *Frank Lyon v. Commissioner*,<sup>63</sup> indicating that tax benefits should be recognized where a transaction 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.”<sup>64</sup> From the “business or corporate purpose”<sup>65</sup> requirement of *Gregory* and the “tax-independent considerations”<sup>66</sup> requirement of *Frank Lyon*, circuit courts have developed the two-pronged economic substance doctrine.<sup>67</sup>

Under the two-pronged economic substance test, a court must examine questionable tax planning activities to determine if (1) the taxpayer had a legitimate non-tax business purpose in entering into the transaction and (2) the transaction had objective economic substance.<sup>68</sup> The first prong prompts

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<sup>58</sup> *Id.* at 810-11.

<sup>59</sup> *Id.* at 810.

<sup>60</sup> *Id.* at 811.

<sup>61</sup> *Gregory*, 293 U.S. at 469.

<sup>62</sup> *Id.*

<sup>63</sup> 435 U.S. 561 (1978).

<sup>64</sup> *Id.* at 583-84.

<sup>65</sup> *Gregory*, 293 U.S. at 469.

<sup>66</sup> *Frank Lyon*, 435 U.S. at 583-84.

<sup>67</sup> *Bail Bonds by Marvin Nelson, Inc. v. Comm’r*, 820 F.2d 1543, 1549 (9th Cir. 1987) (construing *Frank Lyon* to ask two questions: First, “has the taxpayer shown that it had a business purpose for engaging in the transaction other than tax avoidance?” and second, “has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?”).

<sup>68</sup> *Id.*

a subjective determination of the taxpayer's intent when entering into the transaction.<sup>69</sup> This prong typically involves an inquiry into the taxpayer's motivations for entering into the transaction.<sup>70</sup> If the taxpayer considered only tax advantages, this prong is not satisfied.<sup>71</sup> If the taxpayer reasonably considered the possibility for increased profits, decreased liability other than tax liability, or other non-tax business advantages likely to be obtained, this prong is satisfied.<sup>72</sup> Under the second prong, the courts usually engage in an analysis of whether the taxpayer's economic position was modified in a meaningful way by the transaction.<sup>73</sup> Courts disagree as to the nature and degree of economic modification required to satisfy the second prong.<sup>74</sup> Some employ a broad test, requiring only that, aside from the tax benefits, "the transaction affected the taxpayer's financial position in any way."<sup>75</sup> Others employ a narrow test, requiring that "the transaction was likely to produce economic benefits aside from a tax deduction."<sup>76</sup> While still others employ an even narrower test, requiring a "reasonable possibility of profit from the transaction . . . apart from the tax benefits."<sup>77</sup> The last approach disregards non-profit economic benefits (e.g., limited liability through incorporation). Regardless of whether a court employs a broad or narrow test, this prong is not satisfied if the transaction is undertaken solely to reduce tax liability and is not anticipated to affect economic realities.<sup>78</sup>

In addition to disagreements as to the scope of the individual prongs, circuits differ as to whether both prongs must be satisfied for a transaction to be deemed to have economic substance.<sup>79</sup> In circuits where the economic

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<sup>69</sup> *Rice's Toyota World, Inc. v. Comm'r* 752 F.2d 89, 92 (4th Cir. 1985) ("The business purpose inquiry simply concerns the motives of the taxpayer in entering into the transaction.").

<sup>70</sup> See Keinan, *supra* note 55, at 397-98.

<sup>71</sup> See *id.*; see also *United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("[A] transaction . . . must be disregarded if it has no business purpose and its motive is tax avoidance.").

<sup>72</sup> See Keinan, *supra* note 55, at 397-98; see also *United Parcel Serv.*, 254 F.3d at 1019 ("'[B]usiness purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose' . . . as long as it figures in a bona fide, profit-seeking business.").

<sup>73</sup> David P. Hariton, *Sorting out the Tangle of Economic Substance*, 52 TAX LAW. 235, 235-36 (1999).

<sup>74</sup> Keinan, *supra* note 55, at 395.

<sup>75</sup> *In re CM Holdings, Inc.*, 301 F.3d 96, 103 (3d Cir. 2002).

<sup>76</sup> *Bail Bonds by Marvin Nelson, Inc. v. Comm'r*, 820 F.2d 1543, 1549 (9th Cir. 1987).

<sup>77</sup> *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 94 (4th Cir. 1985).

<sup>78</sup> See Keinan, *supra* note 55, at 395-97.

<sup>79</sup> Compare *United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("Even if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance."), and *Gardner v. Comm'r*, 954 F.2d 836, 839 (2d Cir. 1992) ("[A] subjective profit motive can not save a transaction that objectively lacks economic substance."), with *Horn v. Comm'r*, 968 F.2d 1229, 1237-38 (D.C. Cir. 1992) (applying a disjunctive test), and *Rice's Toyota World*, 752 F.2d at 91 (finding no economic substance if "the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and . . . the transaction has no

substance doctrine is considered conjunctive, a transaction must satisfy both the objective and subjective prongs for the tax benefits to be recognized. In circuits where the doctrine is considered disjunctive, only one prong need be satisfied for the taxpayer's transaction to stand.

## II. APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE TO PREPACKAGED TAX PLANNING AND THE EMERGING JUDICIAL BIAS AGAINST VARYING USES OF THE SAME PACKAGE

Recent decisions addressing corporate tax packages and applying the economic substance doctrine exhibit an appellate presumption against such packages. Removed from firsthand impressions of witness credibility and evidentiary weight, appellate courts look past important factual findings indicating economic substance and see only the standardized tax planning package. The judicial bias against prepackaged tax planning is most evident when examining a line of cases where the early cases disallowed the form of a transaction for very specific reasons, for example, because the taxpayer engaged in outside hedge transactions that effectively eliminated any risk and any potential gain. Then, in a later case, the same tax package is presented to the trial court, but this time the taxpayer has modified the transactional structure in a way that addresses the apparent concerns of the appellate court in earlier cases. Recognizing the modification through extensive fact-finding, the trial court determines the later taxpayer engaged in a substantive, risky transaction and has not considered tax advantages alone. Then, despite the trial court's determinations, the appellate court tends to see only the tax package and its similarity to earlier cases, not the factual differences that are paramount in determining whether a transaction has economic substance. This section demonstrates this appellate bias in (1) the D.C. Circuit and (2) the Sixth and Second Circuits.

### A. *CINS and the D.C. Circuit*

Although the first case to examine the CINS transaction was *ACM Partnership v. Commissioner*<sup>80</sup> in the Third Circuit, the D.C. Circuit undoubtedly has the most familiarity with the CINS transaction form and all it entails. Between 2000 and 2003, the D.C. Circuit heard three cases involv-

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economic substance because no reasonable possibility of profit exists"). See generally Keinan, *supra* note 55, at 407.

<sup>80</sup> 157 F.3d 231 (3d Cir. 1998) (ruling against the taxpayer with regard to a contested CINS transaction).

ing the CINS transaction, deciding against the taxpayer in all three.<sup>81</sup> Although the fact that the court ruled against the taxpayer in all three cases is not by itself sufficient to conclusively show or even strongly indicate a judicial bias, significant differences between the first two cases and the final case, without concomitant changes in the reasoning or results of the decisions, indicate the court looked past important factual findings and focused only on the prepackaged nature of the transaction. By misapplying and inappropriately expanding the economic substance doctrine, the D.C. Circuit in *Boca Investerings* disallowed a CINS transaction that had both a business purpose and objective economic substance. This section examines (1) the state of the economic substance doctrine in the D.C. Circuit prior the CINS cases; (2) the D.C. Circuit's initial reaction to the CINS transaction, through an examination of *ASA Investerings* and *Saba Partnership*; and (3) the trial court's differentiation of a subsequent CINS transaction and the D.C. Circuit's expansion of the economic substance doctrine to overrule the lower court's decision in favor of the taxpayer in *Boca Investerings*.

#### 1. The Economic Substance Doctrine in the D.C. Circuit

The D.C. Circuit's application of the economic substance doctrine is most clearly illuminated in *Horn v. Commissioner*.<sup>82</sup> In *Horn*, the court elected to adopt the disjunctive version of the economic substance doctrine, whereby a transaction must lack both a subjective non-tax business purpose and an objective ex ante reasonable possibility of economic gain to be declared a sham.<sup>83</sup> Under this disjunctive test, courts in the D.C. Circuit must look first and foremost to the riskiness of a transaction and ask the question: did the transaction at hand carry with it a reasonable possibility for more than a de minimis economic or other business gain, as well as the potential for an economic or business loss?<sup>84</sup> In the D.C. Circuit, the economic substance doctrine was applied as thus stated until the most recent CINS case, *Boca Investerings*.<sup>85</sup>

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<sup>81</sup> *Boca Investerings v. Comm'r*, 314 F.3d 625 (D.C. Cir. 2003); *Saba P'ship v. Comm'r*, 273 F.3d 1135 (D.C. Cir. 2001); *ASA Investerings P'ship v. Comm'r*, 201 F.3d 505 (D.C. Cir. 2000).

<sup>82</sup> 968 F.2d 1229 (D.C. Cir. 1992).

<sup>83</sup> *Id.* at 1238 (“[A] transaction will not be considered a sham if it is undertaken for profit or for other legitimate nontax business purpose.”).

<sup>84</sup> See *ASA*, 201 F.3d at 514-15 (disallowing the tax benefits of a transaction where the taxpayer did not assume more than de minimis risk); *Horn*, 968 F.2d at 1236 n.8 (“[E]conomic shams’ [are] transactions which actually occurred but which exploit a feature of the tax code without any attendant economic risk.”).

<sup>85</sup> See *Saba*, 273 F.3d at 1141 (remanding to the Tax Court with instructions to apply the analysis used in *ASA*); *ASA*, 201 F.3d at 513-15 (disallowing a transaction that had no business purpose other than tax avoidance and that was not accompanied by more than de minimis risk).

## 2. The Initial Judicial Reaction to CINS—Where’s the Risk?

### a. ASA Investering Partnership v. Commissioner

The D.C. Circuit first dealt with the CINS transaction in *ASA Investering Partnership v. Commissioner*.<sup>86</sup> In 1990, the U.S. company in *ASA Investering*, Allied Signal, anticipated selling a subsidiary for a gain of over \$400 million.<sup>87</sup> Because of the large tax bill this sale would incur, Allied Signal approached Merrill Lynch for tax minimization advice.<sup>88</sup> For a \$7 million fee, Merrill Lynch agreed to set up and complete a CINS transaction.<sup>89</sup> Merrill Lynch located a foreign entity, Algemene Bank Netherlands (“ABN”), willing to enter into a partnership, at least in form, with Allied Signal.<sup>90</sup> The purpose of this partnership was to purchase short-term private placement notes (“PPNs”), which are not traded on established markets,<sup>91</sup> then sell the PPNs for 80% cash and 20% debt instruments, which would be payable over five years and vary in value with the London International Bank Offering Rate (“LIBOR”).<sup>92</sup>

This plan went off without a hitch and the partnership *ASA Investering* was created. ABN created two special purpose corporations to invest in the partnership, while Allied Signal invested partially in its own name and partially through a subsidiary.<sup>93</sup> The initial capital contributions totaled \$850 million, 10% from Allied Signal and 90% from ABN.<sup>94</sup> With that \$850 million, the partnership purchased the planned PPNs from two Japanese banks.<sup>95</sup> Those PPNs were then sold for a little less than \$700 million in cash and eleven five-year LIBOR notes.<sup>96</sup> The partnership recognized \$550 million in capital gains,<sup>97</sup> which was 90% allocable to ABN and 10% allocable to Allied Signal.<sup>98</sup> Over the next few months, Allied Signal entered into a series of buyout transactions with its foreign partners that had the ultimate effect of reducing the foreign partners’ interest in the partner-

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<sup>86</sup> 201 F.3d 505 (D.C. Cir. 2000).

<sup>87</sup> *Id.* at 508.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> To qualify for the installment method of tax accounting, the asset sold must not be traded on an established market. I.R.C. § 453(k)(2)(A) (2000).

<sup>92</sup> *ASA*, 201 F.3d at 508-09.

<sup>93</sup> *Id.* at 509.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> The amount was calculated as cash received (\$681 million) minus 1/6 the purchase price of the PPNs (\$851 million). *Id.* at 510. This calculation yields a capital gain of \$539 million, but *ASA* mistakenly reported the amount as \$549 million on its tax return. *ASA*, 201 F.3d at 510 & n.3.

<sup>98</sup> *Id.* at 510.

ship to 25%, distributing the LIBOR notes to Allied Signal, and distributing cash and commercial paper to the foreign partners.<sup>99</sup> The third year of the partnership was its last, but prior to liquidation Allied Signal sold its LIBOR notes for \$33 million, realizing a capital loss of \$400 million.<sup>100</sup> Over the course of the partnership, Allied Signal realized a capital gain of \$54 million in year one, offset by a capital loss of \$400 million in year three. The only economic change in status to accompany this large tax deduction were transaction costs, mostly paid to Merrill Lynch.<sup>101</sup>

As could be expected, the IRS challenged Allied Signal's tax deduction claim and reallocated much of ASA's capital gains to Allied Signal.<sup>102</sup> Allied Signal then challenged the IRS reallocation and brought the case to Tax Court.<sup>103</sup> The primary question for the courts in *ASA Investering*s was whether the partnership was valid for tax purposes or whether it lacked economic substance and was essentially a "sham."<sup>104</sup> Although Allied Signal and ABN carefully followed the required formalities for establishing a partnership, the Tax Court ruled the relationship between the parties was more like debtor-creditor than partners.<sup>105</sup> ASA appealed and the D.C. Circuit affirmed.<sup>106</sup>

There were several fatal flaws in the formation and structure of *ASA Investering*s that ultimately allowed the D.C. Circuit to conclude that the partnership had been formed only for tax purposes and had no real business purpose or reasonable potential for economic profit.<sup>107</sup> First, Allied Signal had agreed to bear all the costs of formation and to compensate ABN for any potential loss from the fluctuating value of the PPN and LIBOR notes.<sup>108</sup> By guaranteeing a return to ABN, Allied Signal had effectively removed ABN's risk of gain or loss from the partnership and "[a] partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of a partnership."<sup>109</sup> Second, any remaining risk was offset by outside hedge transactions that ABN and Allied Signal entered into individually.<sup>110</sup> Both ABN and Allied Signal had little interest in the actual gains or losses of the partnership, which indicated Allied Sig-

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<sup>99</sup> *Id.*

<sup>100</sup> Sale price (\$33 million) minus remaining basis (\$430 million) equals capital loss (-\$396 million). *Id.*

<sup>101</sup> *Id.* at 515-16.

<sup>102</sup> *Id.* at 506.

<sup>103</sup> *ASA Investering*s P'ship v. Comm'r, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000).

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 336.

<sup>106</sup> *ASA*, 201 F.3d at 506.

<sup>107</sup> *Id.* at 513-15.

<sup>108</sup> *Id.* at 514.

<sup>109</sup> *See id.* at 508, 515.

<sup>110</sup> *Id.* at 510.

nal was motivated purely by favorable tax consequences.<sup>111</sup> Finally, although Allied Signal was able to show that potential fluctuation in value of the PPNs and LIBOR notes created opportunity for actual gain, the partnership was clearly superfluous for capturing that gain.<sup>112</sup> Allied Signal could have realized the exact same gain without incurring the transaction costs necessary for the formation of the partnership.<sup>113</sup>

b. *Saba Partnership v. Commissioner*

In *Saba Partnership v. Commissioner*,<sup>114</sup> the D.C. Circuit dealt with the CINS transaction for the second time. The U.S. company, Brunswick Corporation, was preparing to divest itself of several subsidiaries, which would create large capital gains and thus a large tax bill.<sup>115</sup> To offset this tax bill, Merrill Lynch proposed the CINS transaction.<sup>116</sup> Upon Brunswick's approval, Merrill Lynch enlisted the same foreign entity used in *ASA Investerings*, ABN, to form a partnership with Brunswick with the purpose of investing in PPNs, selling them for cash and LIBOR notes, and selling the LIBOR notes to generate a capital loss to reduce Brunswick's tax bill.<sup>117</sup> The transaction transpired almost exactly the same as in *ASA Investerings*, differing only in dollar amounts.<sup>118</sup>

As in *ASA Investerings*, the Tax Court disallowed the transaction without ruling on the legitimacy of the partnership.<sup>119</sup> On appeal, the Court of Appeals determined this was an improper basis for disallowing the tax deduction and vacated.<sup>120</sup> Rather than analyzing the partnership's transactions, the Tax Court was required to analyze the legitimacy of the partnership itself; that is, the economic substance of the transactional form.<sup>121</sup> Although the Court of Appeals strongly suspected that the partnerships in *Saba* were shams, the case was remanded for further proceedings, in the interest of fairness to Brunswick, which did not have the opportunity to present its case in light of *ASA Investerings*.<sup>122</sup>

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<sup>111</sup> *Id.* at 515.

<sup>112</sup> *ASA*, 201 F.3d at 516.

<sup>113</sup> *Id.*

<sup>114</sup> 273 F.3d 1135 (D.C. Cir. 2001).

<sup>115</sup> *Id.* at 1136.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* at 1138.

<sup>118</sup> *Id.* at 1136.

<sup>119</sup> *Id.*

<sup>120</sup> *Saba*, 273 F.3d at 1141.

<sup>121</sup> *See id.* at 1140-41.

<sup>122</sup> *Id.* at 1141.

Upon remand, the partnership failed for the same reasons as in *ASA Investerings*.<sup>123</sup> First, Brunswick paid substantial fees to ABN, which were designed to guarantee ABN a certain return on investment.<sup>124</sup> Second, both ABN and Brunswick understood that Brunswick would bear all costs associated with partnership operations and Brunswick did in fact bear all costs.<sup>125</sup> By guaranteeing a return to ABN and agreeing to bear all costs, Brunswick effectively eliminated any potential risk to ABN. Third, Brunswick engaged in outside hedge transactions to eliminate any potential gain or loss related to the volatility of the LIBOR notes, indicating a lack of any non-tax business purpose for engaging in the CINS transaction.<sup>126</sup> Finally, the partnerships were intentionally designed to produce only a minimal profit, further indicating the lack of a non-tax business purpose.<sup>127</sup>

### 3. *Boca Investerings Partnership v. United States*

In *Boca Investerings Partnership v. United States*,<sup>128</sup> the D.C. Circuit encountered the CINS transaction for the third time, reaching the same conclusion, but in this instance reversing the trial court, rather than concurring with the trial results.<sup>129</sup> Except for the U.S. company involved, American Home Products (“AHP”), the parties largely remained the same, with Merrill Lynch brokering the transactions and ABN serving as the foreign partner.<sup>130</sup> Although the steps necessary to capture the tax benefits of the CINS transaction were the same as in *ASA Investerings* and *Saba*, there were important differences in AHP’s relationship with ABN and in AHP’s activities outside the partnership.<sup>131</sup>

#### a. *D.C. District Court*

In response to the Commissioner’s recharacterization of Boca’s investing activities, Boca brought suit in the United States District Court for the District of Columbia.<sup>132</sup> The District Court judge was extremely thorough,

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<sup>123</sup> *Saba P’ship v. Comm’r (Saba)*, 85 T.C.M. (CCH) 817, 824 (2003).

<sup>124</sup> *Id.* at 820-21.

<sup>125</sup> *Id.* at 822.

<sup>126</sup> *Saba*, 273 F.3d at 1139.

<sup>127</sup> *Saba*, 85 T.C.M. (CCH) at 824.

<sup>128</sup> 314 F.3d 625 (D.C. Cir. 2003).

<sup>129</sup> *Id.* at 626, 632.

<sup>130</sup> *Id.* at 626, 629.

<sup>131</sup> See *Boca Investerings P’ship v. United States*, 167 F. Supp. 2d 298, 303-63 (D.D.C. 2001), *rev’d*, 314 F.3d 625 (D.C. Cir. 2003).

<sup>132</sup> *Boca*, 167 F. Supp. 2d at 298.

issuing a ninety-page opinion.<sup>133</sup> The judge meticulously discussed the bases for his extensive factual findings and outlined the respective responsibilities, expectations, and potential risk for AHP and ABN.<sup>134</sup> The opinion directly addressed the concerns the D.C. Circuit had expressed in *ASA Investments* and specifically determined that the facts in *Boca* differed substantially and materially.<sup>135</sup> Although it was only necessary for *Boca* to satisfy one prong of the two-pronged economic substance test,<sup>136</sup> the District Court ultimately concluded *Boca* had satisfied both prongs.<sup>137</sup>

After concluding that the plaintiff's witnesses were believable, logical, and creditable, while the defendant's primary witness was untrustworthy and offered inconsistent testimony,<sup>138</sup> the Court issued 392 findings of fact.<sup>139</sup> Embedded within those facts were several crucial points that served to differentiate *Boca* from *ASA Investments* and *Saba*:

- (1) AHP did not guarantee ABN a specified return on investment;<sup>140</sup>
- (2) AHP and ABN shared equally in the partnership's gains and losses, relative to their respective partnership shares;<sup>141</sup>
- (3) AHP and ABN bore the transaction costs and other costs of the partnership equally, relative to their respective partnership shares;<sup>142</sup>
- (4) There was no predetermined agreement on the part of AHP to enter into each of the steps, as outlined by Merrill Lynch, required to capture the tax benefit of the transactions;<sup>143</sup>
- (5) AHP did not enter into any hedge transactions outside of the partnership, which would have served to eliminate downside risk and upside potential;<sup>144</sup> and
- (6) Due to the fluctuating value of the PPNs and the LIBOR notes, there was a reasonable possibility the partnership would realize an actual gain or loss, rather than merely a tax benefit.<sup>145</sup>

Relying on these facts, the District Court applied the economic substance doctrine to determine that AHP and *Boca* had both a subjective legitimate

<sup>133</sup> *Id.* at 298-388.

<sup>134</sup> *See id.* at 318-19, 323, 325, 354, 360-61, 371.

<sup>135</sup> *Id.* at 381-83.

<sup>136</sup> *See Horn v. Comm'r*, 968 F.2d 1229, 1237-38 (D.C. Cir. 1992); *see also* discussion *supra* Part II.A.1.

<sup>137</sup> *Boca*, 167 F. Supp. 2d at 377.

<sup>138</sup> *Id.* at 303.

<sup>139</sup> *Id.* at 303-63.

<sup>140</sup> *Id.* at 328.

<sup>141</sup> *Id.* at 325.

<sup>142</sup> *Id.* at 337.

<sup>143</sup> *Boca*, 167 F. Supp. 2d at 332-33.

<sup>144</sup> *Id.* at 339.

<sup>145</sup> *Id.* at 331.

non-tax business purpose (a return on investment in the PPNs and the LIBOR notes),<sup>146</sup> and an objective ex ante reasonable possibility of profit,<sup>147</sup> thereby satisfying both prongs of the economic substance doctrine. The District Court accordingly reversed the IRS's recharacterization decision.<sup>148</sup>

b. *D.C. Court of Appeals*

On appeal, the D.C. Circuit quickly affirmed the trial court's findings of fact, noting that although the trial court had reached a different conclusion than in other cases with similar facts, this difference in findings did not constitute clear error, especially where, as in this case, the findings were based on the relative creditability of the parties' witnesses.<sup>149</sup> Despite the adherence to the trial court's factual findings, which unequivocally stated that the government's evidence was sorely lacking,<sup>150</sup> the Court of Appeals reversed on the basis that the trial court did not properly apply the holding of *ASA Investorings*, but implicitly expanded that holding to require a non-tax business necessity for a transaction, rather than a mere business purpose.<sup>151</sup> The court also failed to address explicitly the economic substance doctrine as it existed in the D.C. Circuit and as applied by the trial court. While it recognized the requirement of subjective business purpose (or necessity, as the court saw it),<sup>152</sup> it did not address the objective economic substance prong, nor did it recognize that the economic substance test had typically been applied in a disjunctive fashion, where a showing of either subjective business purpose or objective economic substance would allow a transaction to stand.<sup>153</sup> On the whole, the circuit court accomplished its goal of reversal in a rather expedient fashion, undoing in six pages what the trial court had done in ninety, while expanding and modifying the economic substance doctrine in the D.C. Circuit so as to disallow the results of a fact pattern that had been substantially differentiated from previous CINS transactions.<sup>154</sup>

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<sup>146</sup> *Id.* at 380.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at 388.

<sup>149</sup> *Boca Investorings P'ship v. United States*, 314 F.3d 625, 630 (D.C. Cir. 2003).

<sup>150</sup> *Boca Investorings P'ship v. United States*, 167 F. Supp. 2d 298, 303 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003).

<sup>151</sup> *Boca*, 314 F.3d at 630.

<sup>152</sup> *Id.*

<sup>153</sup> *See Horn v. Comm'r*, 968 F.2d 1229, 1237-38 (D.C. Cir. 1992); *see also supra* Part II.A.1.

<sup>154</sup> *Boca*, 314 F.3d at 626-32.

B. *The D.C. Circuit Pattern in Other Circuits*

The pattern demonstrated by the D.C. Circuit in dealing with the CINS transaction is not unique to the D.C. Circuit. Although it is certainly most evident in the cases above, it can also be derived from an examination of prepackaged tax planning decisions in other circuits. While the transactions differ, the judicial pattern is consistent: (1) a specific tax package is examined on a number of occasions, with the result that the tax consequences are disallowed; (2) a trial court encounters another use of that tax package, distinguishes it on a factual basis from previous instances of that package's use and, applying the economic substance doctrine, allows the tax benefits of the transaction; and (3) the circuit court either disregards the trial court's well-documented factual findings or modifies the economic substance doctrine to suit the circuit court's purposes. This section will demonstrate this pattern through an examination of the COLI transaction and the Sixth Circuit's determinations in *Dow Chemical Co. v. Commissioner*<sup>155</sup> and through an analysis of lease stripping and the Second Circuit's determinations in *TIFD III-E, Inc. v. United States*.<sup>156</sup>

1. COLI and the Sixth Circuit—*Dow Chemical Co. v. Commissioner*

a. *The Economic Substance Doctrine in the Sixth Circuit*

The Sixth Circuit applies a more rigid form of the economic substance doctrine than the D.C. Circuit, in that the analysis is two steps, rather than merely being two-part. The court must first determine whether the transaction had objective economic substance before advancing to a determination of whether the taxpayer actually entertained a profit motive in engaging in the transaction.<sup>157</sup> Although the Sixth Circuit requires a two-step economic substance analysis, this is merely a procedural mandate and indicates nothing more than that the Sixth Circuit's application of the doctrine is conjunctive, whereby the taxpayer must satisfy both prongs of the economic substance doctrine for the transaction to be recognized.

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<sup>155</sup> 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

<sup>156</sup> 459 F.3d 220 (2d Cir. 2006).

<sup>157</sup> *Illes v. Comm'r*, 982 F.2d 163, 165 (6th Cir. 1992) (citing *Rose v. Comm'r*, 868 F.2d 851, 853 (6th Cir. 1989); *Mahoney v. Comm'r*, 808 F.2d 1219, 1220 (6th Cir. 1987)).

b. *Initial Cases*

In *Winn-Dixie Stores, Inc. v. Commissioner*,<sup>158</sup> the Eleventh Circuit affirmed a Tax Court decision disallowing the tax benefits of a COLI transaction entered into by Winn-Dixie.<sup>159</sup> The Tax Court concluded that there was neither a reasonable possibility that the COLI transactions would produce a pretax economic benefit nor did Winn-Dixie enter into the transaction with a subjective business purpose other than tax savings.<sup>160</sup> Winn-Dixie's own projections reflected Winn-Dixie's knowledge that the COLI transaction would generate a substantial pretax loss, offset only by the interest and fee tax deductions related to the plan.<sup>161</sup> Accordingly, the tax benefits of the COLI transactions, interest deductions, fee deductions, and tax-deferred inside build-up were disallowed.<sup>162</sup>

In *In re CM Holdings, Inc.*,<sup>163</sup> the Third Circuit affirmed a bankruptcy court decision disallowing the tax benefits of a COLI transaction entered into by Camelot Records.<sup>164</sup> The trial court reached essentially the same conclusions regarding the COLI transactions as the trial court in *Winn-Dixie*.<sup>165</sup> First, the taxpayer in this case, Camelot Records, could not reasonably expect a positive pretax cash flow.<sup>166</sup> Second, the inside build-up of the insurance policies, as well as the death benefits that would eventually be paid out by the policies, would also not result in any actual economic benefit, as the payouts were far outweighed by the costs of the transaction.<sup>167</sup> Finally, the only potential benefit to Camelot was the substantial tax savings that the interest and fee deductions generated.<sup>168</sup> For those reasons, the tax benefits of the COLI transaction were disallowed.<sup>169</sup>

In *American Electric Power Co. v. United States*,<sup>170</sup> the Sixth Circuit affirmed a district court decision disallowing the tax benefits of a COLI transaction entered into by American Electric Power ("AEP").<sup>171</sup> The COLI transaction in *AEP* was essentially the same as the COLI transactions in *CM*

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<sup>158</sup> 254 F.3d 1313 (11th Cir. 2001).

<sup>159</sup> *Id.* at 1314.

<sup>160</sup> *Winn-Dixie Stores, Inc. v. Comm'r*, 113 T.C. 254, 294 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).

<sup>161</sup> *Id.* at 290.

<sup>162</sup> *Id.* at 294.

<sup>163</sup> 301 F.3d 96 (3d Cir. 2002).

<sup>164</sup> *Id.* at 108.

<sup>165</sup> *See id.*; *Winn-Dixie*, 113 T.C. at 294.

<sup>166</sup> *In re CM Holdings, Inc.*, 254 B.R. 578, 653-54 (D. Del. 2002), *aff'd*, 301 F.3d 96 (3d Cir. 2002).

<sup>167</sup> *Id.* at 654.

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> 326 F.3d 737 (6th Cir. 2003).

<sup>171</sup> *Id.* at 739.

*Holdings and Winn-Dixie*.<sup>172</sup> Any financial benefits that AEP could potentially realize were directly attributable to the substantial tax benefits afforded to both life insurance loan interest and fee deductions and inside build-up tax deferrals.<sup>173</sup> The two potential pretax economic benefits of a life insurance policy, death benefits and the accumulation of inside build-up, were intentionally offset by the cost of the insurance and the cost of loans on the insurance policies.<sup>174</sup> Accordingly, the district court disallowed the tax benefits.<sup>175</sup>

c. Dow Chemical Co. v. Commissioner

In *Dow Chemical Co. v. Commissioner*,<sup>176</sup> the Sixth Circuit encountered the COLI transaction for a second time, but on this occasion the trial court had allowed the tax results of Dow Chemical's COLI investments.<sup>177</sup> As in *Boca*, the trial court in *Dow* issued extensive factual findings,<sup>178</sup> differentiated the instant tax package use from previous uses of that tax package,<sup>179</sup> applied the conjunctive form of the economic substance doctrine<sup>180</sup> as required,<sup>181</sup> and reached a different conclusion than previous trial courts.<sup>182</sup> The trial court recognized the existence and relevance of the three previous COLI cases and examined each case in depth to determine the previous factual and legal bases for disallowing the COLI tax benefits.<sup>183</sup> In doing so, the *Dow* trial court found several important factual distinctions: (1) Dow's COLI transactions were structured in such a way that a pretax economic benefit could be realized; (2) Dow needed a cash source to fund future medical costs for retired employees, and using life insurance loans as this cash source was a legitimate business purpose; and (3) Dow had utilized similar transactions in the past to cover contingent liabilities, indicating that the COLI transaction was part of an overall business plan.<sup>184</sup> The trial court then articulated the economic substance doctrine, as it exists in

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<sup>172</sup> *Id.* at 744.

<sup>173</sup> *Am. Elec. Power, Inc. v. United States*, 136 F. Supp. 2d 762, 786-87 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003).

<sup>174</sup> *Id.* at 787-88.

<sup>175</sup> *Id.* at 795.

<sup>176</sup> 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

<sup>177</sup> *Dow Chem. Co. v. United States*, 250 F. Supp. 2d 748, 828 (E.D. Mich. 2003), *rev'd*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

<sup>178</sup> *Id.* at 764-94.

<sup>179</sup> *Id.* at 764.

<sup>180</sup> *Id.* at 799-811.

<sup>181</sup> *See supra* Part II.B.1.a.

<sup>182</sup> *Dow*, 250 F. Supp. 2d at 764.

<sup>183</sup> *Id.* at 758-64.

<sup>184</sup> *Id.* at 764.

the Sixth Circuit, indicating the existence of both the objective and subjective prongs.<sup>185</sup> The court found that, in deciding to engage in the COLI transaction, Dow reasonably relied on prepurchase illustrations showing that the insurance policies could yield a pretax profit.<sup>186</sup> Although they were considered, the tax deductions of the COLI transaction were not the substantial reason Dow purchased the life insurance policies.<sup>187</sup> Also, Dow intended to take the steps necessary to capture any potential economic benefit, indicating subjective business purpose.<sup>188</sup>

On appeal, the Sixth Circuit quickly recognized the thoroughness of the trial court's fact-finding and accepted it in its entirety, but just as quickly stated that the case turned on issues of law, rather than the factual distinctions between *Dow* and previous COLI transactions.<sup>189</sup> In accordance with the procedural mandate of *Illes v. Commissioner*,<sup>190</sup> the circuit court turned first to the objective prong of the economic substance doctrine to determine if Dow's COLI transaction had any economic effect beyond tax benefits.<sup>191</sup> Relying on *Knetsch v. United States*,<sup>192</sup> where the Supreme Court had disallowed the tax benefits of a transaction where actual economic substance was dependant on making future loan payments, but there was no factual support for the taxpayer's intent to actually make those payments, the court disallowed Dow's tax benefits.<sup>193</sup> In doing so, the court disregarded the trial court's factual determination that Dow did intend to make the necessary payments.<sup>194</sup>

In this case, there was a dissenting voice advocating adherence to the fact-finding of the trial court and the trial court's accurate application of the economic substance doctrine.<sup>195</sup> The dissent believed that the factual distinction between *Dow* and other COLI cases was significant enough to warrant a different decision than in the other COLI cases.<sup>196</sup> The trial court had not committed legal error in accepting Dow's Net Present Value ("NPV") analysis, which showed a positive NPV, and in accepting Dow's claim that it intended to make the cash infusions required to reap an actual economic

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<sup>185</sup> *Id.* at 799.

<sup>186</sup> *Id.* at 800-01, 808.

<sup>187</sup> *Id.* at 811.

<sup>188</sup> *Dow*, 250 F. Supp. 2d at 808, 811.

<sup>189</sup> *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

<sup>190</sup> 982 F.2d 163 (6th Cir. 1992).

<sup>191</sup> *Dow*, 435 F.3d at 599.

<sup>192</sup> 364 U.S. 361 (1960).

<sup>193</sup> *Dow*, 435 F.3d at 601-03, 605.

<sup>194</sup> *Id.* at 602.

<sup>195</sup> *Id.* at 611-12 (Ryan, J., dissenting).

<sup>196</sup> *Id.* at 607-12.

profit from the insurance plans.<sup>197</sup> Accordingly, the trial court's ultimate conclusion that Dow's transaction should stand was appropriate.<sup>198</sup>

## 2. Lease Stripping and the Second Circuit—*TIFD III-E*

### a. *The Economic Substance Doctrine in the Second Circuit*

The state of the economic substance doctrine in the Second Circuit is less clear than in the previously discussed circuits. Although the typical statement of the economic substance doctrine indicates that the test is strictly disjunctive,<sup>199</sup> there is sufficient ambiguity to indicate that the test is flexible and requires strict adherence neither to a conjunctive nor disjunctive test.<sup>200</sup> In general, courts in the Second Circuit give slightly more weight to the objective portion of the economic substance test, requiring at least minimal objective economic substance for the transaction to withstand judicial scrutiny where the taxpayer is relying primarily on his subjective business purpose.<sup>201</sup>

### b. *Initial Cases*

In *Andantech L.L.C. v. Commissioner*,<sup>202</sup> the D.C. Circuit affirmed a Tax Court decision disallowing the tax benefits of a lease stripping transaction entered into by the U.S. company Comdisco, a lessor of computer equipment.<sup>203</sup> Comdisco had sold a substantial amount of computer equipment to Andantech, a partnership in which the substantial interest holders were not subject to U.S. taxation, and Andantech had leased that equipment back to Comdisco, allowing Comdisco to avoid recognition of lease income, but retain depreciation deductions on the computer equipment.<sup>204</sup> In examining the transaction, the Tax Court concluded that this “sale-

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 611-12.

<sup>199</sup> See *Jacobson v. Comm'r*, 915 F.2d 832, 837 (2d Cir. 1990) (“A transaction is a sham . . . if it has no business purpose *or* economic effect other than the creation of tax deductions.”) (emphasis added) (quoting *DeMartino v. Commissioner*, 862 F.2d 400, 406 (2d Cir. 1988)).

<sup>200</sup> See, e.g., *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 171 n.68 (D. Conn. 2004) (discussing the flexibility of the Second Circuit's approach to the economic substance doctrine), *aff'd*, 150 F. App'x 40 (2d Cir. 2005).

<sup>201</sup> See, e.g., *Gardner v. Comm'r*, 954 F.2d 836, 839 (2d Cir. 1992) (“[I]t is well established that a subjective profit motive can not save a transaction that objectively lacks economic substance.”).

<sup>202</sup> 331 F.3d 972 (D.C. Cir. 2003).

<sup>203</sup> *Id.* at 981-82.

<sup>204</sup> *Andantech L.L.C. v. Comm'r*, 83 T.C.M. (CCH) 1476, 1476-77 (2002), *aff'd*, 331 F.3d 972 (D.C. Cir. 2003); see also discussion *supra* Part I.A.3.

leaseback” transaction lacked both a reasonable possibility of profit and any other business purpose, thus failing both prongs of the economic substance doctrine.<sup>205</sup> The question of profit potential for the partnership turned on the measure of residual value of the computer equipment after the expiration of the lease term.<sup>206</sup> If the equipment had substantial residual value, then the partnership would still be able to capture a profit above its purchase price.<sup>207</sup> Predicting residual value of computer equipment, however, is highly speculative and the most reliable information in this case indicated that by the time the lease expired, the computer equipment would be outdated and of relatively little value, thereby leaving little room for profit on the part of the partnership.<sup>208</sup> As to any other subjective business purpose other than tax benefits, the Tax Court found that the terms of the computer equipment sale were not consistent with market realities, neither the U.S. company nor the partnership had tried to negotiate the most favorable price, the formalities of the sale contract were not followed, and the transaction took place in an environment controlled primarily by the seller, rather than on the open market—all indicating that Comdisco wished merely to obtain tax benefits, rather than any other business advantage.<sup>209</sup>

In *Nicole Rose Corp. v. Commissioner*,<sup>210</sup> the Second Circuit affirmed a Tax Court decision disallowing the tax benefits of a lease stripping transaction entered into by the Nicole Rose Corporation.<sup>211</sup> In 1993, Nicole Rose had purchased Quintron Corporation and sold off all of Quintron’s assets, thereby increasing Nicole Rose’s income by \$11 million.<sup>212</sup> To offset this large increase in income, Nicole Rose obtained an interest in a preexisting lease stripping transaction.<sup>213</sup> Ostensibly, Nicole Rose was acquiring an ownership interest in computer equipment, as well as an interest in the lease income of the equipment, but this purported profit motive and business purpose did not hold up to scrutiny, as Nicole Rose conducted no investigation into the value of the equipment and sold its interest shortly after acquiring it, thereby creating a \$22 million tax loss.<sup>214</sup> Because Nicole Rose exhibited little interest in ascertaining the value of its purchase and even less interest in holding its purchase, claims of business purpose could not stand and the Tax Court disallowed the tax deduction.<sup>215</sup>

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<sup>205</sup> *Andantech*, 83 T.C.M. (CCH) at 1520.

<sup>206</sup> *Id.* at 1514.

<sup>207</sup> *Id.*

<sup>208</sup> *Id.* at 1516-17.

<sup>209</sup> *Id.* at 1513-17.

<sup>210</sup> 320 F.3d 282 (2d Cir. 2003).

<sup>211</sup> *Id.* at 285.

<sup>212</sup> *Id.* at 284.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.* at 283-84.

<sup>215</sup> *Id.*

## c. TIFD III-E

In *TIFD III-E, Inc. v. United States*,<sup>216</sup> the Second Circuit encountered lease stripping for a second time, implemented on this occasion by General Electric Capital Corporation (“GECC”).<sup>217</sup> GECC owned several aircraft, which it leased to various airlines.<sup>218</sup> Because of financial concerns in the airline industry at the time (the early 1990s), GECC wished to raise immediate cash against its future aircraft rental income.<sup>219</sup> To this end, GECC approached the investment banking firm Babcock & Brown seeking a transactional structure that would provide an immediate cash infusion, as well as a tax savings.<sup>220</sup> Babcock & Brown proposed the formation of a partnership initially substantially owned by a foreign entity.<sup>221</sup> The partnership (“Castle Harbour”) would purchase GECC’s aircraft, providing the cash infusion that GECC desired, and would continue to lease out the aircraft, as GECC had been doing for many years.<sup>222</sup> Castle Harbour provided tax advantages to GECC by utilizing differences between book depreciation and tax depreciation.<sup>223</sup> Although the aircraft had already been fully depreciated for tax purposes, there was still potential for substantial book depreciation.<sup>224</sup> Because book income was calculated post-book depreciation, Castle Harbour’s taxable income was significantly greater than its book income.<sup>225</sup> The foreign partner, which had a 98% interest in the partnership, absorbed the tax consequences, but received only the portion of book income that was greater than book depreciation.<sup>226</sup>

In examining this transaction, the district court had “little trouble” finding the “Castle Harbour transaction had a real, non-tax economic effect,”<sup>227</sup> and that GECC entered into the transaction with the legitimate business purpose of raising capital, as well as demonstrating to investors and management that GECC *could* raise capital on its aircraft.<sup>228</sup> The only way for GECC to receive a cash infusion for its aircraft was to form a separate entity, and the decision to create a partnership with a foreign entity was legitimate and supplied a sufficient non-tax business purpose by raising

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<sup>216</sup> 459 F.3d 220 (2d Cir. 2006).

<sup>217</sup> *See id.* at 225.

<sup>218</sup> *TIFD III-E, Inc. v. United States*, 342 F. Supp. 2d 94, 96 (D. Conn. 2004), *rev’d*, 459 F.3d 220 (2d Cir. 2006).

<sup>219</sup> *Id.*

<sup>220</sup> *Id.* at 97.

<sup>221</sup> *Id.*

<sup>222</sup> *Id.* at 98.

<sup>223</sup> *Id.* at 106-07.

<sup>224</sup> *TIFD III-E*, 342 F. Supp. 2d at 106-07.

<sup>225</sup> *Id.*

<sup>226</sup> *Id.*

<sup>227</sup> *Id.* at 109.

<sup>228</sup> *Id.* at 111.

capital.<sup>229</sup> Accordingly, the Castle Harbour transaction satisfied both prongs of the economic substance test and the tax benefits of the transaction were allowed,<sup>230</sup> unlike the transactions in *Nicole Rose* and *Andantech*.

On appeal, the Second Circuit noted that *TIFD III-E* presented “exceptionally complex facts” and accepted the district court’s “precise, thorough, and careful findings.”<sup>231</sup> Rather than challenging the accuracy of the district court’s application of the economic substance doctrine, the circuit court quickly brushed past the economic substance of GECC’s transaction to apply an alternate judicial test.<sup>232</sup> In implementing the *Culbertson* test, which looks at the totality of the circumstances to determine whether the taxpayer accurately characterized its transaction,<sup>233</sup> the circuit court focused primarily on the question of whether Castle Harbour’s foreign partner was more accurately characterized as a creditor or a partner.<sup>234</sup> Although the district court had determined that the foreign partner held an equity interest, the circuit court disagreed<sup>235</sup> and ultimately reversed the district court’s decision, holding that the foreign partner’s interest in the partnership was more akin to that of a creditor than a partner.<sup>236</sup>

### C. *Modifying the Economic Substance Doctrine to Capture Legitimate Tax Planning*

From *Boca* to *Dow* to *TIFD III-E*, appellate courts have repeatedly expanded the scope of the economic substance doctrine to encompass transactions that trial courts have determined were made with the intention of capturing actual non-tax economic benefit. In *Boca*, the circuit court modified the scope of the economic substance doctrine in the D.C. Circuit in two inadvisable ways: (1) the court disregarded the precedent of *Horn* and did not apply a disjunctive test and (2) the court inserted “necessity” into the business purpose prong of the economic substance doctrine. Prior to *Boca*, it was clear under the circuit court’s ruling in *Horn* that the D.C. Circuit applied a disjunctive test, whereby a taxpayer need satisfy only one prong of the economic substance doctrine for his transaction to stand.<sup>237</sup> Although

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<sup>229</sup> *Id.* at 114.

<sup>230</sup> *TIFD III-E*, 342 F. Supp. 2d at 121.

<sup>231</sup> *TIFD III-E v. United States*, 459 F.3d 220, 224-25 (2d Cir. 2006).

<sup>232</sup> *Id.* at 230-31.

<sup>233</sup> *See Comm’r v. Culbertson*, 337 U.S. 733, 742 (1949) (“The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard . . . but whether, considering all of the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.”).

<sup>234</sup> *TIFD III-E*, 459 F.3d at 232.

<sup>235</sup> *Id.* at 233-34.

<sup>236</sup> *Id.* at 241.

<sup>237</sup> *See discussion supra* Part II.A.1.

the district court recognized the disjunctive test, in the interest of thoroughness, it ultimately concluded that the transaction in *Boca* satisfied both prongs.<sup>238</sup> In its reversal, the court of appeals addressed only the business purpose prong,<sup>239</sup> thereby implicitly reversing *Horn* and implementing a conjunctive test in the D.C. Circuit. In doing so, the *Boca* court disregarded the important judicial values of consistency, predictability and, absent compelling countervailing considerations, adherence to precedent.<sup>240</sup> Additionally, the *Boca* court did so without recognizing the *Horn* decision.

Ultimately, the appellate court disallowed the *Boca* transaction by determining the partnership was not a “business necessity” to capture the economic gains of investing in PPNs and LIBOR notes, rather than examining whether the partnership had a discernible business purpose.<sup>241</sup> The court did not attempt to outline what would constitute sufficient “necessity” for a taxpayer’s chosen transaction form to withstand judicial scrutiny. This is troubling for two primary reasons. First, the taxpayer, provided with apparently concrete and certain rules regarding tax treatment of transactions (the I.R.C.), is left uncertain as to when those rules will be disregarded because the form of a transaction was not “necessary” to attain the goals of the transaction. The D.C. Circuit has provided no guidelines for determining when a certain transactional form is necessary to achieve a certain end and appears to have left such determinations within the court’s sole, arbitrary discretion. With a tax code that takes the form of rules, rather than standards, certain transactions will sometimes receive benefits undesired by Congress, but the courts do not have the latitude to supersede those rules.<sup>242</sup> Second, the term implies a requirement that the taxpayer structure his transactions in such a way as to pay the most taxes or, at the least, requires taxpayer indifference as to the tax consequences of a transaction. This directly contravenes a basic principle of the economic substance doctrine: “[a]ny one may so arrange his affairs that his taxes shall be as low as possible,”<sup>243</sup> so long as there is also economic substance to the transaction. Judge Hand’s statement anticipates taxpayer contemplation of the tax consequences of a transaction and allows such contemplation. To require a non-tax necessity is incongruous with this allowance.

Similarly, in *Dow* the Sixth Circuit reversed the district court despite the trial court’s extensive fact-finding and accurate application of the economic substance doctrine.<sup>244</sup> In doing so, the appellate court explicitly dis-

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<sup>238</sup> *Boca Investorings P’ship v. United States*, 167 F. Supp. 2d 298, 377 (D.D.C. 2001), *rev’d*, 314 F.3d 625 (D.C. Cir. 2003).

<sup>239</sup> *Boca*, 314 F.3d at 630.

<sup>240</sup> See 20 AM. JUR. 2D *Courts* § 129 (2006).

<sup>241</sup> *Boca*, 314 F.3d at 630.

<sup>242</sup> Coverdale, *supra* note 9, at 1522-23.

<sup>243</sup> *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

<sup>244</sup> *Dow Chem. Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

regarded the trial court's factual distinctions between *Dow* and the three previous COLI cases,<sup>245</sup> marginalizing the trial court's role as the most effective fact-finder. The appellate court disregarded the trial court's determination that Dow intended to enter into all the steps necessary to capture the pretax economic benefit of the COLI transaction and that Dow's prior business history supported that fact.<sup>246</sup> In the face of extensive facts supporting Dow's tax deductions as reasonable, the Sixth Circuit, without explicitly finding clear error in the trial court's fact-finding, excluded the facts unfavorable to the circuit's reversal. Although in its consideration of *Knetsch* the circuit contended that the trial court misapplied the law and that Dow had not entertained the actual intent to complete the steps necessary to realize an actual economic benefit,<sup>247</sup> a careful examination of the trial court's fact-finding reveals sufficient factual basis for finding for Dow under the legal standards required by the circuit court.<sup>248</sup> Rather than recognizing important factual distinctions, the circuit court seemed to see only the tax package and ruled accordingly. In this case, the dissenting opinion is the better-reasoned opinion. The dissent found the district court "correctly applied this court's economic substance doctrines, . . . did not commit legal error, . . . did not abuse its discretion, . . . and did not commit clear error in making its central factual findings."<sup>249</sup> The dissent's approach implicitly recognizes the importance of fact-finding in complicated transactional cases and explicitly recognizes the difficulties associated with ad hoc expansion of the economic substance doctrine.<sup>250</sup>

In *TIFD III-E*, the Second Circuit essentially adopted an "if at first you don't succeed, try, try again" approach, recognizing the validity of the trial court's application of the law, but sifting through legal doctrines until it settled on one that would support the circuit court's reversal.<sup>251</sup> Because the economic substance doctrine has been applied consistently, albeit in an inconsistent manner, in cases dealing with tax packages,<sup>252</sup> including cases in the Second Circuit,<sup>253</sup> and because the district court accurately applied

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<sup>245</sup> *Id.* at 605.

<sup>246</sup> *See id.* at 602.

<sup>247</sup> *Id.* at 601-03, 605.

<sup>248</sup> *See Dow Chem. Co. v. United States*, 250 F. Supp. 2d 748, 807, 810 (E.D. Mich. 2003) (finding that although previous COLI transactions were designed with a minimum payment strategy, thereby removing economic substance, "Dow did not intend to operate its policies in that fashion" and "Dow . . . acknowledged that cash would have to be injected into the plan after the seventeenth year"), *rev'd*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

<sup>249</sup> *Dow*, 435 F.3d at 611-12 (Ryan, J., dissenting).

<sup>250</sup> *Id.* at 605-06.

<sup>251</sup> *See TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231-32 (2d Cir. 2006).

<sup>252</sup> *See Keinan, supra* note 55, at 371-72, 453 (asserting that despite playing "an important role in recent . . . decisions," the economic substance doctrine continues to be applied inconsistently by courts).

<sup>253</sup> *See, e.g., Nicole Rose Corp. v. Comm'r*, 320 F.3d 282, 284 (2d Cir. 2002) ("The relevant inquiry is whether the transaction that generated the claimed deductions . . . had economic substance.").

the Second Circuit's version of the economic substance doctrine,<sup>254</sup> the circuit court's only recourse was either to disregard the district court's fact-finding, which the circuit court found to be "precise, thorough and careful"<sup>255</sup> or to downplay the importance of the doctrine and implement an alternate judicial test.<sup>256</sup> In implementing an alternate judicial test, the Second Circuit disregarded the precedent of *Nicole Rose*, where the court had applied the economic substance doctrine to a similar transactional form,<sup>257</sup> and subjected corporate taxpayers to the uncertainty of a court that is free to choose between laws to achieve whatever end it desires.

In *Boca* and *TIFD III-E*, the circuit courts chose, both explicitly and implicitly, to modify the scope of the judicial doctrines applicable to tax packages in their goal of disallowing tax benefits that were obtained by accurate application of the I.R.C. With the insertion of "necessity" in the D.C. Circuit and the "if at first you don't succeed, try, try again" approach of the Second Circuit, the appellate courts disregarded the trial court's differentiation of an instance of tax package use from previous uses with the effect of increasing uncertainty as to judicial outcomes, as well as overriding the express allowances and requirements of the I.R.C. Add the Sixth Circuit's disregard for the trial court's fact-finding in *Dow* to the mix and there are now at least three circuits where the pattern of disallowing the tax benefits of a tax package merely because that package has previously been disallowed emerges.

### III. COURT OF APPEALS DEFERENCE TO THE STATUTORY FRAMEWORK OF THE I.R.C. AND THE FACT-FINDING OF TRIAL COURTS

Effective tax planning has been blamed for widening the "tax gap" and presenting an ethical dilemma whereby taxpayers subvert congressional intent in applying the literal meaning of a statute.<sup>258</sup> These characterizations are patently unfair for two primary reasons.

First, defining and quantifying the term "tax gap" is an attempt to apply definition and quantity where none exists. There are two common definitions of "tax gap," each bearing little relation to the other. The first definition measures the difference between book income and taxable income,<sup>259</sup>

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<sup>254</sup> See *TIFD III-E, Inc. v. United States*, 342 F. Supp. 2d 94, 108-11 (D. Conn. 2004) (recognizing the variability of the economic substance doctrine in the Second Circuit, but applying the most stringent test and finding that the transaction in *TIFD III-E* had both a business purpose and real economic effect), *rev'd*, 459 F.3d 220 (2d Cir. 2006); see also discussion *supra* Part II.B.2.a.

<sup>255</sup> *TIFD III-E*, 459 F.3d at 224-25.

<sup>256</sup> See *id.* at 231.

<sup>257</sup> *Nicole Rose*, 320 F. 3d at 284-85.

<sup>258</sup> See, e.g., James M. Delaney, *Where Ethics Merge with Substantive Law—An Analysis of Tax-Motivated Transactions*, 38 IND. L. REV. 295, 295-97 (2005).

<sup>259</sup> Celia Whitaker, *Bridging the Book-Tax Accounting Gap*, 115 YALE L.J. 680, 682 (2005).

while the second defines “tax gap” as the difference between the amount of tax owed and the amount of tax paid.<sup>260</sup> The first definition assumes impropriety where there may in fact be none. It is natural for corporations to tend to inflate book income, which is analyzed by potential investors, and deflate taxable income, which will form the basis for a calculation of tax liability. There is no illegality inherent in the difference between book income and taxable income and, in the absence of fraud, each calculation is only the result of carefully prescribed accounting procedures. The second definition invites inaccuracy in calculation of the supposed gap. Under our system of taxation, the I.R.C. prescribes specific rules and, until the IRS or a court modifies those rules through interpretation, taxpayers have little guidance as to the application of the rules. The rules can result in differences between the reported taxable income of similarly situated taxpayers, with neither taxpayer using a recognizably incorrect reporting method. Under any definition, the contention that a large tax gap exists and that it is attributable to the capturing of unintended tax benefits is questionable at best.<sup>261</sup>

Second, Judge Hand’s maxim in *Gregory* still stands.<sup>262</sup> A taxpayer is permitted to structure his activities in the most tax beneficial way possible, so long as a certain line is not crossed. This line has been drawn with the economic substance doctrine. This line should be firm, clear, and favor the taxpayer. When a taxpayer is in compliance with the literal meaning of the I.R.C., there should be little room for modifying the results of his compliance. He should not be subjected to the nebulous standard that exists today. Also, as stated by Judge Hand, “there is not even a patriotic duty to pay taxes.”<sup>263</sup> Just as there is no patriotic duty to pay taxes, there is no pervading ethical or moral duty to pay taxes.<sup>264</sup> The duty is to comply with the law; once done, that is all a person need do. Utilizing tax packages is only reprehensible where those tax packages contravene a legal duty, most notably in cases of fraudulent behavior.

This section advocates deference to (1) the statutory and regulatory framework of the I.R.C., through an examination of the amorphous economic substance doctrine and the apparent requirement that a taxpayer de-

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<sup>260</sup> Pamela H. Bucy, *Criminal Tax Fraud: The Downfall of Murderers, Madams and Thieves*, 29 ARIZ. ST. L.J. 639, 640 (1997).

<sup>261</sup> This is questionable not only because there is no settled definition of “tax gap,” but also because measurement of any tax gap is inherently inaccurate. See WHITE PAPER, *supra* note 3, at 32. (“It is very difficult to distinguish tax shelter activity from other activity that results in a book/tax difference.”).

<sup>262</sup> *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 chose the pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”), *aff’d*, 293 U.S. 465 (1935).

<sup>263</sup> *Id.*

<sup>264</sup> An individual can certainly feel morally obligated to pay a certain amount of taxes or to pay taxes on a certain transaction, but there is no moral or ethical obligation that binds all taxpayers to any amount of taxes for any transaction. There is only a legal obligation.

rive Congressional intent when structuring his transactions, and (2) the fact-finding of the trial courts, as tax packages typically employ complicated transactional structures where significant underlying facts may be hard to ascertain, but are of paramount importance.

A. *Deference to the Statutory Framework*

Unlike many other areas of law, tax law has been largely codified and Congress has expended great effort in creating a formal structure to frame acceptable and unacceptable behavior.<sup>265</sup> Congress has presented taxpayers with a set of objective requirements and expects compliance with those requirements.<sup>266</sup> If those requirements produce unintended benefits to a taxpayer, the requirements need to be fixed, not the taxpayer.<sup>267</sup> Reducing undesirable tax benefits (and even defining “undesirable” benefits) is best left in the hands of Congress—through modification of the I.R.C.—and, maybe to a greater extent, the Treasury—through promulgation of interpretative regulations. The imposition of judicial doctrines on prepackaged tax planning in lieu of deference to the statutory and regulatory framework is largely undesirable for two reasons.

First, the primary judicial tool, the economic substance doctrine, is constantly wavering in scope and application. There is no firm baseline for determining whether a transaction will survive the tests of the economic substance doctrine, neither within a circuit nor across circuits. While flexible judicial tests pervade the law and are often necessary to encompass flexible behavior, their necessity is less apparent where an extensive, specific and objective behavioral guide exists, as is the case with tax law.<sup>268</sup>

Second, disregarding the result of the objective tax code requires taxpayers to determine the subjective intent of Congress in enacting the provisions of the I.R.C. In effect, taxpayers must determine when the law as stated is not in fact the law and act accordingly. In what instances should the rules that Congress created be disregarded in favor of the rules that

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<sup>265</sup> See Coverdale, *supra* note 9, at 1526 (“[Arguing] that Congress is unable to update the law . . . is less convincing in the area of tax law than it might be in other areas. In recent times, in fact, Congress has amended the Code with alarming frequency.”).

<sup>266</sup> See *id.* at 1522 (“Most provisions of the Code take the form of rules rather than standards.”).

<sup>267</sup> See *id.* at 1523. Coverdale asserts:

Congress’s choice of precise formal rules comes at a cost. Congress cannot possibly contemplate all of the circumstances in which the rules it enacts will come into play. . . . [However,] [t]his does not mean that courts should treat provisions of the Code that Congress wrote in the form of rules as merely providing the general guidance of a standard.

*Id.*; see also Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1178 (1989) (“[T]he value of perfection in judicial decisions should not be overrated. To achieve what is, from the standpoint of the substantive policies involved, the ‘perfect’ answer is nice—but it is just one of a number of competing values.”).

<sup>268</sup> See sources cited *supra* note 9 and accompanying text.

judges think it meant to create? The taxpayer must ask this question upon entering into any transaction to determine how that transaction should be reported for tax purposes.

### 1. Amorphous Judicial Standards

Over the past several years, as appellate courts strive to exert their influence in combating corporate tax planning, they have alternately expanded and contracted the reach of the economic substance doctrine depending on whether the doctrine is advantageous or detrimental in striking down the use of prepackaged corporate tax-planning. From inserting “necessity” in *Boca*<sup>269</sup> to discrediting the economic substance doctrine in *TIFD III-E*,<sup>270</sup> appellate courts have been uniform in only one respect: if a tax package is used illegitimately once, that package must have no legitimate use.<sup>271</sup> Rather than examining the merits of each case, appellate courts tend to examine the merits of a tax package and then expand the economic substance doctrine as necessary to encompass all uses of that package.<sup>272</sup> In effectively declaring a tax package to be illegal per se, the judiciary treads perilously close to the legal domain of the legislature.

Although the law necessarily strikes a balance between adaptability and predictability, the tax code and applicable doctrines are surely one of the most extensive, confusing, and unpredictable areas of law.<sup>273</sup> These problems of volume and ambiguity should induce the courts to strive for clarification of existing doctrines, rather than further expansion. By only disallowing the tax benefits obtained by a taxpayer who shows egregious disregard for the intended results of the I.R.C., appellate courts can allow the I.R.C. to operate as written, without leaving the judiciary toothless.

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<sup>269</sup> See *Boca Investorings P’ship v. United States*, 314 F.3d 625, 630 (D.C. Cir. 2003).

<sup>270</sup> See *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231 (2d Cir. 2006).

<sup>271</sup> Not all appellate judges are unsympathetic to taxpayers who meet literal statutory requirements, and some have criticized disallowing such transactions as a judicial “smell test.” See, e.g., *ACM P’ship v. Comm’r*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting) (stating, with regard to a transaction where the taxpayer had complied with the statutory requirements but was not allowed to receive the tax benefits of that transaction, that “the majority’s conclusion [disallowing the tax benefits] is, in its essence, something akin to a ‘smell test’”). In the majority of cases, however, it appears that once the judicial nostrils smell a tax package, they do not lose the scent, regardless of any subsequent variations.

<sup>272</sup> See *supra* Part II.C.

<sup>273</sup> See Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 859 (1982). In describing the preeminent tax treatise, Isenbergh states:

There are, of course, aspects of the income tax system—a few entire segments and many more details—that escape Professor Bittiker’s scrutiny. This was inevitable since the income tax provisions of the Internal Revenue Code now contain as many words as any one of Professor Bittiker’s four volumes. Add the Treasury Regulations to the scales, and the entire treatise is comfortably exceeded in length by the law it expounds.

*Id.*

The economic substance doctrine, with its one subjective prong and one objective prong, is, if clarified, certainly an effective tool for containing egregious behavior, while still reasonably allowing taxpayers to structure their transactions so as to incur the least amount of tax liability. The subjective prong, which examines the intent of the taxpayer when entering into the transaction, should be clarified so as to allow transactions where the taxpayer contemplated any business purpose other than tax benefits, including limited liability, appreciation of stock price, and demonstration to investors or creditors of the taxpayer's ability to raise capital. The objective prong should be clarified so as to allow transactions that have anything other than minimal economic substance. Where fluctuating interest rates indicate a risky transaction, that transaction should be allowed, regardless of whether the tax benefits greatly outweigh the potential for pretax gain. The economic substance doctrine, clarified in this manner, would still prohibit transactions such as those in *ASA Investments* and *Saba*, where the taxpayer entered into outside hedge transactions, guaranteed a certain return to its "partners," and otherwise effectively reduced the pretax potential for gain to zero or less than zero. Transactions such as those in *Boca* and *TIFD III-E* would be allowed even though the tax benefits outweighed the pretax gains of the transactions. The taxpayers in *Boca* and *TIFD III-E* engaged in a risky transaction with potential pretax upside and should not be punished for also capturing substantial tax benefits that are not explicitly prohibited and are, in some cases, arguably sanctioned by the I.R.C.

Although the Congressional pace is often slow, it is no slower than judicial procedures in combating undesirable tax package use.<sup>274</sup> Clarification of the economic substance doctrine will allow Congress to fulfill its traditional role as it relates to taxation,<sup>275</sup> without allowing the judiciary to usurp that role through the inconsistent application of judicial doctrines. If Congress wishes to disallow the benefits of a certain tax package prospectively, it is certainly capable of doing so. As evidenced by the COLI cases, where Congress modified the I.R.C. so as to remove many of the tax benefits of the COLI transactions,<sup>276</sup> Congress can effectively react to tax package use and curb undesirable behavior. In the meantime, the judiciary should not disallow tax benefits that are merely the result of the I.R.C. as written.

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<sup>274</sup> See, e.g., *Black & Decker Corp. v. United States*, 436 F.3d 431, 434 (4th Cir. 2006) (deciding, finally, the fate of a tax package deduction claimed on a 1995 tax return); *Dow Chem. Co. v. United States*, 435 F.3d 594, 598 (6th Cir. 2006) (1989 tax return), *cert. denied*, 127 S. Ct. 1251 (2007); *Boca*, 314 F.3d at 629 (1990 tax return; decision in 2003).

<sup>275</sup> See 47A C.J.S. *Internal Revenue* § 4 (2006) (stating that under the U.S. Constitution, determining appropriate taxation policies is a legislative function).

<sup>276</sup> See *Dow Chem. Co. v. United States*, 250 F. Supp. 2d 748, 756 (E.D. Mich. 2003), *rev'd*, 435 F.3d 594 (6th Cir. 2006), *cert. denied*, 127 S. Ct. 1251 (2007).

## 2. The Requirement of Deriving Congressional Intent

In general, any “tax shelter”<sup>277</sup> complies with the literal requirements of the I.R.C. and related regulations, as any transaction that does not is more aptly and simply termed fraudulent.<sup>278</sup> This requires the conclusion that a tax shelter somehow reaps tax benefits unintended by Congress, which would have been prohibited if anticipated. Defining tax shelter “seems impossible . . . *except* in terms of congressional or regulatory intent.”<sup>279</sup> If taxpayers are going to be held accountable for their use of tax shelters, it follows that they are expected to engage in the derivation and interpretation of congressional intent. Even accepting the dubious assumption that a Congress of individuals possesses a uniform intent, the question remains, are taxpayers suited to derive congressional intent and is this expectation reasonable? In short, the answers are both no.

To say the least, determining the intent of Congress is a daunting mandate. This is especially true in the case of the I.R.C., which proposes to be an objective model determining what should be taxed and how it should be taxed.<sup>280</sup> Requiring compliance with congressional intent is tantamount to asking the taxpayer to determine when the objective meaning of the I.R.C. should be disregarded in favor of the subjective meaning. This is inappropriate for several reasons. First, it creates a strong possibility of inconsistent treatment of the same form of transaction by different taxpayers, even reasonable taxpayers. Where Congress itself cannot determine its intent specifically enough to clarify and codify it, it is incongruous to suggest dispersed taxpayers can, especially in a consistent fashion. Second, it encourages disingenuous behavior. If a taxpayer can profess a reasonable belief that the intent of Congress allows his transaction favorable tax treatment, despite the objective rules, should this serve as a defense when the IRS challenges his transaction? Finally, rules are rules for a reason. They serve as a guide to acceptable behavior and where the rules are followed, the behavior should be presumed acceptable. Tax planners work with the tools—the I.R.C. and related regulations—they have at hand and, in the absence of fraud, produce only results those tools are capable of producing. By disregarding those results, the federal government, through Congress and the IRS, is creating the rules at the start of the game and, through the judiciary,

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<sup>277</sup> In this context, “tax shelter” is used to refer to illegal tax planning, as may be defined by the courts, the IRS, or Congress.

<sup>278</sup> Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 330 (2002).

<sup>279</sup> *Id.* (emphasis added).

<sup>280</sup> See Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXECUTIVE 235, 247 (1999) (“[H]ow does one ask a model whether the benefits it dispenses were intentional? Models *do*; they do not *speak*. They are pure agents of action, without any self-consciousness; they cannot inform us when they feel abused.”).

modifying those rules in the middle of the game if the taxpayer appears to be “winning.” When tax law needs to be changed, that change should come from the beginning of the tax process; that is, the I.R.C. and interpretative regulations.

Congress has delegated the ability to engage in clarification of the I.R.C. to the Treasury.<sup>281</sup> The Treasury issues interpretive regulations with great frequency and efficiency<sup>282</sup> and there is no reason to suppose that they cannot alter or create new regulations as undesirable tax “loopholes” come to light. The delegation of regulatory power speeds up the process of eliminating undesirable tax benefits by foregoing the necessarily moderate pace of legislative procedures. Leaving the determination of Congressional intent in the hands of the Treasury properly aligns the incentives of the respective parties. The Treasury is charged with collecting taxes in accordance with the provisions of the I.R.C. and interpreting Congressional intent is consistent with that duty. Taxpayers, on the other hand, seek to pay the least amount of taxes possible and requiring them to determine what Congress believes they “should” pay would frequently produce one of two undesirable results, depending on the taxpayer: overstatement of tax liability by risk-averse taxpayers or understatement by risk-seeking taxpayers.

Critics of this regulatory remedy argue taxpayers take great pains to conceal tax-planning activities that may be considered inappropriate, leading to detection problems.<sup>283</sup> This may have been true in the face of ineffectual detection procedures, but those procedures have been greatly strengthened in recent years. For several years, the primary enforcement tool the IRS had at its disposal was the required disclosure of “listed” transactions.<sup>284</sup> This device was ineffective for several reasons. First, the list was infrequently updated, leading to situations where questionable transactions would not fall under the disclosure requirement for lengthy periods of

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<sup>281</sup> I.R.C. § 7801(a)(1) (2000) (imparting to the Secretary of the Treasury the duty to administer and enforce the provisions of the I.R.C.); *id.* § 7805(a) (imparting to the Secretary of the Treasury the duty to “prescribe all needful rules and regulations”); *see also* I.R.S., Tax Code, Regulations and Official Guidance, <http://www.irs.gov/taxpros/article/0,,id=98137,00.html> (last visited Feb. 15, 2008) (“Treasury regulations (26 C.F.R.)—commonly referred to as *Federal tax regulations*—pick up where the Internal Revenue Code (IRC) leaves off by providing the official interpretation of the IRC by the U.S. Department of the Treasury.”).

<sup>282</sup> One hundred and one interpretive regulations were issued from October 2005 through September 2006. *See* I.R.S., Plain Language Regulations, <http://www.irs.gov/taxpros/content/0,,id=103728,00.html> (last visited Feb. 15, 2008).

<sup>283</sup> *See* WHITE PAPER, *supra* note 3, at 31 (“Quantitative evidence of corporate tax shelters is somewhat sketchy because corporations are not required to identify shelters. In fact, the whole point of tax shelters is to hide income from the tax authority.”).

<sup>284</sup> *See* Schler, *supra* note 278, at 354; *see also* Editorial, *KPMG in Wonderland*, WALL ST. J., Oct. 6, 2005, at A14 (“‘Listing’ is an IRS practice that dates back to the 1980s. It is a kind of early warning system for taxpayers, putting them on notice that the IRS considers the shelter suspect and that those who employ it may be subject to challenge in a Tax Court.”).

time.<sup>285</sup> Second, clever taxpayers could simply modify their transactional steps so the transaction would be sufficiently differentiated from those on the list. Third, tax package promoters developed methods to hide novel packages from detection by the IRS, increasing the length of time between the creation of a novel tax package and its appearance on the IRS's list.<sup>286</sup> Primarily, tax package promoters would sell their packages under conditions of confidentiality, preventing the taxpayer from "spreading the word," which would eventually lead to the IRS discovering the transaction.<sup>287</sup> Finally, there were no well-defined penalties for failure to disclose a listed transaction.<sup>288</sup>

In 2004, however, Congress passed the American Jobs Creation Act of 2004 ("AJCA"),<sup>289</sup> which contained provisions that significantly increased the effectiveness of required disclosure. Taxpayers are still required to disclose transactions that are listed, but must also disclose transactions fitting any one of five other predetermined categories.<sup>290</sup> These new requirements are designed to detect transactions employing typical tax savings devices (large tax loss, but little book loss; quick turnaround of assets), typical detection avoidance measures (confidentiality agreements), and typical promotional activity (contractual provisions protecting the taxpayer).<sup>291</sup> In addition to more stringent disclosure requirements, the AJCA substantially increased the penalties for failing to comply with the disclosure requirements and limited the scope of certain exceptions to the disclosure requirements, thereby reducing the likelihood that a taxpayer will maneuver around those requirements.<sup>292</sup>

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<sup>285</sup> Schler, *supra* note 278, at 354-55.

<sup>286</sup> Donald L. Korb, *Shelters, Schemes and Abusive Transactions: Why Today's Thoughtful U.S. Tax Advisors Should Tell Their Clients to "Just Say No,"* 707 PLI/TAX 9, 23 (2006).

<sup>287</sup> *Id.*

<sup>288</sup> Delaney, *supra* note 258, at 315-16.

<sup>289</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of 26 U.S.C.).

<sup>290</sup> Treas. Reg. § 1.6011-4(b) (as amended in 2003). Disclosure is required if a transaction (1) is listed; (2) is offered to a taxpayer under conditions of confidentiality; (3) is offered to the taxpayer with contractual protections; that is, if the taxpayer will be reimbursed if the transaction is not upheld for tax purposes; (4) results in large losses; (5) results in significant differences between book and tax income; or (6) involves a brief asset holding period. *Id.*

<sup>291</sup> See WHITE PAPER, *supra* note 3, at 11-24 (identifying the common characteristics of corporate tax shelters).

<sup>292</sup> See I.R.C. § 6662(a) (West Supp. 2005) (imposing a twenty percent penalty rate where a transaction is adequately disclosed but is subsequently deemed underreported, and a thirty percent penalty rate where a transaction is not disclosed as required and tax liability is subsequently deemed underreported); *id.* § 6707A(b) (imposing a \$50,000 penalty on any corporation that fails to disclose a reportable transaction and a \$200,000 penalty on any corporation that fails to disclose a listed transaction).

## B. *Deference to Trial Court Determinations*

A recent commentator described the economic substance doctrine as creating a “heads the government wins, tails the taxpayer loses” situation, in which the government has the ability to create objective tax statutes and regulations as well as the ability to modify those objective rules with subjective interpretations.<sup>293</sup> The modification of objective rules is typically simpler at the appellate level, where the court does not have to examine stacks of documents, listen to hours of witness testimony, nor otherwise discern the facts of a case. This grunt work is done by the trial courts, which, in corporate tax planning cases, typically issue extensive statements of fact<sup>294</sup> to correspond with the complexity of corporate tax packages and their operation.<sup>295</sup>

Under the Federal Rules of Civil Procedure, the importance of the trial court’s role as fact finder is explicitly recognized, and the trial court’s factual determinations may not be overturned except for clear error.<sup>296</sup> This holds especially true in cases where factual findings depend particularly on the believability of witnesses at trial,<sup>297</sup> as is the case in many tax package cases,<sup>298</sup> where a determination of economic substance often rests on the subjective intent of the taxpayer in entering into the transaction.<sup>299</sup> Appellate judges are removed from the witness testimony and initial presentation of evidence and are at a disadvantage when it comes to discerning issues of fact.<sup>300</sup>

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<sup>293</sup> Daniel J. Glassman, Note, “*It’s Not a Lie if You Believe It*”: *Tax Shelters and the Economic Substance Doctrine*, 58 FLA. L. REV. 665, 679 (2006).

<sup>294</sup> See, e.g., *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 224 (2d Cir. 2006) (“[The] exceptionally complex facts [of this case] are described in detail in the district court’s opinion.”); *Dow Chem. Co. v. United States*, 435 F.3d 594, 596 (6th Cir. 2006) (“The district court conducted a bench trial lasting over two months, heard testimony from twenty-six witnesses, and received 1,526 exhibits and numerous factual stipulations. The facts of the case and the parties’ arguments are discussed at length in the district court’s two thorough opinions.”), *cert. denied*, 127 S. Ct. 1251 (2007); *Boca Investering’s P’ship v. United States*, 167 F. Supp. 2d 298, 303-63 (D.D.C. 2001) (ninety page opinion containing 392 statements of fact), *rev’d*, 314 F.3d 625 (D.C. Cir. 2003).

<sup>295</sup> The complexity of tax planning has, quite predictably, increased in proportion to the complexity of the tax code. Delaney, *supra* note 258, at 295 (stating, in reference to tax motivated transactions, that “as the Internal Revenue Code . . . becomes more complex, the transactions themselves have become extraordinarily complex and hard to identify”).

<sup>296</sup> FED. R. CIV. P. 52(a)(6) (“Findings of fact . . . must not be set aside unless clearly erroneous, and the reviewing court must give due regard to the trial court’s opportunity to judge the witnesses’ credibility.”).

<sup>297</sup> See *id.*; see also *United States v. Yellow Cab Co.*, 338 U.S. 338, 341 (1949) (stating that findings of fact “depend peculiarly upon the credit given to witnesses by those who hear and see them”).

<sup>298</sup> See, e.g., *Boca*, 167 F. Supp. 2d at 303.

<sup>299</sup> See discussion *supra* Part II.

<sup>300</sup> *United States v. Or. Med. Soc’y*, 343 U.S. 326, 339 (1952) (“Face to face with living witnesses, the original trier of the facts holds a position of advantage from which appellate judges are excluded. In

With an economic substance test that partially focuses on the subjective beliefs of the taxpayer, firsthand impressions can be paramount in ascertaining those beliefs. Although prepackaged tax planning typically specifies transactional steps that must be taken to capture a tax benefit, the surrounding circumstances and beliefs of the taxpayer are rarely the same or even similar across multiple instances of specific tax package use. For circuit courts to disallow tax benefits because of the prepackaged nature of a transaction is to marginalize the fact-finding of the trial court, ignore important factual distinctions outside rote transactional steps, and ignore the subjective expectations of a taxpayer in entering into those steps. As shown in the trial court decisions in *Boca*, *Dow Chemical*, and *TIFD III-E*, factual distinctions among cases utilizing the same tax package can mean the difference between the existence of economic substance and the existence of a “sham” transaction.<sup>301</sup> To overturn each of these cases, the appellate courts necessarily devalued these distinctions.<sup>302</sup>

As great facial deference is usually given to trial court fact-finding, it is unusual for an appellate court to reverse explicitly a trial court’s fact-finding.<sup>303</sup> In tax planning cases, however, courts frequently circumvent this great deference by modifying the applicable law to include the facts as the trial court has stated them.<sup>304</sup> This is imprudent for several reasons. First, it affords the taxpayer little measure of predictability.<sup>305</sup> If the taxpayer cannot determine the scope of the standards by which his actions will be judged, he cannot tailor his actions to conform to the law. Second, expansion and contraction of judicial doctrines at the will of appellate courts downplays the value of precedent in our legal system. Where a trial court determines that a taxpayer has undertaken a risky transaction in compliance with the objective rules as set forth by Congress, acceptance of the facts but reversal of the result is equivalent to modifying the objective rules to exclude the facts. Finally, tax planning cases turn on the subjective intent of the taxpayer in entering into the transaction and the objective economic substance of the transaction. These elements require an intensive examination of evidence and firsthand credibility assessments of witnesses professing their reasonable belief that a transaction had a possibility for economic gain. There is no substitute for firsthand impressions, and under no stated legal standard is prepackaged tax planning presumptively illegal, but appellate courts exhibit an unstated presumption that does not comport with real factual variance.

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doubtful cases the exercise of his power of observation often proves the most accurate method of ascertaining the truth.” (quoting *Boyd v. Boyd*, 169 N.E. 632, 634 (1930)).

<sup>301</sup> See *supra* Part II.

<sup>302</sup> See *supra* Part II.

<sup>303</sup> 61 AM. JUR. *Trials* § 37 (2006).

<sup>304</sup> See discussion *supra* Part II.

<sup>305</sup> Coverdale, *supra* note 9, at 1556.

To overcome problems of unpredictability and disregard for factual distinctions between cases, appellate courts should give meaningful deference to the fact-finding of trial courts. The current variability of the economic substance doctrine is not conducive to consistently equitable results. As a measure of economic substance doctrine clarification, appellate courts should strive first to avoid inserting novel requirements (e.g., “necessity” in *Boca*) and second to articulate the importance of trial courts in their role as fact finder.

In situations where the facts of a tax package case support a finding of real economic effect and legitimate business purpose, the appropriate course is the one taken by the district court in *TIFD III-E*. In that case, the court concluded that although the transaction “sheltered a great deal of income from taxes . . . the IRS should address its concerns to those who write the tax laws,” as the transaction had accurately complied with those laws and there had not been egregious abuse.<sup>306</sup>

## CONCLUSION

As the use of prepackaged corporate tax planning has wound its way through the judicial system, the appellate bias against such tax packages has become increasingly apparent. Circuit courts have shown little restraint in expanding traditional judicial doctrines to disallow the use of a tax package, even if the only apparent reason to do so is that a different taxpayer has previously used the same package illegitimately. There is an alternative to this expansion of existing judicial doctrines. Circuit courts have two important guides when examining tax packages: the I.R.C. framework and the fact-finding of the trial courts. The I.R.C. provides objective rules for taxpayer behavior and the results of those rules, whether intentional or unintentional, are only the result of carefully considered legislative action. Where substantial tax benefits are not the result of clear taxpayer disingenuousness (i.e., where there was a possibility of economic benefit from the transaction and the taxpayer recognized that fact) those benefits should not be disallowed. To aid in the search for clearly disingenuous behavior, trial courts in tax package cases frequently develop comprehensive factual findings. These are of paramount importance, as they often serve to differentiate sincere behavior in one case from quasi-fraudulent behavior in another. In deference to the legislative framework and trial court fact-finding, appellate courts in tax package cases should strive to clarify the existing judicial doctrines, so that taxpayers may conclude with some certainty where the lines have been drawn separating acceptable tax benefits from unacceptable tax benefits.

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<sup>306</sup> *TIFD III-E, Inc. v. United States*, 342 F. Supp. 2d 94, 121 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006).