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## One Prong, Two Prong, Many Prongs: A Look into the Economic Substance Doctrine

Amanda L. Yoder

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## NOTE

# One Prong, Two Prong, Many Prongs: A Look into the Economic Substance Doctrine

*Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537 (5th Cir. 2009).

AMANDA L. YODER\*

### I. INTRODUCTION

Almost every federal circuit, as well as Congress, has weighed in on the economic substance doctrine and attempted to clarify its boundaries. The economic substance doctrine deals with transactions that, although technically in accord with the Internal Revenue Code (the Code or I.R.C.), were originally structured solely for tax avoidance purposes.<sup>1</sup> The Internal Revenue Service and courts dislike these transactions because they thwart the general intent of Congress in enacting certain tax-saving Code provisions.<sup>2</sup> Until recent amendments to the I.R.C., the federal circuits were split between two different approaches to tax avoidance transactions, yet the application of the two approaches was slightly unique in each circuit.<sup>3</sup> There were many, albeit unsuccessful, attempts to codify the economic substance doctrine in the past ten years.<sup>4</sup> Although there were several proposed bills,<sup>5</sup> the language in each proffered version was largely the same – effectively the same language that

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\* B.A., University of Missouri, 2006; M.B.A., University of Missouri, 2007; J.D., University of Missouri School of Law, 2011; Note and Comment Editor, *Missouri Law Review*, 2010-11. I am grateful to Professor Michelle Arnopol Cecil for her advice and guidance throughout this process and her continued dedication as an educator. Special thanks to my family for their constant love and support during my better half of a decade in school at the University of Missouri.

1. Donald L. Korb, Chief Counsel, Internal Revenue Serv., Remarks at the University of Southern California Tax Institute: The Economic Substance Doctrine in the Current Tax Shelter Environment 6-7 (Jan 25, 2005), available at [http://www.irs.gov/pub/irs-utl/economic\\_substance\\_1\\_25\\_05.pdf](http://www.irs.gov/pub/irs-utl/economic_substance_1_25_05.pdf).

2. *In re CM Holdings, Inc.*, 301 F.3d 96, 106 (3d Cir. 2002).

3. See *infra* Part III.

4. Debra J. Bennett, *Economic Substance: Is Codification the Right Ideal*, TAXES, Feb. 1, 2010, at 7; see also H.R. 1265, 111th Cong. § 401 (2009); H.R. 2136, 110th Cong. § 401 (2007); H.R. 2625, 109th Cong. § 101 (2005); S. 1637, 108th Congress § 401 (2003) (specifically referring to § 401(n)(1) & (n)(3)).

5. Bennett, *supra* note 4, at 7; see H.R. 1265, § 401; H.R. 2136, § 401; H.R. 2625, § 101; S. 1637, § 401 (specifically § 401(n)(1) and (3)).

appears in the newly codified economic substance doctrine. The pertinent portion reads:

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE. – (1) APPLICATION OF DOCTRINE. – In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if – (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.<sup>6</sup>

These proposed bills, and now the newly codified doctrine, specify certain factors to be considered (such as profit potential)<sup>7</sup> and the requirements needed to find economic substance.<sup>8</sup>

Although there was a majority forming as to which test to use, the circuit split was creating unrest among the lower courts. At times, even knowing which test a specific circuit used was not particularly helpful in guiding a taxpayer. In addition, if a taxpayer planned incorrectly, he or she may have faced severe tax penalties.<sup>9</sup> Moreover, the different standards applied at the appellate level made it difficult for the tax and district courts to assess particular transactions because the test applied by the court changed depending on where the appeal was heard.<sup>10</sup> Thus, the economic substance issue created uncertainty for both taxpayers and courts and most recently surfaced in the U.S. Court of Appeals for the Fifth Circuit case *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*.<sup>11</sup>

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6. Heath Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029 (2010) (codified at 26 U.S.C. § 7701(o) (West 2010)).

7. The newly codified statute defines potential for profit as follows:

The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

26 U.S.C. § 7701(o)(2)(A).

8. *Id.*

9. Bennett, *supra* note 4, at 7-8.

10. *Id.* at 8.

11. 568 F.3d 537 (5th Cir. 2009) (case was heard jointly with *Kinabalu Strategic Inv. Fund ex rel. Rogue Ventures LLC v. United States*).

## II. FACTS AND HOLDING

*Klamath Strategic Investment Fund* involved two partners who “represented the State of Texas in litigation against the tobacco industry.”<sup>12</sup> The outcome of this litigation provided the two partners, Cary Patterson and Harold Nix, with a substantial increase in income – approximately thirty million dollars each.<sup>13</sup> Because of this influx of income, Nix and Patterson looked into potential investment opportunities.<sup>14</sup> Nix had previously developed an interest in investing in foreign currency transactions that were both high risk and high reward investments.<sup>15</sup> Patterson also became interested in these foreign currency transactions and sought the counsel of a highly experienced businessman, Ed Cox, who frequently dealt with these types of complex investment strategies.<sup>16</sup> “Thereafter, Nix and Patterson jointly decided to pursue . . . foreign currency” investments.<sup>17</sup> Their primary motivation in these transactions was to earn a profit.<sup>18</sup> The district court made note of Nix and Patterson’s delay in getting into these foreign investment strategies.<sup>19</sup> The court felt that if their primary motivation had been tax avoidance only, then Nix and Patterson would have begun their investments in 1999, when they recognized the first of their substantial increases in income from the tobacco litigation, instead of in 2000, when they actually began these transactions.<sup>20</sup>

After making the decision to invest, Nix and Patterson sought the help of an accounting firm.<sup>21</sup> This accounting firm held itself out as competent to provide the type of investment advice the partners required.<sup>22</sup> Nix and Patterson began to rely heavily on the accounting firm for their investment matters.<sup>23</sup> The accounting firm identified an investment advisory firm to help with Nix and Patterson’s investments.<sup>24</sup> This advisory firm, Presidio Advisory Services (Presidio), specialized in the foreign currency transactions that

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12. *Klamath*, 568 F.3d at 540. Nix and Patterson were partners in the law firm of Nix, Patterson & Roach, LLP located in Daingerfield, Texas. *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885, 888 (E.D. Tex 2007), *aff’d in part and vacated in part*, 568 F.3d 537 (5th Cir. 2009).

13. *Klamath*, 568 F.3d at 540.

14. *Id.* at 541.

15. *Klamath*, 472 F. Supp. 2d at 888-89.

16. *Id.*

17. *Id.* at 889.

18. *Id.* at 891.

19. *Id.* at 891 n.9.

20. *Id.*

21. *Id.* at 889.

22. *Id.*

23. *Id.*

24. *Id.*

Nix and Patterson wanted to pursue.<sup>25</sup> Presidio structured a transaction that would take place in three stages.<sup>26</sup> Each stage required the partners to invest a greater amount of capital than the previous stage, which subsequently increased the risk and return available to them.<sup>27</sup> The three stages were spread out over seven years.<sup>28</sup> The investors were allowed to exit at the end of stage one and every sixty days thereafter.<sup>29</sup>

To carry out this investment strategy for Nix and Patterson, Presidio formed two limited liability companies (LLCs), Klamath and Kinabalu (the Partnerships).<sup>30</sup> This move was significant because limited liability companies are not automatically taxed as corporations, but instead are allowed to choose the type of federal taxation classification that they will assume.<sup>31</sup> Presidio chose to have Klamath and Kinabalu taxed as partnerships.<sup>32</sup> Presidio then formed two single-member LLCs,<sup>33</sup> St. Croix and Rogue, which were disregarded for federal income tax purposes and instead treated as sole proprietorships.<sup>34</sup> Nix and Patterson each owned one hundred percent of his respective single-member LLC.<sup>35</sup> In turn, each single-member LLC owned ninety percent of its respective Partnership, Klamath or Kinabalu, with the remaining ten percent owned by subsidiaries of Presidio.<sup>36</sup>

In order to provide a portion of the funding needed for these investments, Nix and Patterson each contributed \$1.5 million to his respective individual Partnership.<sup>37</sup> To provide the remaining capital needed for the initial investments, Nix and Patterson entered into credit agreements with National Westminster Bank (NatWest).<sup>38</sup> NatWest loaned Patterson and Nix each

25. *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 540-41 (5th Cir. 2009).

26. *Id.* at 541.

27. *Id.*

28. *Id.*

29. *Id.* Stage one would last for sixty days. *Id.* At that time, stage two would begin and last until day 180. *Id.* Then, the remaining seven-year investment would be stage three. *Id.*

30. *Id.*

31. IRS.gov, Limited Liability Company (LLC), <http://www.irs.gov/businesses/small/article/0,,id=98277,00.html> (last visited Oct. 5, 2010).

32. *Klamath*, 568 F.3d at 541.

33. A single-member LLC is a limited liability company that is formed with one owner or member, and that owner chooses to have the entity disregarded for tax purposes. IRS.gov, Single Member Limited Liability Companies, <http://www.irs.gov/businesses/small/article/0,,id=158625,00.html> (last visited Oct. 5, 2010). Essentially, the entity is treated as a sole proprietorship for federal income tax purposes. *Id.*

34. *Klamath*, 568 F.3d at 541. Nix and Patterson were the owners of Rogue and St. Croix, respectively. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

\$66.7 million in capital.<sup>39</sup> This loan amount was comprised of \$41.7 million as the stated principal amount and \$25 million as a loan premium.<sup>40</sup> The loan premium was designated as an “exchange” for paying an above-market interest rate on the principal.<sup>41</sup> The \$25 million loan premium was required to be repaid if Nix or Patterson paid off the loan early, but if they paid over the seven-year life of the loan, they would not have to repay the loan premium.<sup>42</sup> The \$66.7 million that each partner withdrew from NatWest was contributed to their respective Partnerships, and the corresponding loan obligations were assigned to the Partnerships.<sup>43</sup> Each Partnership then made investments in short-term forward contracts on foreign currencies.<sup>44</sup>

To execute these investments, the Partnerships deposited the capital provided into accounts controlled by NatWest.<sup>45</sup> NatWest then invested in the foreign currencies on behalf of the Partnerships.<sup>46</sup> The foreign currency investments earned interest that NatWest paid to the Partnerships, and, in turn, the Partnerships paid NatWest interest on the loans assumed from Nix and Patterson.<sup>47</sup> However, the interest paid to the Partnerships on the currency investments was less than the interest payments due on the loans from NatWest.<sup>48</sup> Thus, the Partnerships realized “negative carry” costs on these investments.<sup>49</sup> Although this may have been reason enough to exit the investments, Patterson had other investments at the time that made him reconsider his dealings with Presidio.<sup>50</sup>

Prior to investing with Presidio, Patterson had invested in a local bank.<sup>51</sup> This banking investment was going to require Patterson to invest additional capital.<sup>52</sup> Due to the burden of the additional capital investments required by

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39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.* Essentially, they were paying above-average interest rates on the \$41.7 million as a substitution for paying any interest on the additional \$25 million as a “loan premium.” *Id.* If the loan was paid off early, this benefit would not have been recognized by the bank. *Id.*

43. *Id.*

44. *Id.*

45. *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885, 892 (E.D. Tex. 2007), *aff'd in part and vacated in part*, 568 F.3d 537 (5th Cir. 2009).

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* “Negative carry” costs simply mean that the partnerships were paying more in interest on the loans than they were earning from the foreign investments. *Id.*

50. *Id.* at 892-93.

51. *Id.* at 893.

52. *Id.*

the Presidio investment and the local bank obligation, Patterson opted to withdraw from his foreign currency investments.<sup>53</sup> Nix followed suit.<sup>54</sup>

From 2000 through 2002, Patterson, through Klamath's activities, claimed total losses of \$25,277,202; Nix, through Kinabalu's activities, claimed losses of \$25,272,344.<sup>55</sup> The foreign currency transactions that Nix and Patterson had entered into also caused significant losses to the Partnerships; however, a partner can claim losses only up to the partner's basis, which is the capital that he or she has invested in the partnership.<sup>56</sup> If a partnership also assumes the liabilities of the partner, the amount of the liabilities assumed is subtracted from the partner's basis.<sup>57</sup> In this case, Nix and Patterson each contributed a total of \$68.2 million to his respective Partnership; however, each Partnership also assumed the liabilities from NatWest.<sup>58</sup> In making the basis calculations, Nix and Patterson did not consider the \$25 million loan premiums as liabilities, and thus only subtracted the \$41.7 million principal amounts.<sup>59</sup> Accordingly, each claimed a basis in his respective Partnership interest of approximately \$25.3 million.<sup>60</sup> This allowed Patterson to deduct all of his \$25.2 million in losses from the foreign currency transactions.<sup>61</sup>

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53. *Id.*

54. *Id.*

55. *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 542 (5th Cir. 2009).

56. *Id.*

57. *Id.*; see also 26 U.S.C. § 752(b) (2006) (IRS' guidelines for calculation of partner basis). For example, if a partner contributes \$200,000 of capital and the partnership assumes \$100,000 of liabilities, then the partner's basis would only be \$100,000.

58. *Klamath*, 568 F.3d at 542.

59. *Id.*

60. *Id.*

Specifically, the losses occurred when Patterson received 67,341.88 Euros when Klamath liquidated. He treated these Euros as having a tax basis of \$25,316,393, calculated as:

Premium amount	25,000,000
Cash contributions	1,500,000
Interest income	91,307
Advisory fee to Pollans & Cohen	250,000
Cash distributions from Klamath	(359,635)
Klamath partnership loss	(1,165,279)

**Basis**

**25,316,393**

*Id.* at 542 n.2.

61. *Id.* at 542.

The Internal Revenue Service (the Service) disagreed with Patterson's interpretation of section 752 of the Internal Revenue Code.<sup>62</sup> The Service argued that according to I.R.C. § 752, the loan premium received by Patterson should have been included in the liabilities assumed by the Partnership.<sup>63</sup> The Service contended that the entire \$66.7 million that Patterson received from NatWest was a liability and should have been treated as such when calculating Patterson's basis in the Partnership.<sup>64</sup> The Service felt that the structure of the transactions had no economic purpose other than to avoid tax liability.<sup>65</sup> For this reason, the Service issued final partnership administrative adjustments (FPAAs) to Klamath and Kinabalu that altered Nix and Patterson's basis calculations, disallowed certain deductions taken for operational expenses, and assessed penalties to Nix and Patterson for their underpayment of income tax liabilities.<sup>66</sup>

After being issued the FPAAs, the Partnerships filed suit against the government to challenge the adjustments.<sup>67</sup> Initially, the district court denied the Government's motion for partial summary judgment on the issue of the partners' basis calculations and deemed the calculations to be proper.<sup>68</sup> However, following a bench trial, the district court held that the loan premiums were in fact liabilities and should not have been included in the partners' basis.<sup>69</sup> The district court supported this decision by finding that neither the investors nor the bank intended to remain in the loan transaction for the full seven years, thus making the reason for the loan premium moot.<sup>70</sup> However,

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62. *Id.*; see also 26 U.S.C. § 752.

63. *Klamath*, 568 F.3d at 542.

64. *Id.*

65. *Id.* "A 'tax shelter' includes, among other things, a partnership or an investment plan 'if a significant purpose of such . . . is the avoidance or evasion of Federal income tax.'" *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885, 900-01 (E.D. Tex. 2007), *aff'd in part and vacated in part*, 568 F.3d 537 (5th Cir. 2009); see also 26 U.S.C. § 6662(d)(2)(C)(iii) (2000) (defining "tax shelter" in the I.R.C.). Section 6662(d)(2)(C)(iii) has since been amended, but the discussion above applies the 2000 version of the statute. Compare 26 U.S.C. § 6662(d)(2)(C)(iii) (2000), with 26 U.S.C. § 6662(d)(2)(C)(ii) (2006).

66. *Klamath*, 568 F.3d at 542.

67. *Id.*

68. *Id.* at 542-43.

69. See *id.* at 543.

70. *Klamath*, 472 F. Supp. 2d at 896, 898. The partners stated that the reason for the structure of the loan with an above-market interest rate and the separate loan premium was to protect the bank from the increased risk at each stage of investment as well as the risk of early repayment by the partners. *Id.* at 897. However, if the partners never intended to remain in the investment until these later stages and always intended to repay the loans early, then the "premium" was never a contingency or a legitimate protection against risk in the later stages of the investment. See *id.* at 896.



the district court disagreed with the Service's decision to deny the deduction of operational expenses and assess penalties.<sup>71</sup>

The Fifth Circuit agreed with the district court and held that the loan transactions by Patterson and Nix did not have sufficient economic substance to be recognized for federal income tax purposes and thus constituted "sham transaction[s]" or "tax shelter[s]."<sup>72</sup> Thus, the Fifth Circuit decided to follow the economic substance test practiced in the majority of circuits.<sup>73</sup> All circuits determine the validity of a particular transaction for federal income tax purposes by applying a two-prong test:<sup>74</sup> (1) whether the transaction has any economic effect upon the entities or parties involved apart from tax purposes and (2) whether the transaction has any valid business purpose apart from income tax considerations.<sup>75</sup> However, a majority of circuits will consider a transaction a sham and therefore invalid for federal income tax purposes if the transaction fails only one of these prongs.<sup>76</sup> By contrast, the minority does not classify a transaction as a sham unless the transaction fails both prongs and therefore has no purpose other than tax avoidance.<sup>77</sup>

### III. LEGAL BACKGROUND

The Service has recognized that decreasing the number of abusive tax shelters is a primary concern.<sup>78</sup> Tax shelters are transactions that are structured to inappropriately avoid taxes by a number of different methods.<sup>79</sup> Over the years, the Service has established a number of "listed transactions" that help taxpayers quickly identify tax shelters and structure their transactions accordingly.<sup>80</sup> There are some transactions that violate the Code and some transactions that violate the Treasury Regulations (the Regulations).<sup>81</sup> Other transactions are not prohibited by either the Code or the Regulations.<sup>82</sup> It is these transactions that often pose the most problems for taxpayers and practitioners.

Transactions that did not run afoul of the Code or Regulations, but were nevertheless troublesome, forced the Service to use the judicial doctrine

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71. *Klamath*, 568 F.3d at 543.

72. *Id.* at 540, 544-45, 549.

73. *See infra* Part III.A.

74. *See infra* Part III.A.

75. *See infra* Part III.A.

76. *See infra* Part III.A.

77. *See infra* Part III.B.

78. Korb, *supra* note 1, at 1, 16 (the speech, given in 2005, noted that a resurgence of tax shelter activity had been occurring in the past ten years and, thus, that the Service must "identify and challenge" abusive tax shelters).

79. *Id.* at 1.

80. *Id.* at 2.

81. *Id.* at 3.

82. *Id.*

known as the economic substance doctrine,<sup>83</sup> which has now been codified.<sup>84</sup> This doctrine assists in the interpretation of statutory language and is not meant to contradict congressional intent regarding particular sections of the Code.<sup>85</sup> Essentially, the Service is concerned about those transactions that satisfy the literal language of the Code but are contrary to congressional intent.<sup>86</sup> One law professor stated that the economic substance test is of crucial importance to the tax system because it keeps both the Service and practitioners in line with the goals and purposes of the Code.<sup>87</sup>

As the Supreme Court explained, “taxpayers have the right to decrease or avoid taxes by legally permissible means.”<sup>88</sup> In *Frank Lyon Co. v. United States*, the Supreme Court noted that where

there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.<sup>89</sup>

Unquestionably, a taxpayer may not reap tax benefits from a transaction that is wholly lacking in economic substance,<sup>90</sup> but the appropriate test for determining economic substance is unsettled among the circuits.

All circuits abide by a “two-prong” approach when examining whether transactions should be upheld for federal income tax purposes.<sup>91</sup> The first prong looks at whether a transaction has some rational, nontax business purpose “in light of the taxpayer’s conduct and economic situation.”<sup>92</sup> This prong is a subjective test that looks to the intent of the taxpayer when struc-

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83. *Id.* at 3-4. A transaction can be a “factual sham” if it has been recorded as occurring but has not actually occurred. *Id.* at 4. These are not the transactions discussed in this Note. See *supra* Part II. While factual shams were once a very significant problem for the Service, the more pressing issue discussed in this Note is the problem of determining the tax consequences of transactions that have *actually* occurred. See *infra* Parts IV-V.

84. 26 U.S.C. § 7701(o) (West 2010).

85. Korb, *supra* note 1, at 6-7.

86. *Id.* at 5.

87. *Id.* at 5-6.

88. *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 543 (5th Cir. 2009) (citing *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)).

89. 435 U.S. 561, 583-84 (1978).

90. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006).

91. See *infra* Part III.A-B.

92. Korb, *supra* note 1, at 7.

turing and entering into the transaction.<sup>93</sup> The second prong analyzes whether the transaction has some meaningful enhancement or effects on the taxpayer's economic position other than to reduce taxes.<sup>94</sup> The second prong is an objective test that examines the economic changes that arise from the transaction.<sup>95</sup>

There are several ways that this test can be interpreted. One approach would be to look at both prongs as a general tax shelter test or "factor" approach, such that they are both factors to consider in determining whether the *overall* transaction has practical economic substance but both factors are not required.<sup>96</sup> However, the alternative view would be to apply the test in a rigid two-prong fashion and *require* a transaction to have both factors to be considered a legitimate transaction for income tax purposes.<sup>97</sup> Even among those circuits that use this test in a "rigid" two-prong fashion there is disagreement. Some circuits apply this test "disjunctively: a transaction will have economic substance [and thus be considered legitimate] if the taxpayer had either a nontax business purpose *or* the transaction had objective economic substance[,]" which is essentially a two-prong "either/or" approach (disjunctive two-prong).<sup>98</sup> Other circuits apply this test in a harsher conjunctive fashion by requiring a transaction to have both a business purpose *and* economic substance to be found legitimate; this is a two-prong "both" approach (conjunctive two-prong).<sup>99</sup>

The distinctions among these different tests are infinitesimal, yet of significant importance. There would, in theory, seem to be three ways to approach this two-prong test to economic substance; however, as applied by the courts, there are only two approaches.

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93. *Id.* This "subjective" view looks at whether the taxpayer could have made a profit or had some valid business reason for the transaction. *Id.* at 9. These factors may include (1) "whether a profit was even possible;" (2) "whether the taxpayer had a nontax business reason to engage in the transaction;" (3) whether the transaction was adequately investigated; (4) whether the entities were separate from the taxpayer; (5) whether the transaction was at arms-length; and (6) the marketing of the transaction in question. *Id.* at 9-10.

94. *Id.* at 7.

95. *Id.*

96. *Id.* at 8. This test relies on neither prong individually but looks more at the *totality of the circumstances*. *Id.*

97. *Id.*

98. *Id.* (emphasis added).

99. *Id.*

### A. Majority Approach

The first approach to the economic substance test is a combination of the “factor” approach and the conjunctive two-prong approach. This method is used by the majority of the circuits. While in theory the approaches taken by these circuits can be articulated as separate approaches to the economic substance test, in practice they are almost indistinguishable.

The U.S. Court of Appeals for the Federal Circuit follows a combination of the conjunctive two-prong test and the “factor” approach. For example, in *Coltec Industries, Inc. v. United States*, the court felt that the pertinent factor in determining the economic substance of a transaction is the objective view of how the transaction is structured.<sup>100</sup> The court acknowledged that subjective motivation was pertinent to the tax avoidance purpose, but found that the objective reality of the economic substance of a transaction is the key factor in determining whether to recognize a transaction for federal income tax purposes.<sup>101</sup>

Similarly, in *Schell v. United States*, the Federal Circuit reached a decision based solely upon the objective economic substance of a particular transaction, and not on the subjective motives of the taxpayers.<sup>102</sup> Therefore, in the Federal Circuit, transactions are required to have an economic effect on the taxpayer’s financial situation, and, if an economic effect is found, then a valid business purpose *may* also be considered in determining whether the transaction is a “sham.”<sup>103</sup>

In *Nicole Rose Corp. v. Commissioner*, the Second Circuit defined a “sham” transaction as one that is “‘fictitious or . . . has no business purpose or economic effect other than the creation of tax deductions.’”<sup>104</sup> The court did not discuss the issue of business purpose; however, by finding that the transaction in question had no economic substance and would not be recognized

100. 454 F.3d 1340, 1356 (Fed. Cir. 2006).

101. *Id.* at 1356. The court must analyze the specific transaction that gave rise to the tax benefit and not other subsequent or related transactions. *Id.* at 1357.

102. *See* 589 F.3d 1378, 1382-83 (Fed. Cir. 2009).

103. *See id.*

104. 320 F.3d 282, 284 (2d Cir. 2003) (quoting *DeMartino v. Comm’r*, 862 F.2d 400, 406 (2d Cir. 1988)). This case involved several complicated transactions where computer equipment was sold between foreign corporations, leased back to the selling company, and then payment on these leases was assigned to yet another company. *Id.* at 283. The Director of Nicole Rose Corp. assisted in renegotiations between the companies for the payments on the leases. *Id.* This renegotiation at first included a reduction in payment and the continued leasing of the equipment. *Id.* Subsequently, a restructuring resulted in the assignment of the payments on the leases to Nicole Rose. *Id.* Nicole Rose’s interest in these payments was then immediately “transferred,” leaving the company with a substantial tax loss. *Id.* at 283-84.

for tax purposes,<sup>105</sup> this holding provides an inference that the Second Circuit will find that a transaction has no economic substance based solely on the failure of one prong. Like the Federal Circuit, the Second Circuit essentially looked at the two factors as an overall consideration of the particular transaction, focusing first on the economic effect of the transaction and then analyzing the business purpose if necessary.<sup>106</sup>

The Sixth Circuit abides by a similar combination of the factor approach and the conjunctive two-prong test.<sup>107</sup> Although in a recent case the court never reached the second prong, the Sixth Circuit noted that if economic substance were found, then the subjective inquiry into a business motive might be made.<sup>108</sup> What is slightly different about the Sixth Circuit's test, as compared to the tests adopted by the Third and Fourth Circuits, discussed below, is that the Sixth Circuit determines whether the transaction is a sham based solely on the economic substance of the transaction.<sup>109</sup> Then, if the transaction has economic substance, the court may look into the business purpose for making other determinations regarding tax liability.<sup>110</sup> Therefore, although the court appears to be taking a two-prong approach, in reality it is basing its decision solely on economic substance.<sup>111</sup> Accordingly, the Sixth Circuit may take a two-step approach, but will deem a transaction a sham based on only one prong of the test if necessary.

Like the Sixth Circuit, the Ninth Circuit also applies the two-prong test, but, while the Sixth Circuit focuses more heavily on the economic effect of a transaction,<sup>112</sup> the Ninth Circuit follows a more balanced approach and examines both factors.<sup>113</sup> The Ninth Circuit looks at the objective economic substance of the transaction, together with the subjective business motives of the taxpayer aside from tax avoidance.<sup>114</sup> The wording used by the Ninth Circuit indicates that a transaction will be labeled a sham if it fails either prong of the test. This more closely follows the conjunctive two-prong ap-

105. *Id.* at 284.

106. Korb, *supra* note 1, at 8.

107. *See, e.g.*, Dow Chem. Co. v. United States, 435 F.3d 594 (6th Cir. 2006).

108. *Id.* at 599.

109. *Rose v. Comm'r*, 868 F.2d 851, 853 (6th Cir. 1989).

110. *Id.* Essentially, this means that if a transaction has no economic substance, the court will automatically consider the transaction a sham for federal income tax purposes. If the transaction has economic substance, the transaction will likely be deemed valid for federal income tax purposes, but depending on the business purpose, it may still run into trouble with other sections of the Internal Revenue Code.

111. *Id.*

112. *See supra* notes 107-11 and accompanying text.

113. *Robertson v. Comm'r*, 5 F. App'x 702, 704 (9th Cir. 2001).

114. *Id.* The Ninth Circuit further defines economic substance as "a reasonable opportunity for profit in addition to the . . . tax avoidance" opportunities. *Id.*

proach that requires the transaction to meet *both* the subjective and objective measures, rather than the general tax shelter method.<sup>115</sup>

The Tenth Circuit has also followed a fairly strict conjunctive two-prong approach to the economic substance test that allows a transaction to be invalidated for federal income tax purposes if it fails either of the prongs.<sup>116</sup> The Eleventh Circuit has somewhat danced around the issue of subjective intent in determining a sham transaction;<sup>117</sup> however, the case that has binding precedent in the Eleventh Circuit states that the two-prong test of subjective business purpose along with objective economic substance should be used to evaluate the validity of a particular transaction for federal income tax purposes.<sup>118</sup> Consequently, only one prong need be disproved for the transaction to be considered a sham.<sup>119</sup>

Because under the majority approach the failure to meet only one of the prongs will render the transaction a sham, more transactions will be found to be sham transactions that are invalidated for federal income tax purposes. In following this harsher approach, the courts that form the majority have focused on the language of the United States Supreme Court in *Frank Lyon Co. v. United States*, which states that a transaction is legitimate when it has “economic substance which is compelled or encouraged by business or regulatory realities, [and] is imbued with tax-independent considerations.”<sup>120</sup> However, these courts have failed to give the same consideration to the latter part of this statement by the Court, which emphasizes that a transaction should not be “shaped solely by tax-avoidance features that have meaningless labels attached.”<sup>121</sup> The minority view focuses on this latter part of the Court’s assertion.

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115. See *supra* note 99 and accompanying text.

116. *Keeler v. Comm’r*, 243 F.3d 1212, 1217 (10th Cir. 2001).

117. See *Winn-Dixie Stores, Inc. v. Comm’r*, 254 F.3d 1313, 1316 (11th Cir. 2001) (stating only that a transaction must have more than tax avoidance purposes to be recognized as valid for federal income tax purposes); *United Parcel Serv. of Am., Inc. v. Comm’r*, 254 F.3d 1014, 1018 (11th Cir. 2001) (stating that even if a transaction has economic substance, it will be considered a sham transaction if it lacks a business purpose); *Kirchman v. Comm’r*, 862 F.2d 1486, 1492 (11th Cir. 1989) (stating only that a valid transaction must have “economic effects other than the creation of tax benefits”).

118. *Karr v. Comm’r*, 924 F.2d 1018, 1023 (11th Cir. 1991).

119. See *id.*

120. 435 U.S. 561, 583-84 (1978).

121. *Id.* at 584.

### B. Minority Approach

The test used by a minority of circuits is the disjunctive two-prong test. These circuits place considerable weight on the language of the Supreme Court that an economic sham is one that is “shaped solely by tax-avoidance features that have meaningless labels attached.”<sup>122</sup> These courts believe that the Supreme Court merely requires that the transaction have some legitimate purpose and structure, whether it be an economic or a business purpose.

In *In re CM Holdings, Inc.*, the Third Circuit clearly stated that two aspects should be explored in identifying a sham transaction for federal income tax purposes.<sup>123</sup> The court deemed these two prongs an “objective economic substance” test and a “subjective business motivation” test, and stated that they are not “discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.”<sup>124</sup> In fact, in another case, the Third Circuit went even further and stated that the test does not require both prongs to be met for a transaction to be considered legitimate, but the transaction only need satisfy one of the factors.<sup>125</sup> In *ACM Partnership v. Commissioner*, the Third Circuit stated:

While it is clear that a transaction . . . that has neither objective non-tax economic effects nor subjective non-tax purposes constitutes an economic sham whose tax consequences must be disregarded, and equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes constitutes an economically substantive transaction whose tax consequences must be respected, it is also well established that where a transaction objectively affects the taxpayer’s net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations.<sup>126</sup>

The Third Circuit went on to note that, in conjunction with the subjective portion of the economic substance doctrine, the nontax avoidance motive should be one that was intended by Congress.<sup>127</sup>

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122. *Id.*

123. 301 F.3d 96, 102 (3d Cir. 2002).

124. *Id.* (quoting *ACM P’ship v. Comm’r*, 157 F.3d 231, 247 (3d Cir. 1998)).

125. *ACM P’ship*, 157 F.3d at 247.

126. *Id.* at 248 n.31 (citing *Gregory v. Helvering*, 293 U.S. 465, 468-69 (1935)).

127. *CM Holdings, Inc.*, 301 F.3d at 106.

If Congress intends to encourage an activity, and to use taxpayers’ desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible. But to engage in an activity solely for the purpose of

Similarly, the Fourth Circuit stated in *Rice's Toyota World, Inc. v. Commissioner* that a proper reading of *Frank Lyon* suggested that “a two-pronged inquiry [is required] to determine whether a transaction is, for tax purposes, a sham.”<sup>128</sup> According to the court, this test required the taxpayer to show that he or she was motivated by a business purpose other than tax avoidance and that the transaction had economic substance beyond tax benefits.<sup>129</sup> Essentially, the Fourth Circuit concluded that when a transaction had *no use other than tax avoidance*, it should be considered a sham transaction – basically applying the disjunctive two-prong test.<sup>130</sup> In a later case, the Fourth Circuit laid out a test similar to that of the Third Circuit.<sup>131</sup> The court reiterated that this is a two-prong test that looks at the subjective business purpose behind the transaction as well as the objective economic substance, such that as long as a transaction satisfies one prong the transaction will be deemed legitimate.<sup>132</sup>

The District of Columbia Circuit has also followed the disjunctive two-prong test.<sup>133</sup> The D.C. Circuit stated that, to deem a transaction a sham and thus to invalidate an otherwise legitimate transaction, a court must find that the transaction lacks both economic substance and business purpose.<sup>134</sup> Essentially, the court looks for some reason for the transaction *other than* tax avoidance.<sup>135</sup> When some other reason exists, such as economic substance *or* business purpose, then the transaction will not be deemed a sham.<sup>136</sup> In fact, this circuit quoted a Fourth Circuit case noting that “[t]o *treat a transaction as a sham*, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no reasonable possibility of profit exists.”<sup>137</sup>

In a more recent case, the D.C. Circuit applied this test to several partnerships that were formed in favorable foreign tax jurisdictions.<sup>138</sup> After the partnerships were formed there were a series of transactions that allowed the

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avoiding taxes where that is not the statute’s goal is to conduct an economic sham.

*Id.*

128. 752 F.2d 89, 91-92 (4th Cir. 1985).

129. *Id.* at 91.

130. *Id.* at 92.

131. *Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006).

132. *Id.*

133. *Horn v. Comm’r*, 968 F.2d 1229, 1237 (D.C. Cir. 1992).

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* (emphasis added) (quoting *Friedman v. Comm’r*, 869 F.2d 785, 792 (4th Cir. 1989)).

138. *Boca Investorings P’ship v. United States*, 314 F.3d 625, 627 (D.C. Cir. 2003).



partnerships in the foreign jurisdictions to register large gains and allowed the U.S. corporation to register large losses without actually realizing the losses.<sup>139</sup> The D.C. Circuit determined that the correct law to apply to the transaction was the “business purpose doctrine.”<sup>140</sup> This doctrine specifies that although a taxpayer may structure a business to minimize the tax burden, the transaction must have a legitimate business purpose other than tax avoidance.<sup>141</sup>

As the cases discussed above demonstrate, both the conjunctive and the disjunctive two-prong approaches find support from the Supreme Court’s language. Thus, the resolution of this split among the circuits centers primarily on a determination of which circuits have focused on the correct portion of the Supreme Court’s language in applying the economic substance test.

### C. Economic Substance Codification

Piggybacking on the new health care bill, the economic substance doctrine is now codified in I.R.C. § 7701(o).<sup>142</sup> The language of the new statute requires a conjunctive two-prong approach like that of the majority.<sup>143</sup> This approach requires that a transaction have both a meaningful change in the taxpayer’s economic position other than tax avoidance and a substantial purpose other than tax avoidance.<sup>144</sup> Although at face value this seems exactly like the majority position discussed above,<sup>145</sup> there are significant penalties and other requirements included that make this codification different.<sup>146</sup> In conjunction with the amendment to I.R.C. § 7701(o), I.R.C. § 6662 has also been amended to add certain penalties for the violation of section 7701.<sup>147</sup> If a taxpayer violates the economic substance doctrine, he or she may face a twenty percent underpayment penalty or potentially a forty percent underpayment penalty if the position the taxpayer took when filing his or her tax

139. *Id.*

140. *Id.* at 630.

141. *Id.* at 631.

142. 26 U.S.C. § 7701(o) (West 2010) (also known as I.R.C. § 7701(o)).

143. *Id.* § 7701(o)(1); *see also supra* Part III.A.

144. 26 U.S.C. § 7701(o). The statutory requirements apply only to transactions entered into for profit or in connection with a trade or business. I.R.S. Notice 2010-62, 2010-40 I.R.B. 411. Additionally, the term “transaction,” as defined by the statute, includes a series of transactions. *Id.*

145. *See supra* Part III.A.

146. Jeremiah Coder, *Will Economic Substance Codification be Worth It?*, 127 TAX NOTES 16 (2010).

147. *Id.*; *see also* Heath Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029 (2010) (codified at 26 U.S.C. § 6662(b)(6)); 26 U.S.C. § 6662(b)(6).

return was not previously disclosed.<sup>148</sup> Also, I.R.C. § 6664(c)(2) and (d)(2) were added to eliminate the reasonable cause exception that allowed the taxpayer to avoid the assessment of penalties if he or she had acted on reasonable cause and in good faith in a transaction.<sup>149</sup> Whereas before, the economic substance doctrine was based largely on determinations of facts and circumstances, the new statutory language is much more rigid and applies a strict liability for the taxpayer if he assesses a transaction incorrectly.<sup>150</sup>

Exactly how this new doctrine will play out will depend on the Service's guidance.<sup>151</sup> Even so, some of the potential effects of this codification can be seen in the recent Fifth Circuit case *Klamath Strategic Investment Fund ex rel. St. Croix Ventures v. United States*.<sup>152</sup>

#### IV. THE INSTANT DECISION

The issue in *Klamath* was whether the loan transactions entered into by Nix and Patterson were in fact valid transactions recognizable for federal income tax purposes.<sup>153</sup> Although many circuits have laid out the specific test that they use for finding economic substance, the Fifth Circuit had not yet decided the issue. In *Klamath*, the Fifth Circuit finally had the opportunity to determine its test for economic substance.<sup>154</sup>

The court first discussed the fact that the doctrine generally prevents taxpayers from structuring transactions purely for tax purposes.<sup>155</sup> The Fifth Circuit noted that although the Supreme Court has recognized the taxpayer's ability to avoid taxes by legal means,<sup>156</sup> these means must change the flow of economic benefits to be considered legitimate for tax purposes.<sup>157</sup> The Supreme Court articulated the flow of economic benefits as "compelled or encouraged by business or regulatory realities . . . imbued with tax-independent considerations, and . . . not shaped solely by tax-avoidance features that have

148. Coder, *supra* note 146, at 16; *see also* Heath Care and Education Reconciliation Act of 2010 § 1409; 26 U.S.C. § 6662(b)(6), (i).

149. Coder, *supra* note 146, at 16; *see also* Heath Care and Education Reconciliation Act of 2010 § 1409; 26 U.S.C. § 6664; 26 C.F.R. § 1.6664-4 (2010).

150. Coder, *supra* note 146, at 16. For example, the new code section specifies that using the potential for profit to meet the requirements of § 7701(o)(1) requires a showing that "the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the claimed net tax benefits." I.R.S. Notice 2010-62, 2010-40 I.R.B. 411.

151. Coder, *supra* note 146, at 16.

152. 568 F.3d 537 (5th Cir. 2009); *see also infra* Part IV.

153. *Klamath*, 568 F.3d at 543.

154. *Id.*

155. *Id.*

156. *Id.* (citing *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)).

157. *Id.* (citing *Higgins v. Smith*, 308 U.S. 473, 476 (1940)).

meaningless labels attached.”<sup>158</sup> However, in determining whether a particular transaction is lacking economic substance, the Fifth Circuit recognized that the law is somewhat unsettled within the Fifth Circuit, as well as other circuits.<sup>159</sup>

In *Klamath*, the Fifth Circuit deemed the majority view among the circuits the proper interpretation of the economic substance doctrine.<sup>160</sup> The majority view states that a lack of economic substance alone is sufficient to negate a transaction, despite other considerations and reasons for structuring a transaction in a particular way.<sup>161</sup> The Fifth Circuit reasoned that the Supreme Court had essentially set up a multi-factor test to determine whether a transaction is legitimately structured.<sup>162</sup> According to the court, if any factor is lacking, then the transaction as a whole fails the economic substance test.<sup>163</sup> The court ruled that this is true “even if the taxpayer[] profess[es some other] genuine business purpose without [a] tax-avoidance motivation[.]”<sup>164</sup> In reaching its decision, the Fifth Circuit fell in line with the majority of circuits in focusing on the language of the Supreme Court that lists both economic realities and business purpose as factors to look at in a questionable business transaction.<sup>165</sup>

Originally, the district court deemed Nix and Patterson’s transactions to lack economic substance based on several factors.<sup>166</sup> First, the partners claimed that the structure of the loans was designed to protect NatWest from the future risk inherent in the latter stages of the foreign currency transactions.<sup>167</sup> However, the district court found that neither the investors nor the bank ever intended to reach the latter stages of this investment strategy.<sup>168</sup> The high-risk transactions would not occur until stage three in the investment strategy, at which time the protective structure of the loans would be re-

158. *Id.* (quoting *Frank Lyon, Co. v. United States*, 435 U.S. 561, 583-84 (1978)).

159. *Id.* at 544.

160. *Id.*; see, e.g., *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1355 (Fed. Cir. 2006); *United Parcel Serv. of Am., Inc. v. Comm’r*, 254 F.3d 1014, 1018 (11th Cir. 2001); *ACM P’ship v. Comm’r*, 157 F.3d 231, 247 (3d Cir. 1998); *James v. Comm’r*, 899 F.2d 905, 908-09 (10th Cir. 1990).

161. *Klamath*, 568 F.3d at 544.

162. *Id.* These factors include “whether the transaction (1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax-avoidance features.” *Id.* (citing *Frank Lyon*, 435 U.S. at 583-84).

163. *Id.*

164. *Id.*

165. See *supra* Parts II, III.A.

166. *Klamath*, 568 F.3d at 546. The Fifth Circuit decided the elements of this case based upon the economic substance doctrine and not by the classification of liabilities under 26 U.S.C. § 752. *Id.*

167. *Id.* at 544-45.

168. *Id.* at 545.

quired.<sup>169</sup> On appeal, the Fifth Circuit examined numerous bank documents that further supported the conclusion that neither of the investors intended to keep the loans outstanding past the seventy-day mark, and that if the investors chose to continue the investments, NatWest would force the investors out.<sup>170</sup> The court felt that the lack of intention to remain in the loans as shown by these documents clearly indicated that the loans were merely a sham.<sup>171</sup>

Second, the district court felt that the claimed profit motives were not relevant to the loan transactions.<sup>172</sup> The district court stated that taxpayers could not combine multiple transactions to find “profit motive,” but instead must look at specific transactions.<sup>173</sup> In this case, the district court felt that the low-risk investments that were actually made came from the \$1.5 million capital invested by the partners’ personal funds.<sup>174</sup> Therefore, although the partners may have been seeking a profit through investments, this was not a proper consideration in looking at the structure of the loans from NatWest.<sup>175</sup> The Fifth Circuit agreed with the district court that these transactions lacked economic substance, that the profit motive for related transactions was not relevant, and that the transactions would be disregarded for tax purposes.<sup>176</sup>

The economic substance of these transactions, or lack thereof, was the pivotal issue in *Klamath*. However, after determining that the loan transactions were tax shelters, there were several related issues that the court had to consider.<sup>177</sup> The first issue was the imposition of penalties for the partners’ underpayment of tax liabilities.<sup>178</sup> The government contested the jurisdiction of the district court to determine whether penalties were appropriate and also challenged the finding that penalties could not be assessed.<sup>179</sup> The Fifth Cir-

169. *Id.* The \$25 million loan premium and above-market interest rate were originally part of the loan as a protection for NatWest in loaning to Nix and Patterson in their high-risk investment. *Id.* at 541.

170. *Id.* at 544-45.

171. *Id.* at 545.

172. *Id.* at 544.

173. *Id.* at 545.

174. *Id.*

175. *Id.* If the investments had reached the final stages where the funds from the loan would be required, the Fifth Circuit may have viewed these transactions differently.

176. *Id.*

177. *Id.* at 545-46.

178. *Id.*

179. *Id.* at 546-47. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TERFA), a court in which a petition is filed has the jurisdiction to make all determinations of partnership items for a particular taxable year, including any applicable penalties. *Id.* at 547. The Fifth Circuit ruled that the district court had the jurisdiction to assess penalties and deemed that “[n]o penalty shall be imposed under section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.” *Id.* (quoting 26 U.S.C. § 6664(c)(1) (2006)). However, the

cuit held that the partners relied on valid sources for advice in structuring and reporting these transactions and, therefore, penalties should not be assessed in this case.<sup>180</sup>

The second of these derivative issues was the deduction of operational expenses taken out on these loan transactions.<sup>181</sup> The court determined that both Nix and Patterson had profit-seeking motives, which allowed them to deduct the operational expenses tied to these investment strategies.<sup>182</sup> The final secondary issue addressed was the collateral estoppel concern raised by the government.<sup>183</sup> The government had several pending matters against Presidio, the investment firm involved in this case.<sup>184</sup> The court held that the issues determined in this case (the economic substance doctrine) would have no collateral estoppel effect on other pending litigation against Presidio.<sup>185</sup> Ultimately, while the court supported the government's arguments that the loan transactions lacked economic substance, the court did not support the

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appellate court also determined that the district court did not have the jurisdiction to order the Service to issue a refund. *Id.* at 552. Instead, the Fifth Circuit required the partners to seek a refund through administrative proceedings pursuant to 26 U.S.C. § 7422. *Id.* This is one area where the new statutory provisions will most significantly alter the economic substance doctrine. In this case, the court found that the partners were not liable for penalties because they had reasonable cause and good faith to have structured the transactions in this manner. *Id.* at 548. However, in light of the new statutory provisions, the partners would have been liable for penalties between twenty to forty percent of the tax liability underpayment. *See supra* Part III.C.

180. *Klamath*, 568 F.3d at 548. The appellate court determines this based upon the “‘quality and objectivity of the professional advice which they obtained.’” *Id.* (quoting *Swayze v. United States*, 785 F.2d 715, 719 (9th Cir. 1986)). The appellate court looked into the sources of the partners' due diligence in this case and deemed the sources legitimate. *Id.*

181. *Id.* at 545-46. Generally, deductions for operational expenses are not allowed on transactions that have been disregarded for federal income tax purposes. *Id.* at 549. However, after extensive discussion, the appellate court determined that the proper test was to determine the profit-seeking motives of the investors and to allow the deduction of expenses according to this motive. *Id.* at 550.

182. *Id.*; *see supra* note 181 and accompanying text.

183. *Klamath*, 568 F.3d at 546.

184. *Id.* The government argued that even though it was the prevailing party, this ruling might have adverse effects on subsequent litigation against the accounting firm Presidio. *Id.* A party that claims collateral estoppel only has standing where it can show that “the ultimate judgment in [a] case was ‘dependent’ on the earlier adverse ruling.” *Id.* (citing *In re DES Litig.*, 7 F.3d 20, 23 (2d Cir. 1993)). Here, there was no adverse ruling against the government except in the minor issues of penalty assessment and operating expense deduction. *Id.* In fact, the government feared any collateral estoppel on the determination of these loans as a liability under 26 U.S.C. § 752. *Id.* However, the issue of whether these loans qualified as liabilities was not determined by this court and thus would not be an issue of collateral estoppel. *Id.*

185. *Id.*

government's claims for denying deductions on related business expenses or its claim for underpayment of tax liability penalties.<sup>186</sup>

## V. COMMENT

The Eighth Circuit has already addressed the economic substance doctrine and has chosen to follow the majority of circuits in *IES Industries, Inc. v. United States*.<sup>187</sup> The *IES Industries* opinion provides significant insight as to why the majority's test has been so highly ambiguous. The Eighth Circuit cited the Fourth Circuit's decision in *Rice's Toyota World* as persuasive authority in determining how to assess a transaction's validity for federal income tax purposes.<sup>188</sup> The Eighth Circuit purported to use the disjunctive two-prong test set out in *Rice's Toyota World* but suggested, as it did in *Shriver v. Commissioner*,<sup>189</sup> that a transaction is a sham if it fails either prong.<sup>190</sup> The *Shriver* case laid out why the Eighth Circuit acknowledged the disjunctive two-prong approach in *Rice's Toyota World* but then read the language of *Frank Lyon* differently than the Fourth Circuit.<sup>191</sup> The Eighth Circuit explained that the Fourth Circuit's test is certainly supported by the Supreme Court's language of *Frank Lyon*, but is not *required* by that decision.<sup>192</sup> What is contradictory about the language of the Fourth Circuit's test is the emphasis on the rigidity of the Fourth Circuit's application of the disjunctive two-prong test. As many courts have done, the Eighth Circuit found that by looking at both prongs of the economic substance test in the disjunctive, either/or context, the Fourth Circuit's test is in fact the *more* rigid of the two approaches.<sup>193</sup> The courts feel this is the more rigid approach because it requires two factors to be considered, whereas the conjunctive two-prong test only looks to one factor.<sup>194</sup>

However, the context of the transaction being assessed in *Frank Lyon* suggests that the majority's conjunctive two-prong test is actually the more rigid approach. In *Frank Lyon Co. v. United States*, the taxpayer, Frank Lyon Co. (Lyon), was involved in a sale-leaseback transaction.<sup>195</sup> Lyon agreed to purchase a building from Worthen Bank and Trust Company.<sup>196</sup> Worthen

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186. *Id.* at 553.

187. 253 F.3d 350, 353-54 (8th Cir. 2001).

188. *Id.* (citing *Rice's Toyota World v. Comm'r*, 752 F.2d 89, 91-92 (4th Cir. 1985)).

189. 899 F.2d 724, 725-26 (8th Cir. 1990).

190. *IES Indus., Inc.*, 253 F.3d at 353-54.

191. *Shriver*, 899 F.2d at 727.

192. *Id.*

193. See *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 538, 544 (5th Cir. 2009).

194. See *Shriver*, 899 F.2d at 727.

195. 435 U.S. 561, 565 (1978).

196. *Id.* at 566.

planned to finance and build a new bank across the street from its local competition.<sup>197</sup> Unfortunately for Worthen, because of the planned financing for the transaction and Worthen's current capital structure, the Federal Reserve required it to restructure its financing in order to move forward with the construction of the building.<sup>198</sup> Lyon came in during the restructuring process. Lyon agreed to buy the building from Worthen and then allow Worthen to lease the building from it for a specified number of years with options to purchase at set time periods.<sup>199</sup> Upon an audit of Lyon's tax return, the Service claimed that there was no legitimate purpose for the transaction and it should be classified as a sham for federal income tax purposes.<sup>200</sup>

After analyzing the facts of *Frank Lyon*, the Supreme Court made its famous statement on economic substance:

[W]e hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.<sup>201</sup>

Essentially, the Supreme Court looked at the transaction as a whole; analyzed different economic, business, and regulatory factors; and determined that, because *some* of these factors were present, the transaction should be respected for income tax purposes.<sup>202</sup>

The Supreme Court also emphasized that the "question for determination" was whether congressional intent in enacting a particular code section is taken into consideration when the transaction is structured.<sup>203</sup> For example, if a transaction follows the literal language of the Code but does not further the purpose behind the Code, then that transaction is not valid for federal income tax purposes. In fact, as seen in *Frank Lyon*,<sup>204</sup> if the transaction was not upheld for federal income tax purposes it would frustrate the purpose of some

197. *Id.* at 563.

198. *Id.* at 564. This was due to regulations placed on banks to keep them sound for depositors. *Id.*

199. *Id.* at 564-65.

200. *Id.* at 568.

201. *Id.* at 583-84.

202. *Id.* at 582-84.

203. *See* *Knetsch v. United States*, 364 U.S. 361, 365 (1960) (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)).

204. *See* *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

Code sections and regulatory provisions. If the leaseback of the bank building were not allowed for federal income tax purposes, then the taxpayers would be saddled with regulatory burdens to structure the transaction in a particular way but then not enjoy the benefits of certain Code sections specifically enumerated for such circumstances.<sup>205</sup> Therefore, in finding congruence with congressional intent, there may not always be both an economic effect and a business purpose behind any particular transaction.

Although the economic substance doctrine has recently been codified, it was done on the coattails of critical healthcare legislation that was almost certain to pass regardless of the inclusion of menial provisions such as the economic substance doctrine.<sup>206</sup> Congress repeatedly rejected the current statutory language of the economic substance doctrine in previous years.<sup>207</sup> The proposals were criticized by government officials and commentators.<sup>208</sup> Many felt that clarifying this doctrine by codification would create an even more rigid approach to the economic substance doctrine.<sup>209</sup> It appears that there may be some truth to this.

In the new statutory language, there are now even stricter guidelines for the conjunctive two-prong test.<sup>210</sup> Although some courts have required this conjunctive two-prong test for a number of years,<sup>211</sup> the new statutory language increases the barrier to meeting these requirements by adding language such as “in a meaningful way” and “substantial purpose” when determining whether a particular transaction has an economic effect and a business purpose.<sup>212</sup> Additionally, the definition of profit potential under the prior judicial doctrine of economic substance was a reasonable expectation of “more than an insignificant pretax profit.”<sup>213</sup> However, now taxpayers will be required to

205. In this case, the taxpayer, Frank Lyon Co., was at risk of losing certain legitimate business deductions for the transaction with Worthen because the Service felt that it was a sham. *Id.* at 573, 580-81.

206. *See supra* Part III.C; *see also* 26 U.S.C. § 7701(o) (West 2010) (codification of the economic substance doctrine); Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010); H.R. 3590, 111th Cong., (2d Sess. 2010) (new healthcare legislation).

207. *See supra* Part I.

208. *Legislative Proposals to Codify the Economic Substance Doctrine*, 508 TAX MGMT. (BNA) U.S. INCOME § VIII, at 2 (2008).

209. *Id.*

210. *See* 26 U.S.C. § 7701(o). The new statutorily defined conjunctive two-prong test includes stricter guidelines than those of the older, judicially defined conjunctive two-prong test.

211. *See supra* Part III.A.

212. 26 U.S.C. § 7701(o)(1)(A)-(B). The new statutory provisions heighten the standard that taxpayers have to meet before their transaction can be considered valid for federal income tax purposes.

213. *See* Coder, *supra* note 146, at 18; *see also* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 172 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d



show that the profits will be substantial in comparison to the tax benefits received from the transaction.<sup>214</sup> Congress has taken the conjunctive two-prong test of the judicial economic substance doctrine and made it even more difficult to satisfy. As the Supreme Court's landmark case *Frank Lyon* demonstrates, this doctrine depends largely on the facts and circumstances of any given case.<sup>215</sup> However, the heightened burden now required by the statutory language will eliminate many valid transactions because they cannot meet this strict review.

Not only has the recent codification implemented stricter language, but also the strict language is somewhat ambiguous.<sup>216</sup> Whereas previously the ambiguities in the doctrine likely kept taxpayers from abusing the economic substance doctrine, these ambiguities may now inhibit taxpayers from entering into legitimate transactions for fear of the penalties that they may incur if they structure a transaction, even inadvertently, in a way that does not meet this new economic substance doctrine. For example, how is a taxpayer to define "meaningful way" and "substantial purpose" when approaching a particular transaction? Is he or she to engage only in those transactions that drastically change his or her economic position? The code specifies that the economic substance doctrine is to be clarified by its common law corollary,<sup>217</sup> however, as can be seen above, the common law is somewhat confusing in and of itself.<sup>218</sup> And, if he or she guesses wrong, can he or she afford the twenty to forty percent tax liability underpayment penalties? The Service does not intend to issue any administrative guidance as to what specific transactions will or will not be considered valid for federal income tax purposes and instead expects the common law guidance to continue to develop.<sup>219</sup>

Although society does not want taxpayers abusing the tax benefits that Congress has provided in the Code, it also does not want to restrict taxpayer movement within legitimate business transactions in a way that negates the intent of Congress or, for that matter, in a way that stifles business and economic growth.<sup>220</sup> A more flexible approach to the economic substance test

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Cir. 2005); Korb, *supra* note 1, at 10 (citing *Gilman v. Comm'r*, 933 F.2d 143, 146 (2d Cir. 1991)).

214. Coder, *supra* note 146, at 18. This is not only a higher burden as to the amount of profit that is earned but also a higher burden as to the certainty that profit *will* be earned.

215. *Id.* at 17-18; *see also* *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

216. Coder, *supra* note 146, at 17-18.

217. 26 U.S.C. § 7701(o)(5)(A).

218. *See supra* Part III.A-B.

219. I.R.S. Notice 2010-62, 2010-40 I.R.B. 411.

220. *See* Mona L. Hymel, *Consumerism, Advertising, and the Role of Tax Policy*, 20 VA. TAX REV. 347, 354-56 (2000) ("Taxes not only claim billions of dollars from citizens; they also influence billions of daily decisions – shaping, or misshaping, the economy."); Bruce I. Kogan, *Taxation of Prizes and Awards – Tax Policy Winners*

would be ideal. This approach could still be codified if Congress so chooses. However, if this is the course Congress wishes to take, the statutory language should allow for flexibility, clearly define all terms, and reduce the strict liability penalties that now exist. By allowing this more flexible approach, courts would be able to assess a transaction and effectively balance the needs of taxpayers with the Service's need to enforce the Code and the congressional intent underlying it.

## VI. CONCLUSION

The Supreme Court has articulated several factors to assess when determining whether a transaction should be recognized for federal income tax purposes. Several circuits have interpreted the Supreme Court's language to require a finding of both prongs before a transaction is considered to have economic substance, whereas other circuits have held that the prongs are merely a list of factors to be considered in looking at a transaction. Congress has taken it one step further by codifying the conjunctive two-prong test in a very restrictive way. Although Supreme Court precedent could support either approach, what is more important is the reasoning behind the Supreme Court's holding. The Supreme Court has articulated that it is important for a transaction to have a purpose other than tax avoidance, but also that a transaction should imbue those characteristics that were intended by Congress in enacting that particular code section.<sup>221</sup> It is these two objectives that are most important in applying the economic substance test to any transaction. Therefore, it is critical to find a test that can best effectuate these two objectives.

Although the majority claims that the minority view is a "rigid" approach to this test, in fact, the approach used by the majority, and now codified by Congress, may at times contradict the two objectives that the Supreme Court has specifically articulated as critical to a finding of economic substance. Instead, the disjunctive approach used by the minority, an approach that will allow flexibility in structuring transactions, is the better approach. This flexibility will allow the reasonable businessperson to structure transactions in ways that are best for his or her business and yet also capitalize on the benefits intended by Congress through the Code. At times, the businessperson may find that a transaction is structured in a way that has a legitimate business purpose but may not change his or her economic position, and vice versa. By following the disjunctive two-prong test of the minority circuits, courts could still analyze such transactions for legitimate economic substance but have more flexibility in upholding a transaction.

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*and Losers*, 63 WASH. L. REV. 257, 258 (1988) ("Tax policy now encourages productivity, economic efficiency, and competitiveness in the world marketplace.").

221. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

