POINTS TO **REMEMBER**

EDITOR'S NOTE: The three **POINTS** in this issue discuss recent judicial and legislative developments and explore the use of non-traditional investments in retirement plans. In the first Point Glen Mincey and Matt Belcher analyze the implications of recent tax shelter litigation in which taxpayers have prevailed. Mike Steinsaltz then explains the operation of recently enacted section 965, which is designed to encourage repatriation of foreign earnings. Finally, Alexander Drapatsky suggests that individuals consider using retirement plan accounts to hold real estate, businesses, and other assets not usually associated with such accounts.

RECENT CASES ADDRESS SHAM TRANSACTION DOCTRINE

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While much has been said regarding the IRS's successful tax shelter litigation in *Long Term Capital Holdings v. United States*,[1] a number of cases have recently been decided in which the IRS has been unsuccessful: *TIFD III-E Inc., v. United States*[2] ("*Castle Harbour*"), *Black & Decker Corporation v. United States*,[3] and *Coltec Industries, Inc. v. United States*.[4] It of course remains to be seen exactly what impact these decisions will have, as well as whether the decisions will be affirmed on appeal.

LONG TERM CAPITAL HOLDINGS

Long Term Capital Holdings involved the importation of high basis, low value preferred stock that a foreign bank contributed to a partnership in exchange for a partnership interest. The foreign bank simultaneously acquired a "put right" that entitled the bank to sell its partnership interest to another partner. The bank later exercised its put right and sold its partnership interest at a time when the partnership did not have a section 754 election in effect. Thus, when the partnership later sold the high basis, low value preferred stock, the acquirer of the bank's partnership interest was able to utilize the loss inherent in the property.

The IRS argued that the transaction in *Long Term Capital Holdings* lacked economic substance.[5] The U.S. Supreme Court first applied the economic substance doctrine in the context of disregarding a corporate entity,[6] and the doctrine has since been equally applicable in the context of disregarding transactions that lack economic substance.[7] In holding that a separate entity or a purported transaction may only be disregarded where it is a sham or unreal, the Court established the now landmark two-part test for determining such "sham" status: the first prong—a subjective standard—requiring the taxpayer to demonstrate a legitimate, non-tax business purpose for the formation of the entity under scrutiny; and the second prong—an objective standard—merely requiring a demonstration that the entity has engaged in sufficient business activity to warrant its recognition as a reality.

This standard has been universally applied by courts in matters involving separate entity recognition where corporations are involved.[8] The test for economic substance has also been applied by courts in determining whether partnerships should be respected as entities.[9] While it appears clear that satisfaction of either prong of the test will result in the recognition of a purported transaction or the separate existence of an entity, regardless of whether the other prong is satisfied, these recent cases arguably hold that the two-prong test for economic substance is conjunctive, rather than disjunctive.[10]

The court found that the taxpayers in *Long Term Capital Holdings* had no business purpose in engaging in the transactions at issue other than tax avoidance and that the transaction had no economic substance beyond the creation of tax benefits. Significantly, taking into account transaction costs, the court determined that there was no pre-tax profit potential in the acquisition of the preferred stock. In addition, although the taxpayers averred

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1 330 F. Supp. 2d 122 (D. Conn. 2004).

2 342 F. Supp. 2d 94 (D. Conn. 2004).

3 340 F. Supp. 2d 621 (D. Md. 2004).

4 62 Fed. Cl. 716 (Cl. Ct. 2004).

5 The IRS also argued that the transactions should be recast under the step transaction doctrine. The court applied the "end result" test to recast the transactions as a direct sale of the preferred stock by the bank to the partner that purportedly purchased the bank's partnership interest. It appears that the aggressive nature of the transactions may have encouraged the court to apply the most liberal version of the step transaction doctrine even though the recast required the creation of steps that did not actually occur (the contribution by the purchasing partner of the preferred stock to the partnership).

6 Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

7 *See* Frank Lyon Co. v. U.S., 435 U.S. 561 (1978); Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985).

8 *See, e.g.*, Bollinger v. Commissioner, 485 U.S. 340 (1988); National Carbide v. Commissioner, 336 U.S. 422 (1949); Strick Corp. v. United States, 714 F.2d 1194 (3d Cir. 1983); Britt v. United States, 431 F.2d 227 (5th Cir. 1970); Lowndes v. United States, 384 F.2d 635 (4th Cir. 1967); Kimbrell v. Commissioner, 371 F.2d 897 (5th Cir. 1967); Chelsea Products v. Commissioner, 197 F.2d 620 (3d Cir. 1952); Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945); Ross v. Commissioner, 129 F.2d 310 (5th Cir. 1942).

9 *See, e.g.*, Campbell County State Bank v. Commissioner, 37 T.C. 430 (1961), *rev'd on other grounds*, 311 F.2d 374 (8th Cir. 1963); Friedlander Corp. v. Commissioner, 216 F.2d 757 (5th Cir. 1954); Cooper v. Commissioner, 61 T.C. 599 (1974); Buffalo Meter Co. v. Commissioner, 10 T.C. 83 (1948), acq. 1948-1 C.B. 1 (1948); Seminole Flavor Co. v. Commissioner, 4 T.C. 1215 (1945).

10 ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000); Boca Investerings Partnership v. United States, 314 F.3d 625 (D.C. Cir. 2003); Saba Partnership v. Commissioner, 273 F.3d 1135 (D.C. Cir. 2001); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

that part of the motivation of the transaction was to establish and advance a relationship with the investing bank, the bank's investment in the partnership was intended to be sold to other partners in as short a time as possible and none of the principals in the partnership knew any of the bank owners or officers. Thus, because the court found that the taxpayers in *Long Term Capital Holdings* had failed both prongs of the economic substance test, the court determined that the transactions lacked economic substance and should be disregarded for federal tax purposes.

CASTLE HARBOUR

In *Castle Harbour*, a number of subsidiaries of General Electric Capital Corporation ("GECC") leased commercial aircraft to airlines. To reduce the risk involved in holding aging aircraft in the aircraft leasing business (and, apparently, to replace debt on GECC's balance sheet with minority interest equity), the GECC subsidiaries sought to form a partnership to raise capital from investors. To that end, the GECC subsidiaries contributed the leased aircraft to a partnership with two Dutch banks. The GECC subsidiaries received an 82% interest in the partnership, and the Dutch banks received an 18% interest in the partnership. Under the allocations of the partnership agreement, the banks were allocated virtually all (98%) of the operating income and were subject to minimal risk of loss. In addition, the Dutch banks were allocated a relatively modest share of any appreciation in the assets of the partnership (up to $3 million plus 1% of any gains in excess of $3 million). Finally, although allocated only 2% of the operating income of the partnership, the GECC subsidiaries received an annual guaranteed payment under section 707(c) that equaled, in effect, approximately one half of the annual net income of the partnership.

The GECC subsidiaries had fully depreciated the leased aircraft prior to contributing the aircraft to the partnership. Under application of the partnership rules then in effect (specifically, section 704(c)(1)(A)), the GECC subsidiaries did not have to take into account the difference between the fair market value and the tax basis of the contributed aircraft. Thus, although depreciation was taken into account in determining the section 704(b) book income of the partnership, no tax depreciation was deducted in determining taxable income. Because the Dutch banks were allocated 98% of the net book income of the partnership, the Dutch banks were allocated a corresponding 98% of the taxable income of the partnership; however, because there was no tax depreciation in the partnership, the Dutch banks were not allocated, and could not deduct, any tax depreciation. Thus, the transaction resulted in the allocation of a substantial amount of taxable income from the aircraft leases to the Dutch banks.

The IRS argued that (i) the formation of the partnership in *Castle Harbour* did not have economic substance; (ii) the Dutch banks were not partners, but rather were lenders to the partnership; and (iii) the partnership allocations did not have substantial economic effect. The IRS's argument that the formation of the partnership was a sham should be noted in light of recent decisions in which the D.C. Circuit concluded that, even if the taxpayer in question had a legitimate non-tax business purpose for engaging in a particular transaction, the formation of each partnership served no non-tax purpose.[11] The Connecticut District Court noted that there may be a question in the courts as to whether the test for economic substance required a satisfaction of either prong of the test or both prongs of the test. Nevertheless, because the court determined that the formation of the partnership had both economic effect and business purpose, it did not answer the question.

First, the court found that the contribution by the Dutch banks of $117 million for use by the partnership had real non-tax economic effect. The Dutch banks received a substantial share of the partnership's income in exchange for their investment, and the partnership utilized the funds in its operations to purchase aircraft or to retire liabilities. In addition, the court found that the GECC subsidiaries had a valid business purpose in the need to raise capital and, more importantly, to demonstrate financial viability to their investors despite their fleet of aging aircraft. Thus, the court held that the formation of the partnership had economic substance and was not a sham.

The IRS's argument that the Dutch banks were not partners is also significant in light of the D.C. Circuit decisions mentioned above. In ASA Investerings, foreign investors in a partnership had invested in such a manner that they were in substance never partners but rather lenders to the partnership. The IRS argued that, because the Dutch banks had guaranteed their return from the partnership with minimal risk of loss, and the partnership allocations provided the Dutch banks with only a modest share in partnership asset appreciation, the banks should be considered lenders as were the partners in ASA Investerings. Although the Dutch banks had indeed invested in such a manner that they would receive a minimum return, the banks' return was subject directly to the performance of the aircraft leasing business. Thus, the court held that the Dutch banks should be respected as partners in the partnership.

Finally, the IRS argued that the partnership allocations in *Castle Harbour* did not have substantial economic effect. Even though the GECC subsidiaries owned 82% and the Dutch banks owned 18% of the interests of the partnership, the practical effect of the allocations resulted in virtually all of the net income being allocated to the Dutch investors. The IRS argued that the allocations should have been made in accordance with the partners' investment in capital of the partnership. In addition, although it is not entirely clear from the court opinion, it seems that the IRS argued that the guaranteed payment paid to the

11 *ASA Investerings Partnership*, supra, n. 10; *Boca Investerings Partnership*, supra, n. 10.

GECC subsidiaries should have been treated as an allocation of income. The court stated that investment in capital is only a factor in determining the partners' interests in the partnership, and found that the economic reality of the allocations resulted in the "unambiguous assignment" of 98% interest of the operating income of the partnership to the Dutch banks.[12] Thus, the court found that the allocations of income had substantial economic effect.

COLTEC AND BLACK & DECKER

Coltec and *Black & Decker* involved transactions in which the taxpayers sought to isolate contingent liabilities (asbestos litigation claims in *Coltec* and employee healthcare claims in *Black & Decker*) from other company assets. In each case, the taxpayer contributed assets to a corporation subject to the contingent liability. While the contingent liability reduced the fair market value of the stock received by the taxpayers, such contingent liability was not treated as a liability for purposes of sections 357 or 358. Thus, the liability would not reduce the basis of the stock received by the taxpayers. In each case, each taxpayer later sold the high basis, low value stock for a substantial capital loss and utilized such loss to offset capital gains.

The IRS argued that the transactions in *Coltec* and *Black & Decker* did not have economic substance. Unlike the Connecticut District Court in *Castle Harbour*, which did not address the issue of whether the legal sham test is a disjunctive or a conjunctive test, the Maryland District Court in *Black & Decker*, and the Court of Federal Claims in *Coltec* did address this question. Both the Maryland district court and the Court of Federal Claims analyzed each respective transaction under the disjunctive test. In *Black & Decker*, the court noted that, although the taxpayer conceded for purposes of summary judgment that tax avoidance was its sole motivation for structuring the transaction as it did, the corporation engaged in bona fide economically-based business transactions and therefore had economic substance. Quoting *Rice's Toyota World*, the court stated that it could not ignore a transaction that had economic substance, even if the motive for the transaction was to avoid taxes.[13] In *Coltec*, in finding that the taxpayer had satisfied both the business purpose and economic effect prongs, the court stated that the economic substance doctrine is satisfied upon the satisfaction of "at least" one prong of the two-prong test.[14] Notably, in both *Coltec* and *Castle Harbour*, the courts indicated that Congress, rather than the judicial branch, had the responsibility for establishing the law on what constitutes economic substance.

CONCLUSION

As mentioned above, it remains to be seen exactly what impact these decisions will have, as well as whether the decisions will be affirmed on appeal. However these cases are ultimately resolved, the guidance that such resolution will provide will be eagerly anticipated by tax practitioners.

A **TAX HOLIDAY** FOR REPATRIATED FOREIGN EARNINGS: NEW SECTION 965

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INTRODUCTION

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 ("Act"), which contains the most comprehensive international tax reform since the Tax Reform Act of 1986. This Point discusses one of the most important and highly anticipated provisions of the Act: new section 965, which, for a limited time, provides very favorable tax treatment for repatriated foreign earnings.

Section 965 allows for a one-year 85 % dividends received deduction ("DRD") for certain cash dividends received by U.S. shareholders from controlled foreign corporations ("CFCs"). The deduction will make it possible for many taxpayers to repatriate foreign earnings at a much lower tax cost than would be possible under current law. If several technical issues with the Act are resolved favorably for taxpayers, effective tax rate on dividend distributions under section 965 will be 5.25%.[1]

Not surprisingly, some limitations apply. The DRD is limited to the excess of all current year dividends from CFCs over a base period amount ("extraordinary dividend limitation") and is capped at the greater of $500 million or the amount of permanently reinvested earnings shown on the taxpayer's most recent financial statements certified on or before June 30, 2003. The new provision also restricts how such dividends can be financed ("related party indebtedness rule") and how the cash received by U.S. shareholders must be used ("domestic reinvestment plan"). It also disallows foreign tax credits and allocable expenses to the extent that they relate to the deductible portion of the dividends. The effective date is, at the taxpayer's election, either the last taxable year that begins before the date of enactment, or the first taxable year that begins during the one-year period beginning on the date of enactment.

Because the new provision can be so beneficial to so many taxpayers and because it is of limited duration, it is important to begin planning immediately. Optimizing the planning opportunities under section 965 requires an examination of some of the questions raised by the provision. This Point will identify those questions and discuss likely appropriate responses.

12 *Castle Harbour*, supra, n. 2, at 80.

13 *Black & Decker*, supra, n. 3 at 7.

14 *Coltec Industries*, supra, n. 4 at 128.

1 On Friday, November 19, 2004, a Technical Corrections Bill (the "Bill") was introduced into the House of Representatives. The Bill addresses several key issues identified in this Point. As of the date of publication, the technical corrections contained in the Bill have not been enacted into law. Nevertheless, where relevant, the impact of the Bill is noted.