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Reframing Economic Substance

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REFRAMING ECONOMIC SUBSTANCE

*Karen C. Burke**

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I. INTRODUCTION

Under the economic substance doctrine as codified in section 7701(o), legislatively unintended tax benefits may be disallowed if a transaction lacks a substantial business purpose or fails to accomplish a meaningful change in the taxpayer's economic position.¹ In a recent

* Warren Distinguished Professor, University of San Diego School of Law. This paper stems from my participation in a panel commenting on *The Frame Game: How Defining the "Transaction" Decides the Case* by David Hariton, reprinted as the preceding article in this issue, at the Virginia Tax Study Group Conference held in Charlottesville on March 25, 2011. I would like to thank my co-panelists, William Alexander and David Hariton.

¹ Pub. L. No. 111-152, § 1409, 124 Stat. 1029 (Mar. 30, 2010). Although no "official" legislative history is available, there are several sources of guidance. See JOINT COMM. ON TAXATION, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act"* (JCX-18-10) (Mar. 21, 2010) [hereinafter *Technical Explanation*]; H.R. Rep. No. 111-443, pt. 1, 111th Cong., 2d Sess. (2010);

article on framing the “transaction” in economic substance cases, David Hariton makes three interrelated points.² First, he observes that even though the judicial outcome may depend largely on how the relevant transaction is framed, few courts have explicitly focused on the framing issue. Second, he proposes that courts should presumptively frame the underlying transaction broadly by focusing on the entirety of the taxpayer’s undertaking, rather than disaggregating particular tax-motivated steps or structures. Finally, he believes that the principal target of the economic substance doctrine should be “tax shelters” whose defining hallmark is that they are “extraneous to the taxpayer’s business rather than merely an aspect of it.”³

Although Hariton was an early supporter of the economic substance doctrine,⁴ he has consistently opposed applying the doctrine outside the tax shelter context.⁵ For this purpose, a tax shelter may be loosely defined as a transaction intended to generate losses that offset income from another unrelated transaction or activity.⁶ Framing the relevant transaction narrowly for purposes of testing economic substance would generally allow the broadest possible scope for section 7701(o). Hariton is concerned, however, that a “disaggregation” approach would impermissibly impinge on legitimate tax planning in which tax-motivated steps are integrated with a larger transaction. To cabin application of section 7701(o), Hariton proposes that the Treasury issue regulations that would effectively add a third prong to the economic substance test: section 7701(o) would generally disallow only tax benefits (e.g., deductions, losses, and basis increases) that shelter items of income or gain

see also I.R.S. Notice 2010-62, 2010-2 C.B. 411 (providing interim guidance); I.R.S. Treas. Dir. LB&I-04-0711-015 (July 18, 2011) (directive to IRS examiners and managers).

² *See* David P. Hariton, *The Frame Game: How Defining the “Transaction” Decides the Case*, 63 TAX LAW. 1 (2009).

³ *Id.* at 38.

⁴ *Id. See, e.g.*, David P. Hariton, *Sorting out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999) [hereinafter Hariton, *Sorting*]; David P. Hariton, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1 (2003) [hereinafter Hariton, *Kafka*].

⁵ *See, e.g.*, David P. Hariton, *How to Fix Economic Substance*, 99 TAX NOTES 539 (2003).

⁶ Hariton would define a “tax shelter” as “a financial transaction that produces a tax deduction or loss in the absence of any economic loss.” David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied*, 60 TAX L. REV. 29, 31 (2006); *id.* (“This noneconomic tax loss then serves to offset unrelated income and thus ‘shelter’ the tax that would otherwise have been imposed on the taxpayer.”).

extrinsic to the taxpayer's business.⁷

It is useful to consider how Hariton's framing guidelines would affect the outcome of several recent economic substance cases. In enacting section 7701(o), Congress chose to clarify and enhance the common-law economic substance doctrine — itself an amalgam of other judicial doctrines⁸ — rather than address tax shelters specifically.⁹ Congress left further development of the doctrine to the courts, while expressly approving of the courts's ability to aggregate, disaggregate, or otherwise recharacterize transactions.¹⁰ The Treasury and courts should be wary of mechanical approaches to framing that would restrict the range of potential transactions to which the economic substance doctrine may be considered relevant. Notwithstanding the risk of increased planning uncertainty, courts need a measure of flexibility in framing economic substance cases to accomplish the intended purpose of section 7701(o).

II. HIDDEN EFFECT OF FRAMING: *COLTEC* AND *SHELL PETROLEUM*

To appreciate the significance of framing, it is useful to consider two recent cases in the corporate context involving acceleration and potential duplication of losses: *Coltec*¹¹ and *Shell Petroleum*.¹² While the taxpayer lost in *Coltec* and won in *Shell Petroleum*, it seems likely that § 7701(o) would strengthen the government's litigating position under circumstances similar to *Shell Petroleum*. As these cases illustrate, courts must often choose between alternative "frames" of a particular transaction. The government may seek to define the

⁷ See Letter from David P. Hariton to Michael F. Mundaca, Assistant Sec'y, Tax Policy (Proposed Regulations Under Section 7701(o) Clarifying the Economic Substance Doctrine, July 27, 2010), 2010 TNT 145-21.

⁸ On the role of the economic substance doctrine as a method of statutory interpretation, see generally Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000); JASPER L. CUMMINGS, JR., *THE SUPREME COURT'S FEDERAL TAX JURISPRUDENCE: AN ANALYSIS OF FACT FINDING METHODS AND STATUTORY INTERPRETATION FROM THE COURT'S TAX OPINIONS, 1801 – PRESENT* (2010).

⁹ See, e.g., Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1952 (2005) (proposing to disallow noneconomic losses and to add back income that is uneconomically shifted from the taxpayer to a tax-exempt party).

¹⁰ See *infra* notes 29–34 and accompanying text.

¹¹ *Coltec Indus., Inc., v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007).

¹² *Shell Petroleum Inc. v. United States*, 2008–2 U.S.T.C. ¶ 50,422 (S.D. Tex. 2008).

transaction narrowly so as to isolate tax-motivated steps from a purported larger business transaction, while the taxpayer argues that the transaction should be defined broadly.¹³ Given the fact-intensive nature of economic substance cases and differing judicial temperaments, it is often impossible to predict how another court would handle a nearly identical or closely similar case.¹⁴

The facts of *Coltec*, somewhat simplified, were as follows. Coltec transferred its own note and contingent asbestos liabilities to a subsidiary in exchange for stock in a tax-free section 351 transaction. Coltec treated the basis of the stock as equal to the amount of its note transferred to the subsidiary, unreduced by the offsetting contingent liabilities assumed by the subsidiary. Coltec then sold the high-basis, low-value stock to a third party, claiming a \$380 million loss on the sale.¹⁵ On appeal, the Federal Circuit observed that “the transaction to be analyzed is the one that gave rise to the alleged tax benefit.”¹⁶ It found that the transactional steps used to create the high-basis, low-value stock (the transfer to the subsidiary of a note in exchange for assumption of liabilities) were “separate and distinct” from the taxpayer’s claimed business purpose of having the subsidiary manage and administer the asbestos liabilities.¹⁷ So viewed, the relevant transaction lacked any meaningful purpose apart from saving taxes.¹⁸

¹³ Applying familiar step-transaction principles, the government may also seek to aggregate purportedly separate steps of an overall transaction.

¹⁴ See, e.g., CUMMINGS, *supra* note 8, at 146 (emphasizing the role of fact-finding in economic substance cases).

¹⁵ To put an end to *Coltec*-type transactions, Congress enacted section 358(h). See I.R.C. § 358(h) (requiring a basis step-down to reflect contingent liabilities).

¹⁶ *Coltec*, 454 F.3d at 1356; *id.* at 1353 (noting that “the economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code”); see also *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 545 (5th Cir. 2009) (noting that “when applying the economic substance doctrine, the proper focus is on the particular transaction that gives rise to the tax benefit, not collateral transactions that do not produce tax benefits”); *Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006) (focusing on the “specific transaction whose tax consequences are in dispute”).

¹⁷ *Coltec*, 454 F.3d at 1358; *id.* (“The first asserted business purpose focuses on the wrong transaction . . .”). The court found that the taxpayer “has not demonstrated any business purpose to be served by linking [the subsidiary’s] assumption of the liabilities to the centralization of litigation management.” *Id.*

¹⁸ *Id.* at 1347. The court also rejected the taxpayer’s claim that creation of the subsidiary added a barrier to a third party’s ability to pierce the corporate veil because there was “no objective basis” for the taxpayer’s assertion that the subsidiary’s assumption of liabilities “would in any way ameliorate this veil-piercing problem.” *Id.* at 1359.

Hariton argues that *Coltec* misframed the relevant transaction. Rather than viewing the transaction as a whole, the court wrongly “focused on a preliminary transaction step that served to create” the high-basis, low-value stock.¹⁹ Hariton’s argument is not that *Coltec* was wrongly decided, but rather that narrow framing leaves taxpayers without any meaningful guidance concerning when the economic substance doctrine applies.²⁰ When the transaction to be tested is defined narrowly as merely the tax-motivated steps, the taxpayer is almost certain to lose. Viewed in isolation, the tax-motivated steps lack any business purpose and have no significant effect on the taxpayer’s overall economic position. As a last resort, the taxpayer must argue that the tax-motivated steps should nevertheless be respected because they are in accordance with congressional intent.²¹ This claim is unlikely to succeed, however, when the relevant transaction is structured to exploit an unintended statutory or regulatory gap while purportedly complying with the literal language of the Code.²² Had Congress or the Treasury considered the matter explicitly, the taxpayer’s aggressive position most likely would not have been sanctioned. Thus, the court’s framing of the transaction may often determine the outcome.

Coltec’s narrow framing arguably reflects a “fundamental misunderstanding”²³ of the Supreme Court’s seminal decision in *Gregory*.²⁴ By contrast, other courts have “applied the reasoning” of *Gregory* to disallow tax benefits only when a transaction lacked “business purpose and economic substance considered as a whole.”²⁵ Hariton would therefore define the term “transaction,” for purposes of section 7701(o), as including “the entirety of what might reasonably be proposed to a taxpayer as a coherent undertaking.”²⁶ The relevant transaction would not be framed so broadly as to encompass the

¹⁹ Hariton, *supra* note 6, at 29–30.

²⁰ *Id.* at 30–31.

²¹ See *Technical Explanation*, *supra* note 1, at 152 n.344 (“If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.”).

²² See Chirelstein & Zelenak, *supra* note 9, at 1939–40 (“It is beyond doubt that such manipulations are contrary to congressional intent . . .”).

²³ Hariton, *supra* note 6, at 41; *id.* at 41 n.45 (noting *Coltec*’s reliance on *Gregory* to support narrow framing).

²⁴ *Gregory v. Helvering*, 293 U.S. 465 (1935).

²⁵ See Hariton, *supra* note 6, at 43–44; *id.* at 44 (claiming that “there is . . . no doctrine that disallows the tax benefits arising from mere transaction steps”).

²⁶ Hariton, *supra* note 7, at 3 (defining “transaction”).

taxpayer's entire business (or line of business), nor so narrowly as to encompass "mere tax-motivated structures or steps that are part of the relevant undertaking."²⁷ If *Coltec* arose under section 7701(o), Hariton would frame the relevant transaction as the "entire series of transactions by which the taxpayer seeks to accelerate, and possibly duplicate, an asbestos-related loss by selling preferred stock to an unrelated party."²⁸

In enacting section 7701(o), Congress clarified that the economic substance doctrine applies to a single transaction or series of transactions.²⁹ The statutory provision is intended to eliminate any uncertainty concerning courts' ability to "aggregate, disaggregate, or otherwise recharacterize" transactions.³⁰ Indeed, the legislative history refers favorably to *Coltec*, noting that a court has the ability "to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits."³¹ Prior codification proposals included a requirement that the transaction under scrutiny be a "reasonable means" of accomplishing the taxpayer's nontax purpose,³² reinforcing the courts' ability to separate transactions that are ostensibly linked. Although section 7701(o) does not expressly include the reasonable means requirement, such a standard is implicitly taken into account in determining whether steps in an overall transaction should be aggregated or disaggregated.³³ Individual steps of a multi-step

²⁷ *Id.* Certain structures and steps would be carved out if "they bear a strained and tangential relation to the relevant business transaction." *Id.*

²⁸ *Id.* (Ex. 5) ("The first step [formation of the special purpose subsidiary] is not a transaction in its own right for this purpose.")

²⁹ See I.R.C. § 7701(o)(5)(D) ("The term 'transaction' includes a series of transactions.").

³⁰ *Technical Explanation, supra* note 1, at 153.

³¹ *Id.* Several courts have approved the bifurcation approach. See, e.g., *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *Long Term Capital Holdings LP v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 2005-2 U.S.T.C. ¶ 50,575 (2d Cir. 2005).

³² See, e.g., H.R. 2625, 109th Cong. (1st Sess. 2005) (Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2005).

³³ *Technical Explanation, supra* note 1, at 154 n.354 ("Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant

transaction may be disaggregated unless the taxpayer demonstrates that such steps are reasonably related to the nontax purpose of the overall transaction (and the overall transaction is consistent with Congressional intent).³⁴ A reasonable means or “comparative relatedness” test inevitably requires an exercise of judgment concerning the proximity of the tax-motivated means and asserted business objective.³⁵

In *Shell Petroleum*, the district court rejected “slicing and dicing” a transaction involving facts similar to *Coltec*.³⁶ The facts of *Shell Petroleum*, somewhat simplified, were as follows. Separate Shell subsidiaries transferred income-producing assets and nonproducing oil properties with a low value and high basis to a newly-formed subsidiary (Frontier) in exchange for common stock and preferred stock. Simultaneously, Frontier raised \$164 million in cash by transferring preferred stock to independent investors. As in *Coltec*, the internal restructuring allowed Shell to claim two potential tax losses as a result of a single economic loss.³⁷ While the government

industry.”) (quoting *ACM P’ship v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), *aff’d on this issue*, 157 F.3d 231 (3d Cir. 1998)).

³⁴ See N.Y. STATE BAR ASS’N, TAX SEC’N, REPORT ON CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE 81 (2011); Monte A. Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 127 TAX NOTES 289, 298 (Apr. 19, 2010) (noting that the “‘germaneness’ of the means chosen by the taxpayer to effectuate the transaction [is now a factor] in evaluating” the substantiality of the taxpayer’s asserted nontax purpose).

³⁵ Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485, 524 (1967) (“What emerges is that an anti-tax avoidance principle tends in practice to resemble a comparative relatedness test. Often the critical question, in effect, ultimately becomes: How close is the relationship that can be seen between action of the kind taken and the asserted non-tax objectives?”).

³⁶ *Shell Petroleum Inc. v. United States*, 2008–2 U.S.T.C. ¶ 50,422, at ¶ 85,080 (S.D. Tex. 2008); see Hariton, *supra* note 7, at 4 (Ex. 6) (claiming the relevant transaction is “the entire series of transactions by which the taxpayer seeks to obtain both equity capital and a current tax loss . . . [and the] fact that the taxpayer may have chosen a less efficient means of obtaining equity capital in order to accommodate its tax objectives is irrelevant”).

³⁷ Because the high-vote auction rate preferred stock received by the independent investors represented more than twenty percent of the total voting power of Frontier, Frontier was no longer includible in Shell’s consolidated group. See *Shell Petroleum*, 2008–2 U.S.T.C. ¶ 50,422, ¶ 85,065; I.R.C. § 1504(a). On the planned sale of the high-basis, low-value preferred stock received in exchange for the nonproducing properties, another Shell subsidiary (Western) was thus allowed to realize a loss. Subsequently, Frontier redeemed the independent investors’ preferred stock and rejoined Shell’s consolidated group, potentially allowing Shell to duplicate the loss on the stock sale when it eventually disposed of the nonproducing properties.

relied on *Coltec*'s framing approach, the District Court found no Fifth Circuit precedent sanctioning the disaggregation approach.³⁸ It was impressed by "the non-illusory nature of Shell's real losses" and found that *Coltec* was readily distinguishable because Shell's purported business objectives — raising cash and asset management and preservation — were not tainted by "objective impossibility."³⁹ Although Shell could have employed alternative means to achieve its business objectives, the means chosen were legitimate even though they yielded significant tax benefits.⁴⁰

Confronted with facts similar to *Shell Petroleum*, another court might well have reached a different result, even without the benefit of section 7701(o). Under the district court's analysis, any section 351 transaction that raises outside cash would apparently satisfy the business purpose prong. Nevertheless, the transfers in *Shell Petroleum* arguably "did not accomplish anything economically,"⁴¹ notwithstanding the presence of independent investors who essentially sought an interest-like return on their preferred investment. The district court conspicuously failed to consider whether the transfer by the independent investors was functionally related to the Shell subsidiaries' contribution of built-in loss property in a manner sufficient to warrant allowing the claimed tax benefits.⁴² In assessing Shell's nontax business purpose, lack of such a functional relationship might justify treating the transfers as separate for purposes of section 7701(o).⁴³

³⁸ *Shell Petroleum*, 2008–2 U.S.T.C. ¶ 50,422, ¶ 85,080 (citing Hariton's critique of *Coltec*).

³⁹ *Id.* ¶¶ 85,080–81; see also *id.* ¶ 85,079 (noting that "a taxpayer's restructuring of a going concern is a recognized, valid business purpose").

⁴⁰ See *id.* ¶ 85,082.

⁴¹ *New Economic Substance Law Seen Helping IRS in Cases Similar to 'Shell,'* Daily Tax Report at K–5 (April 26, 2010) (quoting William Alexander, I.R.S. Assoc. Chief Counsel (Corporate)); see also *Shell Petroleum*, 2008–2 U.S.T.C. ¶ 50,422, ¶¶ 85,079–80 (noting that the independent investors could not rely on the nonproducing properties to service dividend payments, obliging Shell to contribute other income-producing properties).

⁴² See Robert Willens, *Shell Oil's Double-Dipping Strategy Pays Off*, 120 TAX NOTES 687, 688 n.2 (Aug. 18, 2008) (noting that independent investors might not be viewed as bona fide members of the control group under section 351). Alternatively, the government could argue that the contribution of the nonproducing properties was a separate transaction that was required to satisfy section 7701(o) independently.

⁴³ See Martin J. McMahon, *Beyond a GAAR: Retrofitting the Code to Rein in 21st Century Tax Shelters*, 98 TAX NOTES 1721, 1728 (Mar. 17, 2003) (noting that courts have applied a "functionally unrelated" test to disaggregate transactions in the reorganization area).

Even if framed broadly, the *Shell Petroleum* transaction might well lack economic substance based on a comparison of the relative magnitude of the potential tax and nontax benefits from the transaction.⁴⁴ The nontax benefits from Shell's asserted business goals of raising outside cash and providing better "fit and focus" for its nonproducing properties "appear to pale in comparison to the more than \$100 million of immediate tax savings" generated by the restructuring.⁴⁵ Any sensible application of the economic substance doctrine should require comparison of the tax and nontax benefits.⁴⁶ In a *Shell Petroleum*-type case, the comparative approach would likely result in a decision in favor of the government even if a court proved unwilling to disaggregate purely tax-motivated steps.⁴⁷ In enacting section 7701(o), Congress dispelled any lingering doubt that courts should be free to apply the economic substance doctrine either to an entire transaction viewed broadly or, under the disaggregation approach, to separate tax-motivated steps. Nevertheless, Congress did not require a court confronted with a similar transaction to adopt the framing approach employed by either *Coltec* or *Shell Petroleum*.

Following enactment of section 362(e), a taxpayer can generally no longer obtain a double loss — once on sale of the stock and subsequently on sale of the contributed assets — as a result of a section 351 contribution of high-basis, low-value property.⁴⁸ By analogy to *Cottage Savings*,⁴⁹ it might be argued that a taxpayer in Shell's situation should thus be permitted to determine the timing of recognition of a single economic loss inherent in the stock. Yet, *Shell Petroleum* is clearly distinguishable from *Cottage Savings*. Rather than merely involving a timing benefit, the overall transaction in *Shell Petroleum* allowed the taxpayer to realize a loss from the sale of the

⁴⁴ See I.R.C. § 7701(o)(2)(A) (Nontax benefits must be "substantial in relation to the . . . tax benefits."); see also Hariton, *supra* note 7, at 6 (Ex. 12) (concluding that the court has discretion to determine that obtaining \$164 million equity capital is not "meaningful and substantial" in relation to acceleration of loss).

⁴⁵ See Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 441, 448 (2010).

⁴⁶ See Bankman, *supra* note 8, at 26.

⁴⁷ Similarly, if the *Coltec* transaction were framed broadly, the comparative benefit test should reach the same result. See Hariton, *supra* note 7, at 7 (Ex. 14) (disallowing loss in *Coltec* under broad framing).

⁴⁸ See I.R.C. § 362(e)(2) (requiring a step-down in the transferee's basis in the contributed assets (or the transferor's basis in the stock) to avoid duplication of built-in loss).

⁴⁹ *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991) (loss realized under section 1001 on swap of economically identical loan portfolios).

high-basis, low-value stock while retaining the economic upside in the nonproducing properties that generated the loss. Hariton suggests that loss duplication represents an “arguably much more egregious” violation than mere manipulation of timing benefits.⁵⁰ Many tax-motivated transactions revolve around timing mismatches, however, rather than creation of artificial losses. In *Coltec*, the court was clearly aware that the transaction had the potential both to accelerate and potentially to duplicate losses (once on sale of the stock and again on payment of the liability).⁵¹ Even if section 362(e)(2) precludes a double benefit in a *Shell Petroleum*-type transaction, the government should nevertheless be free to argue that transaction steps intended to accelerate loss may be disaggregated for purposes of section 7701(o).⁵²

III. SALE OF A BUSINESS: *STOBIE CREEK* AND *COUNTRYSIDE*

In the context of a sale of a business, the disposition itself normally satisfies the requirement that the relevant transaction has a substantial business purpose and results in a meaningful economic change in the taxpayer’s position. If additional steps are inserted, however, the issue is whether such steps should be treated as a separate transaction in their own right or merely as a tax-motivated means of accomplishing a legitimate business transaction. Two recent cases illustrate the problem of framing in the context of tax-engineering ostensibly related to the sale of a business: *Stobie Creek*⁵³ and *Countryside*.⁵⁴ Hariton suggests that the court’s broad framing of the transaction in one case (*Countryside*) meant that the transaction had both a business purpose and economic substance, while the court’s narrow framing in the other case (*Stobie Creek*) effectively precluded such a finding.⁵⁵

In *Stobie Creek*, the taxpayers sought to eliminate gain on a planned sale of stock in their family business by contributing low-

⁵⁰ Hariton, *supra* note 6, at 31. See Hariton, *supra* note 7, at 2 (Ex. 2) (economic substance doctrine relevant if loss acceleration is outside the “reasonable ambit” of what Congress intended); *id.* at 2–3 (Ex. 3) (economic substance always relevant in transactions generating noneconomic loss).

⁵¹ *Cf.* Hariton, *supra* note 6, at 31 (faulting *Coltec* court for failing to specify the ground on which the claimed loss was objectionable).

⁵² See N.Y. STATE BAR ASS’N, *supra* note 34, at 80–81 (discussing *Shell Petroleum*).

⁵³ *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636 (2008), *aff’d*, 608 F.3d 1366 (Fed. Cir. 2010).

⁵⁴ *Countryside Ltd. P’ship v. Commissioner*, 95 T.C.M. (CCH) 1006 (2008).

⁵⁵ Hariton, *supra* note 2, at 4–9.

basis, high-value stock to a partnership and using offsetting foreign currency options to enhance outside basis artificially. By ignoring the offsetting contingent obligation for purposes of the partnership basis rules, the taxpayers claimed that this “Son-of-BOSS” transaction eliminated \$202 million of gain (equal to the inflated outside basis subsequently transferred to the stock) on the sale of the family business.⁵⁶ The court found that the offsetting option transaction lacked both a business purpose and economic substance. While the taxpayers theoretically had a possibility of hitting a \$400 million jackpot in the unlikely event that the foreign currency spot price fell within a narrowly defined range at the end of a specified period, the sweet spot turned out to be an illusion.⁵⁷ Because the fees paid to the option counterparty and the shelter promoters dwarfed any potential profit, the court had no difficulty in concluding that the transaction “lacked objective economic reality.”⁵⁸

The *Stobie Creek* transaction was structured to enhance basis rather than generate an artificial loss. In Hariton’s view, this basis-boost structure allowed the taxpayers to argue that the “option transactions were merely a way of structuring their sale of stock — a tax-efficient way, to be sure — but nevertheless a way of structuring what clearly was a legitimate business transaction.”⁵⁹ For purposes of the economic substance analysis, the relevant question ought thus to be whether the option transactions were properly viewed as a separate and distinct undertaking or as part of an integrated transaction resulting in disposition of the stock. If the option transactions were treated as separate from the stock sale, the taxpayers should have easily lost, since the “‘transaction’ was, in that case, nothing but a tax shelter.”⁶⁰ While the court implicitly assumed that the option transactions should be viewed separately, it did not even enunciate

⁵⁶ For a discussion of the offsetting-option shelter, see generally Karen C. Burke & Grayson M.P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, 62 TAX LAW. 59 (2008).

⁵⁷ Since the option counterparty (Deutsche Bank) could prevent the sweet spot from being hit, the taxpayers could not realistically hope to make a lucky strike. See Karen C. Burke & Grayson M.P. McCouch, *Stobie Creek: Too Good to Be True?*, 120 TAX NOTES 705, 705 (2008) (“No matter how large the jackpot, a lottery ticket is worthless if the lottery is rigged.”). In connection with its participation in tax shelters, Deutsche Bank entered into a nonprosecution agreement and paid substantial penalties. See Amy S. Elliott, *Deutsche Bank Admits Tax Shelter Wrongdoing, Will Pay \$550 Million to U.S.*, 2010 TNT 245-1.

⁵⁸ *Stobie Creek*, 82 Fed. Cl. at 697.

⁵⁹ Hariton, *supra* note 2, at 4.

⁶⁰ *Id.* at 4-5.

this “conclusion upon which its entire decision rested.”⁶¹ Hariton speculates that the taxpayers might have won if the option investment were considered part of the stock sale, since the “court agreed with the [taxpayers’] technical analysis and the sale of stock obviously had business purpose.”⁶²

Hariton’s criticism notwithstanding, the lower court in *Stobie Creek* should not be faulted for failing to inquire whether the planned stock sale somehow imbued the sham option transaction with a business purpose. Indeed, the only link between the option investment and stock sale was that the Welles family turned to the shelter promoter (Paul Daugerdas of *Jenkins & Gilchrist*) because they desired to eliminate the large anticipated gain on their stock. Except that it boosted basis, the *Stobie Creek* transaction was indistinguishable from loss-generating transactions that the government challenged in Notice 2000–44.⁶³ Although the sale of the family business was “a real transaction with economic substance,” the option investment was “not a way of structuring [that] deal;” rather, it was “simply a means to the desired end of creating a tax benefit.”⁶⁴ Had Jeffrey Welles, who controlled the managing partner, asserted that he “viewed our purchase and sale of options as a necessary step in selling [the family] stock” in the most tax-efficient way,⁶⁵ any experienced judge would presumably have rejected this self-serving assertion.

Hariton would define the relevant transaction presumptively as consisting of an entire series of transactions viewed as a whole. He would nevertheless allow tax-motivated structures or steps to be carved out if, as in *ACM Partnership v. Commissioner*, they bear a “strained and tangential relation to the relevant business transaction.”⁶⁶ *ACM* involved a contingent installment note sale (CINS) transaction which generated a large capital loss (and a large offsetting gain allocated to a foreign partner). The taxpayer argued that its initial investment in AAA notes (which were later exchanged for the contingent installment obligations and cash) served a

⁶¹ *Id.* at 4 (noting that “[t]he court simply took it for granted that the relevant transaction was the investment in options”).

⁶² *Id.*

⁶³ 2000–2 C.B. 255, 2000 WL 1138430.

⁶⁴ *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1379 (2010).

⁶⁵ Hariton, *supra* note 2, at 5. As a highly educated professional with substantial investment banking experience, Welles should have known that the tax shelter was “too good to be true.” *Stobie Creek*, 608 F.3d at 1382–83.

⁶⁶ Hariton, *supra* note 7, at 3.

legitimate nontax purpose — namely, to repurchase its debt through a partnership. The court in *ACM* rejected this argument, concluding that the investment in AAA notes, viewed separately, “did not constitute an economically substantive transaction.”⁶⁷ Because this separate investment generated only a relatively small net return in relationship to the large capital loss claimed, Hariton would treat this carved-out transaction as lacking both a business purpose and economic substance.⁶⁸

ACM illustrates the “slippery slope” if taxpayers are permitted to satisfy the economic substance test by tying tax-motivated steps or structures to the ordinary course of their business.⁶⁹ One can readily imagine scenarios in which the CINS investment is more closely linked to the taxpayer’s ordinary business.⁷⁰ If certain tangential or contrived steps may be carved out for separate treatment, however, Hariton’s premise that the economic substance test should be applied presumptively to an entire series of transactions viewed as a whole may itself lack much substance. A complex, tax-advantaged way of accomplishing a business purpose would be respected only if the tax-motivated steps producing the claimed tax benefit were “not essential to completion of the transaction or if the tax benefit did not bear the proper relationship to the transaction.”⁷¹ Setting aside administrative considerations, there is no principled justification for curtailing the application of the economic substance doctrine simply because tax-engineered steps are tied more or less closely to a taxpayer’s ordinary business.

Broad framing of the relevant transaction implicitly assumes taxpayers are entitled to plan a transaction in the most tax-

⁶⁷ *ACM P’ship v. Commissioner*, 157 F.3d 231, 251 (3d Cir. 1998).

⁶⁸ See Hariton, *supra* note 7, at 4–5 (concluding that the relevant transaction “does not include the business-motivated repurchase of the taxpayer’s outstanding debt”).

⁶⁹ See Bankman, *supra* note 8, at 17 (“The favorable tax treatment for tax-motivated transactions tied to ordinary business operations . . . raises obvious line-drawing questions . . .”).

⁷⁰ See Hariton, *supra* note 4, at 269–70 (suggesting that the taxpayer in *ACM* might have won if it had acquired and sold an office building for a contingent installment obligation); cf. David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 238 (2002) (“But encouraging taxpayers to build empty buildings . . . that nobody wants to inhabit does not seem like the best policy.”).

⁷¹ Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131, 145 n.77 (2001) (suggesting that “[t]his leaves little substance to [Hariton’s] initial proposition”).

advantageous manner.⁷² Even if such tax planning is permissible, however, one would expect courts to prove more willing to bifurcate transactions when the intermediate steps are engineered to take advantage of a loophole that can be readily replicated at virtually no economic cost. Otherwise, such tax-engineered steps would lead to large revenue losses and encourage other taxpayers to structure transactions using the identical or similar steps. If “a rare transaction is taxed incorrectly,” the threat is that the “transaction will become common as taxpayers take advantage of the problem.”⁷³ *Countryside* illustrates how mistaxation of an uncommon transaction — a novel “add-on” to an otherwise real business transaction — would permit conversion and indefinite deferral of gain whenever depreciated real property is sold.⁷⁴

Like *Stobie Creek*, the *Countryside* transaction used the partnership basis rules to avoid gain on a sale of low-basis property (real estate) and to duplicate basis in other property (AAA notes). Consider a simplified version of the *Countryside* transaction involving only two (rather than three) tiers of partnerships.⁷⁵ Assume that the ABCD partnership owns real estate with a basis of zero and a value of \$12 million; partners *A* and *B* own ninety-nine percent and partners *C* and *D* own one percent of the partnership. ABCD borrows slightly less than \$12 million to purchase AAA notes and contributes the notes to the new AB partnership; ABCD then distributes its entire interest in AB to partners *A* and *B* in redemption of their interests.⁷⁶ The AB partnership claims to have a \$12 million basis in the notes equal to their purchase price, even though *A* and *B* have a zero basis in their partnership interests.⁷⁷ Finally, the continuing CD partnership

⁷² See Am. Bar Ass’n, Section of Taxation, *Comments on Notice 2010-62* at 28, 2011 TNT 12-13 (Jan. 18, 2011) (“This principle is implicit in historical application of the economic substance doctrine to a broader definition of the transaction to sanction a taxpayer’s choice of a favorable intermediate step.”).

⁷³ Weisbach, *supra* note 70, at 247. Indeed, one purpose of broad anti-abuse rules is precisely to address such uncommon transactions.

⁷⁴ The *Countryside* transaction converted gain from depreciation recapture on the real estate (taxed at twenty-five percent) to deferred capital gain (taxed at fifteen percent). See Karen C. Burke, *Tax Avoidance As a Legitimate Business Purpose*, 118 TAX NOTES 1393, 1394 (Mar. 31, 2008).

⁷⁵ This simplified version is derived from Hariton, *supra* note 7, at 5-6.

⁷⁶ *A* and *B* have a zero basis in their new partnership interest equal to the basis of their former partnership interest. See I.R.C. § 732(b).

⁷⁷ In the case of a tiered partnership, the upper-tier partnership is not permitted to increase the basis of its assets when it distributes an interest in a lower-tier partnership unless both partnerships have section 754 elections in effect. See I.R.C. §

sells the real estate for \$12 million and uses the proceeds to repay the borrowing used to purchase the notes. Rather than realizing a \$12 million gain on the sale, however, the CD partnership recognizes only de minimis gain (one percent), since it claims that the basis of the real estate is stepped up to reflect the gain left behind by *A* and *B* (ninety-nine percent).⁷⁸ Meanwhile, *A* and *B* may defer indefinitely and potentially eliminate their share of the gain inherent in the real estate, assuming the transaction survives scrutiny under various anti-abuse rules.⁷⁹

Again, the issue is how a court should frame the relevant transaction for purposes of testing economic substance. In *Countryside*, Hariton suggests that the taxpayers won because the Tax Court defined the relevant transaction as “the broader one (*i.e.*, the sale of the real estate) and it conceived of the investment in the AAA notes as a means of effecting the sale.”⁸⁰ Contrary to Hariton’s assertion, however, the court in fact defined the relevant transaction narrowly as the ABCD partnership’s redemption of *A* and *B*, isolated from the subsequent sale of the real estate by the continuing CD partnership. Indicating that the “transaction requiring economic substance is *Countryside*’s redemption” of the withdrawing partners’ interests, the court framed the question as “whether such a redemption may be respected for tax purposes if the means undertaken to accomplish it are chosen for their tax advantage.”⁸¹ It

761(e)(2) (treating distribution of a partnership interest as a deemed sale for purposes of section 743); Rev. Rul. 87-115, 1987-2 C.B. 163; *see also* Rev. Rul. 92-15, 1992-1 C.B. 215. To avoid a basis step-down in the notes from \$12 million to zero, the actual *Countryside* transaction involved two lower-tier partnerships and inconsistent use of section 754 elections.

⁷⁸ In Hariton’s example, both partnerships have section 754 elections in effect. For transfers after June 23, 2003, the special basis allocation rules for “substituted basis” exchanges would apply. *See* Treas. Reg. § 1.755-1(b)(5)(ii). Since the redeemed partners take a zero basis in the distributed lower-tier partnership interest, a \$12 million downward adjustment should be required to the basis of the notes. Under the revised regulations, however, no adjustment would be permitted because the property held by the lower-tier partnership does not have a built-in loss. *See* William F. McKee et al., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶¶ 24.04[1][a][ii]–[iii], at 24–20 to 24–23 (4th ed. 2007); *id.*, ¶ 25.07[2], at 25–44.

⁷⁹ The revised regulations warn that “abusive transactions” intended to exploit the special basis allocation rules for substituted-basis exchanges may be challenged under “a variety of judicial doctrines, including substance over form or step transaction, or under Treasury Regulation 1.701-2.” *See* T.D. 8847, 1999-2 C.B. 701, 704.

⁸⁰ Hariton, *supra* note 2, at 7–8.

⁸¹ *Countryside Ltd. P’ship v. Commissioner*, 95 T.C.M. (CCH) 1006, 1019

found that the redemption transaction served a genuine nontax business purpose and had economic substance because it accomplished a conversion of the taxpayers' partnership interests into AAA notes, "two economically distinct forms of investment."⁸² Without determining whether the continuing partnership's basis step-up was valid,⁸³ the court opined that the disaggregated transaction (an investment in AAA notes and redemption) had both a business purpose and economic substance.⁸⁴

Framed broadly, the relevant transaction in *Countryside* consisted of the abusive tiered-partnership structure and each of its contrived steps: the borrowing and purchase of AAA notes, the formation of two lower-tier partnerships, the deferral of gain to the redeemed partners, the step-up in the basis of the real estate, and the lack of a basis step-down in the AAA notes.⁸⁵ By contrast, the taxpayers asked the court to ignore the steps that actually occurred and recast the transaction "as if" the redeemed partners had received a simple distribution of nonmarketable notes.⁸⁶ The court's narrow holding was that this fictional distribution of notes had economic substance, even though analysis of the larger transaction might well require a different

(2008). For purposes of partial summary judgment, it was conceded that the redemption was structured to defer tax to *A* and *B* by acquiring and distributing nonmarketable notes (rather than marketable securities). *Id.* at 1014; *cf.* I.R.C. § 731(c) (treating distribution of certain marketable securities as taxable).

⁸² *Countryside*, 95 T.C.M. (CCH) at 1017-18 (2008) (concluding that change in the redeemed partners' economic position satisfied the second prong of the economic substance test).

⁸³ With respect to the larger transaction, the court indicated that the government had a choice of remedies including: (1) requiring a \$12 million step-down in the basis of the AAA notes, or (2) retroactively denying the \$12 million basis step-up in *Countryside*'s real estate. *Id.* at 1022 n.29; *see also id.* at 1013 n.16 (noting potential whipsaw issue). For the stipulated decision in the consolidated *Countryside* case, see note 98 *infra*.

⁸⁴ The court expressly stated that it was not ruling on the issue (involving a different taxable year) of the partnership's basis step-up in the real estate. *See id.* at 1010 n.8; *cf.* Hariton, *supra* note 7, at 5 (Ex. 9) (querying whether the whole transaction resulting in a disposition of real estate with a stepped-up basis has economic substance).

⁸⁵ *See Countryside*, 95 T.C.M. (CCH) at 1010 (noting government's argument based on the "totality of the transactions . . . and elections giving rise to the basis results, as constituting 'an abusive tax avoidance result'").

⁸⁶ *Id.* at 1017; *cf.* Burke, *supra* note 74, at 1398 (noting that the court's hypothetical recasting created a quandary, since it was impossible to determine the basis of the notes (in the hands of the redeemed partners or the partnership) without ruling on the abusive basis duplication steps).

result. Having ruled favorably on the economic substance issue, the court summarily concluded that the redemption satisfied the partnership anti-abuse rule.⁸⁷ Such a conclusion was possible only because, under the court's truncated view of the relevant transaction, it was possible to ignore the abusive basis duplication steps. Had it framed the transaction broadly, the court might have reached a more sensible result under the partnership anti-abuse regulation, without having to invoke the economic substance doctrine.⁸⁸

Hariton asks whether the "distinction between [*Countryside*] and *Stobie Creek* has enough analytic coherence to allow taxpayers to know what to expect in the future."⁸⁹ If one believes that *Countryside* was wrongly decided, that query should be answered negatively.

As in *Stobie Creek*, the redemption transaction in *Countryside* was linked to the sale of the real estate only because the taxpayers' tax adviser suggested inserting additional steps to achieve the desired tax goals.⁹⁰ Indeed, Hariton acknowledges that, under a narrow framing, the *Countryside* taxpayers might have lost, had the court rejected their "dubious and self-serving" testimony that "they had invested in AAA notes because they found them to be an irresistibly attractive investment."⁹¹ In this event, the court might have concluded that "such an investment lacked business purpose and economic substance and could not serve to defer tax on a sale of real estate."⁹²

Since *Countryside* arose prior to the effective date of section 7701(o), it is not clear how a similar case would be decided under current law.⁹³ Even absent section 7701(o), taxpayers should not be permitted to gain a strategic litigation advantage by severing one portion of a transaction from a larger overall transaction that, when viewed as a whole, may lack economic substance.⁹⁴ Although a

⁸⁷ See *Countryside*, 95 T.C.M. (CCH) at 1021-22; cf. Treas. Reg. § 1.701-2(c) (requiring a "comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction"); Treas. Reg. § 1.701-2(d), (Ex. 8).

⁸⁸ Indeed, both the *Stobie Creek* and *Countryside* transactions might have been better addressed under the partnership anti-abuse rules.

⁸⁹ Hariton, *supra* note 2, at 9.

⁹⁰ See *id.* at 7 ("Is it not possible to describe the investment by the taxpayers in AAA notes as extraneous to their sale of real estate?").

⁹¹ *Id.* at 9.

⁹² *Id.*

⁹³ Under one view, the economic substance doctrine should not be relevant at all in a case such as *Countryside*. See Monte A. Jackel, *When Is the Economic Substance Doctrine Relevant*, 132 TAX NOTES 77, 79 (2011).

⁹⁴ See Treas. Reg. § 1.701-2 (partnership anti-abuse rule).

business purpose for a partnership distribution may normally be presumed, the nonrecognition rules should not be read so broadly as to allow partners to identify property they would like to receive, and arrange for the partnership to acquire the property and distribute it to them.⁹⁵ The redemption transaction served the redeemed partners' desire to defer (and potentially eliminate) gain, but did not serve any business purpose of the partnership.⁹⁶ Viewed broadly, the *Countryside* transaction should thus be vulnerable under section 7701(o) because it lacked a substantial business purpose and had little, if any, economic significance apart from the tax savings.

Countryside may appear to embody a type of legitimate transactional “tweaking” designed to structure the sale of a business in the most tax-advantageous manner. Both the *Countryside* and *Stobie Creek* transactions shared the common feature, however, of exploiting rather obvious gaps in the partnership rules to defer or eliminate gain with little or no economic risk. Recent legislation aimed at curbing abusive manipulation of the partnership basis adjustment rules would apparently leave the *Countryside* result unaffected.⁹⁷ Indeed, *Countryside* suggests a routine planning strategy for partners in real estate partnerships who wish to indefinitely defer and convert gain on depreciated real estate through a pre-sale redemption.⁹⁸

⁹⁵ See Burke, *supra* note 74, at 1400–01; see also Monte A. Jackel, *Subchapter K and the Codified Economic Substance Doctrine*, 128 TAX NOTES 321, 324–25 (2010) (discussing business purpose and partnership distributions).

⁹⁶ In an arm’s-length business transaction, it would have made no sense for the nonredeemed partners to have assumed the risk of loss of the partnership’s basis step-up (exposing them to nearly \$12 million of additional gain) solely to save taxes for the redeemed partners. *Cf. Countryside*, 95 T.C.M. (CCH) at 1017 (“All of the parties to the transaction had legitimate business purposes . . .”).

⁹⁷ Congress in 2004 required mandatory section 754 adjustments in certain situations. See I.R.C. §§ 734(a), 743(a). A mandatory section 743 adjustment is triggered only if there is a “substantial built-in loss” following the distribution; since the lower-tier partnership holding the AAA notes in *Countryside* claimed a basis equal to their fair market value, there was no built-loss to trigger a downward basis adjustment. See I.R.C. § 743(d); *cf.* I.R.C. § 734(d) (triggering a mandatory adjustment if there would otherwise be a “substantial basis reduction”).

⁹⁸ In the *Countryside* litigation consolidated in the Tax Court, the parties eventually entered into a stipulated decision. *Countryside Ltd. P’ship v. Commissioner*, No. 22023–05 (U.S.T.C. May 26, 2011); *Countryside Ltd. P’ship v. Commissioner*, No. 3162–05 (U.S.T.C. May 26, 2011); *CLP Promisee LLC v. Commissioner*, No. 2176–08 (U.S.T.C. May 26, 2011); *Manchester Promisee LLC v. Commissioner* No. 2178–08 (U.S.T.C. May 26, 2011). Applying section 743(b) and Treasury Regulation § 1.701–2 (2010), the court ordered a \$12 million step-down in

IV. UNINTENDED TAX BENEFITS: *UPS* AND *CASTLE HARBOUR*

When the economic substance doctrine is relevant, Hariton's approach would disallow only "unintended tax benefits."⁹⁹ Tax benefits would be defined restrictively as consisting of "deductions, losses, increases in basis[,] and other items that might reasonably serve to reduce, offset[,] or eliminate unrelated items of income or gain."¹⁰⁰ For Hariton, the key issue is whether the transaction — viewed as a whole without bifurcating tax-motivated steps — gives rise to a tax benefit that serves to eliminate tax on unrelated income: "This is the 'framing question,' and it is the hardest question to answer, but unless and until one answers it, the remaining questions do not have any meaning."¹⁰¹ This inquiry would, in effect, constitute a third prong of the economic substance test: it would confine the scope of the economic substance doctrine to tax-shelter transactions.

Hariton claims that, as currently formulated, the two-pronged economic substance test is hopelessly amorphous: absent a definition of a tax shelter, it is impossible to draw a meaningful distinction between cases like *ACM* and *UPS*.¹⁰² In Hariton's view, "[t]he only meaningful difference between *UPS* and [*ACM*] is that the latter, but not the former, gave rise to a large tax benefit that was used to offset the tax that otherwise would have been paid on unrelated income."¹⁰³ Because the *ACM* transaction served to shelter unrelated income, it constituted a tax shelter rather than merely aggressive tax planning. Unless it is possible to distinguish between a tax shelter and a legitimate business transaction, Hariton suggests that the economic

the basis of the AAA notes (while preserving the \$12 million basis step-up in Countryside's real property), triggering \$12 million of deferred capital gain to the redeemed partners when the AAA notes were ultimately paid. The redeemed partners were also liable for a twenty percent penalty on a portion of the tax underpayment. Although the stipulated decision addresses the basis duplication portion of the transaction, it leaves intact the gain deferral and conversion sanctioned in the original *Countryside* decision.

⁹⁹ Hariton, *supra* note 7, at 7 (defining "unintended tax benefits").

¹⁰⁰ *Id.* (defining "tax benefits"); see also Hariton, *supra* note 6, at 30 (proposing that the economic substance doctrine be applied only to tax shelters, "define[d] as transactions that, when considered as a whole, serve primarily to generate net losses, deductions[,] or credits that can be used to eliminate the tax that otherwise would be imposed on unrelated income").

¹⁰¹ Hariton, *Kafka*, *supra* note 4, at 33.

¹⁰² *ACM P'ship v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001).

¹⁰³ Hariton, *Kafka*, *supra* note 4, at 22.

substance doctrine may prove self-defeating because, under an expansive application, the government will be unable to single out marketed shelters for appropriately harsh penalties.¹⁰⁴

According to Hariton, *UPS* was not a tax shelter case because the transaction, considered as a whole, did not give rise to any tax benefits, and was merely a way of structuring UPS's parcel insurance business to "insulate itself from the imposition of U.S. tax on these profits by transferring them to an offshore affiliate."¹⁰⁵ Rather than offsetting unrelated income, the transaction eliminated tax on income derived from UPS's highly-profitable parcel insurance business. Prior to the restructuring, UPS collected an "excess value charge" (EVC) from customers to insure packages above a low fixed limit on UPS's liability. Following the restructuring, UPS continued to deal with its customers in handling receipts and claims, but remitted the net EVC to an unrelated insurance company (NUF), which remitted the EVC as a reinsurance premium to a Bermuda corporation (OPL) whose stock was owned almost entirely by UPS's shareholders. To reallocate income to UPS and away from the related foreign corporation, the government invoked the economic substance doctrine as well as section 482.

In *UPS*, the court stated that "a transaction has a 'business purpose' . . . as long as it figures in a bona fide profit-seeking business."¹⁰⁶ Since the EVC arrangement itself served a business purpose — "there was a real business that served the genuine need for customers to enjoy loss coverage" — the majority found that the restructuring served a valid business purpose.¹⁰⁷ Focusing only on the parties' formal arrangements, the majority concluded that the transaction created genuine third-party obligations and thus had "real economic effects."¹⁰⁸ The majority framed the transaction broadly for the business purpose test, but narrowly for the economic effect test. By contrast, the dissent found that the tax-motivated steps —

¹⁰⁴ See *id.* at 32 (responding to criticism that penalties are appropriate because "there is no right to engage in aggressive tax planning"); cf. Weisbach, *supra* note 70, at 224 (arguing that policy makers should not be concerned about inhibiting tax planning because "all tax planning, all altering of behavior in response to taxes, should be suspect").

¹⁰⁵ Hariton, *supra* note 6, at 44.

¹⁰⁶ *United Parcel Serv.*, 254 F.3d at 1019.

¹⁰⁷ *Id.* at 1020 ("The transaction under challenge here simply altered the form of an existing, bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive.").

¹⁰⁸ *Id.*

insertion of the unrelated insurance company and creation of the UPS-affiliated offshore company — lacked a valid business purpose.¹⁰⁹ It also determined that any nontax economic effects were essentially meaningless: in return for a large fee, the third-party insurer assumed only an infinitesimal exposure to loss and passed on the net EVC income to the UPS-affiliated offshore entity.¹¹⁰

Under section 7701(o), the *UPS* transaction might well run afoul of the economic substance test. In *UPS*, the court indicated that a valid business purpose for a transaction need not be “free of tax considerations,” emphasizing that “tax planning is permissible.”¹¹¹ Under the majority’s expansive view of a business purpose as potentially including a purpose to reduce taxes, it would be virtually impossible for most corporate transactions to fail to satisfy this prong of the economic substance test. By contrast, section 7701(o) requires a substantial nontax purpose, apart from tax savings.¹¹² Even assuming UPS’s stated business purpose were sufficient, it is not clear that the offshore captive insurance arrangement represented a reasonable means of accomplishing UPS’s nontax goal. Moreover, any nontax economic effects might well be viewed as insignificant in relationship to the tax benefits, since the transaction had virtually no effect on UPS’s overall economic position.

Hariton praises the decision because UPS was conducting a real business and the government should not be permitted to “ferret out” tax-motivated steps or structures that, “considered on their own, lacked business purpose and economic substance.”¹¹³ Basically, Hariton’s claim is that the *UPS* transaction was not a tax shelter and thus should not be subject to attack under the economic substance doctrine, even though it might fail on other grounds.¹¹⁴ Unlike the *ACM* transaction which generated “a capital loss that dwarfed the business objectives of the taxpayer and any profits arising from them,” the *UPS* restructuring did not give rise to any tax benefits “that could

¹⁰⁹ *Id.* at 1021–22 (Ryskamp, J., dissenting).

¹¹⁰ *Id.* at 1021 (“In essence, [the third-party insurer] received an enormous fee from UPS in exchange for nothing.”).

¹¹¹ *Id.* at 1019.

¹¹² See I.R.C. § 7701(o)(1)(B).

¹¹³ Hariton, *supra* note 5, at 541; *id.* (maintaining that broader application would be “tantamount to applying a general antiabuse rule to tax-related structuring”).

¹¹⁴ See Hariton, *Kafka*, *supra* note 4, at 11 (“In *UPS*, moreover, the tax benefit from the business restructuring did not exceed the tax that otherwise would have been imposed on the profits arising from the business itself.”).

be used to offset the tax on unrelated income.”¹¹⁵ Even if one accepts the distinction Hariton draws between *ACM* and *UPS*, Congress rejected proposed legislation that narrowly focused on tax-shelter transactions. For purposes of applying section 7701(o), the focus should not be on whether the *UPS* restructuring gave rise to an unintended tax benefit (under Hariton’s restrictive definition) by reducing *unrelated* income.¹¹⁶ Framed narrowly, the *UPS* transaction obviously yielded a substantial tax benefit — by deflecting income to an offshore affiliate, it eliminated tax on income that would otherwise have arisen in *UPS*’s parcel insurance business.¹¹⁷ The relevant question should thus be whether the tax benefit arising from the transaction was reasonably intended by Congress.

Following enactment of section 7701(o), the economic substance doctrine should not necessarily invalidate the *UPS* transaction. Even if the formation of the offshore affiliate was entirely tax-motivated, an important line of cases would arguably respect an entity’s separate status as long as it conducts some business. Under *Moline Properties*,¹¹⁸ the fact that a corporation is formed merely to obtain a tax advantage is not necessarily fatal. For purposes of scrutiny under section 7701(o), *UPS* might well be able to argue successfully that the creation of the offshore affiliate was immunized by the exception for certain basic business transactions, including “a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C.”¹¹⁹ In this light, the *UPS* transaction could be viewed as “simply taking advantage of the combination of several long-standing, well-understood, and generally accepted tax principles” upholding use of the corporate form to structure a business in a tax-efficient manner.¹²⁰

One should be careful, however, not to extrapolate from *UPS* lessons applicable outside the corporate area. In *Culbertson*, the Supreme Court held that a valid partnership exists only if “the parties

¹¹⁵ *Id.* at 11–12.

¹¹⁶ *Cf. id.* at 17 (“But the answer depends on the definition of tax benefits.”).

¹¹⁷ *But see id.* at 18 (“But if we do define the transaction more narrowly, then how do we define the transaction when the taxpayer’s business is not restructured but rather is aggressively structured to begin with?”) (emphasis in original).

¹¹⁸ *Moline Props. v. Commissioner*, 319 U.S. 436 (1943).

¹¹⁹ *Technical Explanation, supra* note 1, at 152 (listing transactions exempt from the economic substance doctrine).

¹²⁰ Martin J. McMahon, *Living With the Codified Economic Substance Doctrine*, 128 TAX NOTES 731, 738 (Aug. 16, 2010); *id.* (noting that the tax benefits in *UPS* “should be considered to have been ratified by decades of congressional inaction”).

in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.”¹²¹ Even if a partnership has sufficient business purpose and objective economic substance to avoid being treated as a sham, the Second Circuit’s decision in *Castle Harbour* suggests that *Culbertson* may require closer scrutiny to determine whether the form of the transaction accurately reflects its substance.¹²² The *Castle Harbour* transaction involved two tax-exempt Dutch banks and two subsidiaries of General Electric Capital Corp. (the GECC entities), which owned fully depreciated airplanes that were net-leased to an unrelated user. Nearly all (ninety-eight percent) of the partnership’s book and tax income was allocated to the banks, but most of their share of book income was offset by book depreciation, leaving the banks with a much smaller share of economic income. The net result was to redirect most of the economic income to the GECC entities free of tax, allowing them essentially to “redepreciate” the zero-basis planes and reduce their tax liability by \$62 million.¹²³

The district court found that the transaction had real nontax effects and a valid business purpose: it actually raised \$117 million of capital and was subjectively motivated, in part, by GECC’s desire to demonstrate its ability to monetize the leased aircraft.¹²⁴ The court

¹²¹ *Commissioner v. Culbertson*, 337 U.S. 733 (1949); see also *ASA Investering P’ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) (disregarding sham partnership).

¹²² *TIFD III-E, Inc. v. United States (Castle Harbour II)*, 459 F.3d 220 (2d Cir. 2006), *rev’g* *TIFD III-E, Inc. v. United States (Castle Harbour I)*, 342 F. Supp. 2d 94 (D. Conn. 2004). On remand to consider issues under section 704(e), the district court once again held that the banks were partners of a valid partnership for income tax purposes, prompting a renewed appeal to the Second Circuit. *TIFD III-E, Inc. v. United States (Castle Harbour III)*, 660 F. Supp. 2d 367 (D. Conn. 2009); see generally Karen C. Burke & Grayson M.P. McCouch, *Snookered Again: Castle Harbour Revisited*, 128 TAX NOTES 1143 (Sept. 13, 2010); Monte A. Jackel & Robert J. Crnkovich, *Castle Harbour Strikes Again*, 125 TAX NOTES 591 (Nov. 2, 2009).

¹²³ In return for facilitating the transaction, the Dutch banks received essentially a guaranteed return of their investment plus a specified rate of return. See Chirelstein & Zelenak, *supra* note 9, at 1966 (“The banks were creditors in all but name, and the annual distribution of book income was nothing more than a ‘fast-pay’ repayment of debt plus interest.”).

¹²⁴ Noting that “[i]n a transaction where a part of an ongoing business is spun off into a separate partnership, the fact that the underlying business has economic substance does not necessarily preclude a finding that the creation of the spin-off was a sham transaction,” the district court nevertheless found that the formation of the *Castle Harbour* partnership was valid. *Castle Harbour I*, 342 F. Supp. 2d at 113; *id.* at 113 n.38 (distinguishing *United Parcel Service* where the “court found the underlying

also upheld the validity of the partnership, finding that *Culbertson* was satisfied because the partnership had economic substance and was not a sham.¹²⁵ On appeal, the Second Circuit found that the district court erred by confining its *Culbertson* analysis to the narrow issue of whether the partnership was a sham and “by accepting at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities.”¹²⁶ Given the overwhelmingly debt-like nature of their interests, the Dutch banks lacked a “bona fide equity participation” and failed to qualify as partners for income tax purposes.¹²⁷ While the Dutch banks purportedly enjoyed a limited upside potential, the Second Circuit found that the arrangement, viewed as a whole, was “more in the nature of window dressing designed to give ostensible support to the characterization of equity participation, which was essential to the dominant tax objective, than a meaningful stake in the profits of the venture.”¹²⁸

In comparison to *UPS*, *Castle Harbour* suggests that *Culbertson* imposes a heightened business purpose requirement when a portion of a business is spun off to a partnership. Requiring a weightier nontax business purpose may well be justified, given the heightened tax-avoidance opportunities arising from use of the partnership form. *Castle Harbour* also serves as a reminder that the economic substance doctrine and other common law doctrines such as substance over form

business purpose of a reorganized entity to be sufficient to justify the reorganization transaction”).

¹²⁵ See *id.* at 112–13 (equating economic substance, business purpose, and sham doctrines, and finding *Culbertson* was satisfied because “the transaction that created *Castle Harbour* was not a sham”); see *id.* at 116 n.40. The district court concluded that there was a “legitimate non-tax reason to create a separate entity” and that the partnership arrangement was “one — even if not the only — legitimate way of achieving [GECC’s] non-tax purpose.” *Id.* at 114.

¹²⁶ *Castle Harbour II*, 459 F.3d at 231.

¹²⁷ *Id.* at 241. As the Second Circuit explained, the “[t]he [service’s] challenge to the taxpayer’s characterization [of the Dutch banks’ partnership interest] is not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective.” *Id.* at 232.

¹²⁸ *Id.* at 236. Because the Second Circuit found that the Dutch banks’ interest was overwhelmingly debt-like, it was unnecessary to address the economic substance issue on appeal. See *id.* at 231 n.11. If the Second Circuit affirms the district court’s section 704(e)(1) holding that the banks nevertheless qualified as partners — based on their ownership of a capital interest under section 704(e)(1), without regard to *Culbertson* — it will need to determine the validity of the partnership’s allocations under section 704(b). See *TIFD III-E, Inc. v. United States (Castle Harbour III)*, 660 F. Supp. 2d 367, 383–95 (D. Conn. 2009).

are often overlapping, making it difficult to sort out when a particular doctrine should apply.¹²⁹ Although section 7701(o) is not intended to limit a taxpayer's choice to capitalize a business with debt or equity,¹³⁰ this exception should not serve to immunize a *Castle Harbour*-type transaction in which a debt-like instrument is cast as equity to exploit the tax-indifferent status of a putative partner. In comparison to the anticipated tax savings, GECC's purported business purpose was quite weak.¹³¹ If section 7701(o) applied to such a transaction, a court should reject the notion that the tax benefits were clearly contemplated: structuring a transaction in a manner intended to shift tax (but not economic) income to a tax-exempt party upon a contribution of high-value, low-basis property is inconsistent with the purpose of Subchapter K.¹³²

V. CONCLUSION

In considering framing explicitly, Hariton focuses on what is arguably the most difficult issue that courts are likely to face in applying the economic substances doctrine — namely, whether to disallow tax benefits by disaggregating tax-motivated steps (which, standing alone, clearly lack economic substance) from a purported larger transaction. While Hariton understandably seeks to establish an outer boundary for *Coltec*'s disaggregation approach, his proposed presumption against bifurcation would deprive the economic substance doctrine of much of its essential flexibility. In enacting section 7701, Congress expressly approved of the disaggregation approach and gave courts broad discretion in framing the relevant transaction. Although such flexibility inevitably gives rise to

¹²⁹ See *Technical Explanation, supra* note 1, at 142 n.300 (noting that certain substance-over-form cases involving tax-indifferent parties “have also involved examination whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed”); *Altria Grp. v. Commissioner*, 694 F. Supp. 2d 259, 277 (S.D.N.Y. 2010) (“*Castle Harbour*, however, teaches that the Government enjoys the benefit of the resulting legal uncertainty, and is not limited to the test most favorable to the taxpayer’s position. . .”).

¹³⁰ See *Technical Explanation, supra* note 1, at 152.

¹³¹ Not only did GECC not need to raise an additional \$117 million of cash for use in its aircraft leasing business, but there was no evidence that the Dutch banks’ cash was actually used for that purpose.

¹³² Under current law, such a transaction is covered by a specific anti-abuse rule. See Treas. Reg. § 1.704–3(a)(10) (2010); see also Treas. Reg. §§ 1.704–3(b)(2), ex. 2, (c)(4), ex. 3 (2010).

uncertainty, the central question under the codified version of economic substance (as under prior law) is whether the overall result of a multi-step transaction is consistent with Congressional intent. If the tax benefits are clearly contemplated — as arguably was the case in *UPS* — the taxpayer should win.¹³³ By contrast, transactions that seek to exploit unintended technical gaps deserve to fail. Perhaps ironically, codification may encourage taxpayers to argue that such transactions do not work technically, in the hope of avoiding strict liability penalties under section 7701.

¹³³ See Bankman, *supra* note 8, at 13 (economic substance doctrine cannot apply where “a sensible reading of text, legislative intent, and purpose suggest it should not apply”).