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Tax Notes Today

JANUARY 20, 2012

Practitioners Still Seeking Tax Shelter Success as Courts Side With Government

by Shamik Trivedi

Summary by taxanalysts

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Practitioners examined some recent decisions from high-profile tax shelter cases and discussed what transactional elements qualified, or should have qualified, under the two prongs of the economic substance doctrine: objective profit potential and subjective business purpose.

John Lindquist, a senior litigation counsel for the Justice Department's Tax Division, speaking on his own behalf, said that before 2001, the industry standard was to structure a transaction so that it had "any profit possibility," which was evident in the range of son-of-BOSS cases.

Practitioners have since become better at structuring transactions and presenting

arguments in a way that better reflects economic substance, he said. Lindquist said he looked to *Fidelity* as a "wonderful example of the application of that [objective profit potential] test." (For *Fidelity International Currency Advisor A Fund LLC v. United States*, 747 F.Supp.2d 49 (D. Mass. 2010), see *Doc 2010-10960* or *2010 TNT 96-16*.)

Fidelity represents a second-generation son-of-BOSS transaction demonstrating that practitioners are now designing the transaction "to have the appearance of the possibility of being able to cover your fees," Lindquist said.

The taxpayer in *Fidelity*, former U.S. Ambassador to Ireland Richard Egan, engaged in a transaction that was both a loss generator and a gain eliminator. It was designed to create a "head of the pin payout" whereby the possibility of a payout "hitting the gusher" would be low, but the payout itself would be quite high, Lindquist said. The appearance of a possibility for a large profit "gives legs to the transaction for economics," he said.

Nonetheless, in the end, the government's examination of supporting documents, including e-mails and communications, showed that the preparations were "after-the-fact machinations to show a valid business purpose," not unlike the transaction undertaken in *WFC Holdings*, he said. (For *WFC Holdings Corp. v. United States*, No. 0:07-cv-03320 (D. Minn. 2011), see *Doc 2011-20825* or *2011 TNT 192-9*.)

In *WFC Holdings*, which involved a purported tax shelter by Wells Fargo & Co., an employee in the bank's tax department was tasked with creating a business purpose memo to justify the transaction, said Mark D. Allison, a partner with Caplin & Drysdale.

If the memo had been written and simply placed in a file, the result might have been different, but the employee "had to keep rewriting the memo because they kept coming up with better or different business purposes," Allison said, adding, "The court saw right through that."

Better Profit Projections, but Unused

George A. Hani, a member with Miller & Chevalier, questioned whether having legitimate, reasonable data that could show profit potential could have saved the taxpayer in *Pritired*, a tax shelter case involving a purported foreign tax credit generator concocted by Citibank.

In *Pritired*, the District Court for the Southern District of Iowa prohibited Principal Life Insurance Co. from claiming more than $20 million in foreign tax credits that the company sought based on a complex transaction involving a $300 million payment to two French banks. The court concluded that the transaction was a loan rather than

an equity investment, that it lacked economic substance, that it violated the partnership antiabuse rule, that it had no business purpose and no reasonable expectation of profit, and that the Notice 98-5 safe harbor did not apply. The court didn't decide whether the allocation of the foreign taxes had substantial economic effect. (For *Pritired 1 LLC v. United States*, No. 4:08-cv-00082 (S.D. Iowa 2011), see *Doc 2011-20916* or *2011 TNT 193-9*. For prior coverage, see *Doc 2011-22304* or *2011 TNT 205-9*. For Notice 98-5, 1998-1 C.B. 334, see *Doc 98-175* or *98 TNT 247-3*.)

Running profit projections actually could have occurred in *Pritired*, Lindquist said, adding that the taxpayer in that case had a model that could show the effect of earnings on perpetual certificates under varying interest rates. A sharp drop in interest rates resulted in a significant decrease in Pritired's return -- something that could have been detected and planned for. "When you have something that foresight could have showed you, not just hindsight, you're in trouble," Lindquist said.

Government Sponsored Profit Potential?

There was some debate among the panelists about whether a subsidy created by Congress -- in the case of *Historic Boardwalk*, a rehabilitation credit -- has a sufficient possibility of profit or can serve as the sole reason for a profit. (For *Historic Boardwalk Hall LLC v. Commissioner*, 136 T.C. No. 1; No. 11273-07 (2011), see *Doc 2011-80* or *2011 TNT 2-15*.)

In that case, the Tax Court held in favor of the taxpayer and found that Congress had created the rehabilitation credit as a way to encourage private investment in historic rehabilitations. Coupled with a rate of return of 3 percent, the transaction had economic substance.

"A lot of what's relevant in a case is the extent to which the litigators develop the facts," Lindquist said. "There's no question that [*Historic Boardwalk*] was a tax shelter -- and there are legal tax shelters," he said, adding that he wouldn't consider the transaction abusive, because it wasn't a listed transaction. It would be troubling for a congressionally mandated tax credit to be called a tax shelter, Allison said.

Stuart J. **Bassin**, a partner with Baker & Hostetler LLP, said he found it interesting that the court in *Historic Boardwalk* didn't examine whether the 3 percent rate of return was sufficient for profit potential. The government had argued that the prevailing risk-free rate of return at that time was greater than 3 percent, and the court decided to ignore that argument, he said.

Hani pointed out that in the era of the codified economic substance doctrine, the statute applies "when relevant." In *Historic Boardwalk*, the taxpayer argued that the doctrine shouldn't apply, but the court didn't address that. "It's almost as if, in that

opinion, the economic substance doctrine applies in any transaction, for any statute of the code," Hani said.

That could affect other types of modernization transactions, like energy credits, he said, adding that practitioners working on those kinds of transactions would have appreciated the court in *Historic Boardwalk* providing some guidance about when the doctrine is irrelevant.

Business Purpose

Allison said that the difficulty in applying the second prong of the economic substance test -- whether there is a subjective business purpose -- arises from courts having to read taxpayers' minds.

He said many of the economic substance cases have in some way been started by promoters. "That leads to the evolution of the transaction . . . [and] it's virtually impossible to overcome that taint," he said.

"Once the seed is planted [by a promoter], you're done, and what these cases imply is that you may as well not even bother continuing," Allison said. He took particular issue with the reasoning in *WFC Holdings*, in which the court found that Wells Fargo's tax department drove the transaction and that there was no nontax business purpose for engaging in the transaction.

"That just seems to go too far, particularly in a corporate context, because that's how corporations run," Allison said. "You pay good people to come up with good ideas for managing a company's exposure."

Lindquist responded that while all transactions involve a tax adviser, "not all these transactions involve a promoter coming in with a turnkey product." He said that sometimes fees are incurred as a fixed percentage of the tax loss generated.

"When you see a transaction where the taxpayer is calculating the tax benefit right at the get-go, at the time of the marketing, it hurts the business purpose claim," Lindquist said. Proper planning involves advisers, but when they are charged a contingent fee, "you've got a problem," he said.

Tax Analysts Information

Code Sections: Section 47 -- Rehabilitation Credit
Section 7701(o) -- Economic Substance Codification
Jurisdiction: United States