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Countryside Limited Partnership: Pro-Taxpayer Decision Despite Economic Substance Attack

By Bruce Givner[1]

I. INTRODUCTION

The economic substance doctrine has been around for a long time.[2] It is a common-law doctrine[3] which the IRS uses to persuade courts to disregard transactions which lack economic substance despite the transactions' literal compliance with the Code.[4] In 2006, the IRS convinced three appellate courts to use the economic substance doctrine to overturn pro-taxpayer trial court decisions. Also in 2006, the National Office of the IRS issued a coordinated issues paper on "redemption Bogus Optional Basis" ("BOB") transactions[5] which invited auditors to use the economic substance doctrine to strike down certain partnership transactions. The California Franchise Tax Board promptly joined the "BOB" bandwagon.

Despite repeated attempts, the most recent of which was in 2007, Congress has not yet codified the economic substance doctrine, and the IRS does not support codification.[6] The year 2007 closed with an understandable taxpayer economic substance loss (*Jade Trading, LLC,* discussed below).

On January 2, 2008, the decision by United States Tax Court Judge Halpern in Countryside *Limited Partnership*[7] provided welcome news to taxpayers and their advisors who were numbed by the three adverse Appeals Court decisions in 2006. This case is also significant because it can be read as a rejection of the National Office's coordinated issues paper.

II. THREE IRS APPEALS COURTS VICTORIES IN 2006

On January 23, 2006, the United States Court Of Appeals for the Sixth Circuit reversed a pro-taxpayer district court decision in *Dow Chemical.*[8] The Appeals Court affirmed the IRS's view that the highly leveraged corporate owned life insurance plans and corresponding interest deductions had no economic substance. Lack of substance was shown by negative pre-deduction cash flows, little or no net equity in the insurance contracts so as to preclude the benefit of any inside policy build-up, and the negligible chance of realizing mortality gains.

On July 12, 2006, the United States Court of Appeals for the Federal Circuit reversed a Court of Federal Claims pro-taxpayer decision in *Coltec.*[9] The Appeals Court held that although Coltec's claimed $378.7 million capital loss fell within the "literal terms of the statute," the transaction that created high basis in the stock lacked economic substance and, therefore, must be disregarded for tax purposes. The court agreed that the creation of the separate subsidiary had a business purpose. However, that was not the step which needed a business purpose. The Appeals Court did not agree that transferring the asbestos liability to the new subsidiary had a business purpose: "Looking at the transaction objectively, there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary."[10]

On August 3, 2006, the United States Court of Appeals for the Second Circuit reversed a pro-taxpayer district court decision in *TIFD III-E, Inc.*[11] (The case is also known as "Castle Harbour," after the name of the partnership.) The district court decision had sustained allocations of partnership income away from a General Electric subsidiary to foreign partners (Dutch banks) that did not pay U.S. tax. The district court determined that the transaction was economically real, undertaken, at least in part, for a non-tax business purpose. However, the Appeals Court agreed with the IRS that the Dutch banks were lenders, not partners.

Having three Appeals Court victories on economic substance grounds made 2006 a great year for the IRS. Three of the largest taxpayers in the United States—Dow Chemical, Goodyear (parent of Coltec) and General Electric Credit Corporation (parent of TIFD III-E, Inc.)—had chosen to pay disputed taxes, hire top law firms[12] and sue for a refund. As the expression goes,[13] every taxpayer is entitled to his or her decade in court.[14] These large taxpayers won at trial and lost on appeal. Two of them tried to get to the U.S. Supreme Court, but were rejected.[15]

III. FEBRUARY, 2006, IRS COORDINATED ISSUES PAPER

This Coordinated Issues Paper describes a transaction that the IRS had been noticing on audit and which it found troublesome. The IRS instructed its agents that the so-called "redemption bogus optional basis ('BOB') transactions" are being used to improperly increase the basis of an appreciated asset so that when the asset is sold, the built-in gain is inappropriately deferred or avoided.

A. "BOB" Described

The "BOB" transaction is described as involving individuals or controlled entities who transfer low basis, high value property, such as land, interests in a partnership, or stock, to a newly formed partnership in which related parties own the remaining interests. The partnership elects under IRC §754 to adjust the basis of its assets (the "inside basis") as to certain partners' interests to match those partners' bases in the partnership (the "outside basis") where a triggering event has occurred under IRC §743(b). To create a §743(b) adjustment, there must be a sale or exchange of a partnership interest.

At some later point the partnership redeems all or part of one partner's interest in exchange for promissory notes which are assumed by the other partners. The remaining partners' interests are transferred to another newly formed partnership, triggering a basis adjustment under IRC §§754 and 743(b). Once the original partnership makes a distribution of partnership property or sells the assets subject to the step-up in basis, a tax benefit, in the form of gain reduction, is triggered due to the stepped-up basis.

B. IRS's Suggested Attacks On "BOB"

The IRS suggested six theories of attack on the "BOB" transactions.[16] For purposes of this article, the primary focus is on the IRS's call to use the economic substance doctrine to disregard the increased basis of the partnership property. Mention is made of two other grounds of attack listed in the Coordinated Issues Paper since they will appear during the discussion of *Countryside.*

1. Economic Substance

The Coordinated Issues Paper notes that there is no agreement on an economic substance doctrine test. There are "two prongs": (i) objective economic substance of the transaction; and (ii) the taxpayer's subjective business motive. Must they both be satisfied? Yes, in the Sixth Circuit.[17] No; one is enough in the Fourth Circuit.[18] Other circuits, notably the Ninth,[19] interpret the two prongs as interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.

The IRS advises its auditors that the economic substance doctrine attack is fact-driven and therefore must be carefully developed at the Exam level. Since the facts are generally found in documents, "[s]ummonses should be promptly issued whenever necessary."

2. Treasury Reg. §1.701–2, The Anti-Abuse Of Partnership Rule

There is a lengthy treatment of the potential use of the anti-abuse of partnership regulation, §1.701–2. Under that regulation the partnership itself can be disregarded and its assets treated as owned directly by the partners. The IRS notes that "[t]axpayers engaging in these transactions generally claim to have organized the partnerships for asset protection purposes; however, it is unclear what asset protection purpose is promoted by the transfer of the partnership interests, which ultimately triggers the §743(b) adjustment." (Recall that it was a claim of asset protection that the Court of Appeals for the Federal Circuit rejected as unsubstantiated in *Coltec.*)

3. Penalties

First, the National Office discusses the potential application of the IRC §6662 accuracy related penalty, which is 20% of the amount of the underpayment attributable to negligence (as applicable to "BOB"), in connection with a substantial understatement of income tax or a substantial valuation misstatement. The percentage becomes 40% in the case of a "gross" valuation misstatement.[20]

Second, in the discussion of the substantial understatement variation of the accuracy related penalty, the National Office describes the ways to reduce the penalty: (i) substantial authority; or (ii) disclosure plus a reasonable basis for the tax treatment of the item.[21] It is at that point that the Coordinated Issues Paper reaches its climax: "In this case, the transaction fits within the definition of a tax shelter." With that label, the National Office takes away the "disclosure plus reasonable basis" method of reducing the penalty. Also, the "substantial authority" method of reducing the penalty is amplified by regulation to include the requirement that "[t]he taxpayer reasonably believed at the time the return was filed that the tax treatment of that item was *more likely than not* the proper treatment."[22] [emphasis added]. A review of the statute suggests that the "more likely than not" addition by regulation is beyond the scope of authority granted by Congress, and should be struck down by a competent court.

Third, the National Office discusses the IRC §6664(c) reasonable cause exception[23] to the application of the accuracy related penalties. The "reasonable cause" exception has two parts: (i) the taxpayer had reasonable cause for the underpayment; and (ii) the taxpayer acted in good faith. How do you determine if the taxpayer acted in good faith? The rules are unhelpful and/or circular: "Reliance on an information return, professional advice, or other facts . . . constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."[24]

C. Why Not A "Listed Transaction"?

The National Office of the IRS labeled the "BOB" transaction a "tax shelter." Why did it not go the next step and

label it a "listed transaction"? We can only speculate. One possible answer is that the transaction described—a redemption of a partnership interest—is too common. The "substantially similar" language found in each "listed transaction" notice, coupled with the $230,000 per year penalty[25] for failure to file a Form 8886[26] would cause tax practitioners to protectively file millions of forms each year. (Query if a similar result will now occur with Form 8275[27] and the May, 2007 changes to IRC §6694,[28] which are still roiling the tax community.)

D. Franchise Tax Board Joins "BOB" Bandwagon

After publication of the IRS Coordinated Issues Paper, the FTB put up a page on its web site devoted to "BOB"[29] and has aggressively pursued these audits. There is a report of (i) the FTB treating one accountant as a promoter and (ii) a tax lawyer fleeing the country in the face of malpractice claims.[30] (Given the favorable Countryside result, one wonders whether that lawyer will be returning to California soon.)

IV. MARCH, 2007, LMSB'S INDUSTRY INDUSTRY ISSUE FOCUS INITIATIVE

In March, 2007, the Large and Mid-Size Business Division (LMSB) of the IRS announced that it was implementing an Industry Issue Focus (IIF) approach to compliance as part of its overall issue management strategy.[31] It labeled Tier I Issues as those having (i) high strategic importance to LMSB and (ii) significant impact on one or more industries. All the usual suspects are in Tier I, e.g., all of the transactions "listed" on Notice 2004–67. There are 14 new ones, including "Backdated Stock Options, and "Tax Shelter—Redemption Bogus Optional Basis," listing the "issue owner executive" as "Patricia Chaback, Industry Director, Communications, Technology, and Media."

V. JADE TRADING

On December 21, 2007, the U.S. Court of Federal Claims decision in *Jade Trading, LLC*[32] explicitly followed the *Coltec* decision in denying multimillion dollar loss claims based on complex euro options spread transactions. The court cited *Coltec* as "reaffirming the vitality of the economic substance doctrine. . . . that the legitimacy of a transaction for tax purposes is not guaranteed merely because a technical interpretation of the Code would support the tax treatment."[33]

One point of this article is that the amorphous "economic substance doctrine" has become too powerful of a weapon for the IRS due to the three 2006 Appeals Court victories described above. However, *Jade Trading* seems to also be a particularly appropriate case for application of the economic substance doctrine. Judge Williams, in *Jade Trading*, stated that the transaction's fictional loss,[34] inability to realize a profit,[35] lack of investment character,[36] meaningless inclusion in a partnership,[37] and disproportionate tax advantage as compared to the amount invested and potential return,[38] "compel a conclusion that the spread transaction objectively lacked economic substance."[39]

VI. COUNTRYSIDE LIMITED PARTNERSHIP

A. Facts[40]

1. Countryside.

Countryside was formed as a Massachusetts limited partnership in 1993 to acquire and operate a 448 unit residential property in Manchester, New Hampshire. As of December, 2000, there was a 1% corporate GP, and the LPs were Messrs. Winn (69%), Curtis (25%) and Wollinger (5%).

2. Debt.

In October, 2000, Countryside borrowed $8.5 million from a bank and contributed it for 99% of the membership interests in a Massachusetts LLC (CLPP). That LLC, in turn, contributed the money for a 99% interest in another Massachusetts LLC (MP). That lowest tier LLC (MP) then borrowed another $3.4 million from the bank. Both loans were guaranteed by Mr. Winn, the largest Countryside limited partner; the loan to Countryside was secured by the 448 unit property.

3. Redemption.

On December 26, 2000, Countryside distributed its 99% interest in CLPP to Messrs. Winn and Curtis in complete liquidation of their respective partnership interests in Countryside. As a result, the corporate GP owned 16.7% and Mr. Wollinger owned 83.3%.

4. Sale Of Property.

On January 26, 2001, Countryside executed an agreement for sale of the Manchester property. That agreement was the culmination of negotiations between Countryside and a buyer that began with an unsolicited inquiry, in May or June, 2000. The sale of the Manchester property closed on April 19, 2001, and, on that date or soon thereafter, Countryside repaid the $8.5 million loan.

B. Arguments

Messrs. Winn and Curtis treated the distribution of the LLC membership interests to them as a distribution of property in liquidation of their partnership interests. As such,

they recognized no gain on the receipt of these interests pursuant to the general rule of §731(a)[41] and took a carryover basis in the membership interests tied to their ending basis just before the Countryside redemption pursuant to IRC §732(b).[42] Countryside treated the liquidating distribution as a distribution triggering the application of IRC §734,[43] thus stepping up the partnership's basis in the partnership's assets.

The IRS objected to "the totality of the transactions . . . and the elections giving rise to the basis results, as constituting 'an abusive tax avoidance result' (i.e., the indefinite or, possibly, permanent nonrecognition of the gain on the sale of Countryside's assets), which should not be given effect."[44] The IRS argued that "[t]he entire series of transactions is a sham and should be disregarded for federal income tax purposes . . . [and] recast . . . in accordance with [their] substance, which, in respondent's view, is a distribution of cash or a cash equivalent to Mr. Winn and Mr. Curtis."[45]

The taxpayers admitted that the exact structure they used to accomplish their goal was selected due to the tax effect it gave them, but claimed that there was an underlying change in circumstance for the departing partners (whose tax is the matter in question here). As a result, the taxpayers argued that the IRS is prevented from asserting a general economic substance attack on the transaction and making use of the partnership anti-abuse regulation.

C. Ruling

The decision in this case is particularly surprising, since the taxpayer *conceded* that the series of transactions was *entirely tax-motivated.* Judge Halpern summarized his view by concluding that the economic substance doctrine has 2 prongs—an objective prong and a subjective prong:

- The objective prong requires that the transaction change the taxpayer's economic position.

- The subjective prong requires that the taxpayer have a nontax business purpose for entering into the transaction.

After reviewing several cases in which various courts of appeals applied the 2 prongs in different fashions, he concluded that the prongs should be applied disjunctively; i.e., a transaction will satisfy the economic substance doctrine if it satisfies *either* the objective or subjective prong of the test.

In applying his view of the economic substance doctrine to the facts in the case, he ruled that all of the parties satisfied the *first* prong of the test. The partnership's economic position changed because the ownership interests of 2 significant partners were eliminated. The economic position of the 2 partners changed because they *converted* their ownership interest in a real estate partnership to an ownership interest in interest-bearing notes: "While the employed means were designed to avoid recognition of gain to Mr. Winn and Mr. Curtis, those means served a genuine, nontax, business purpose; viz, to convert Mr. Winn's and Mr. Curtis's investments in Countryside into 10-year promissory notes, 2 economically distinct forms of investment."[46]

D. Will The IRS Appeal?

Countryside is welcome news for taxpayers. However, Judge Halpern's decision is certain to attract criticisms, if for no other reason than the fact that he relies on cases decided 60 and more years ago.[47] Also, the pattern of IRS success established by *Dow Chemical, Coltec,* and *TIFD III-E, Inc.* makes it almost certain that the IRS will appeal. It is presumed that IRS Chief Counsel, Donald Korb, will not let an economic substance defeat tarnish the IRS's current record. Additionally, the outcome in *Coltec* suggests that the IRS will get a sympathetic hearing in the United States Court of Appeals for the Federal Circuit.

VII. CONCLUSION

The economic substance doctrine is a powerful tool for the government to use to deny certain transactions their desired tax results despite literal compliance with the relevant statutory provisions. The weapon's power is amplified by the fact that the doctrine is so unclear. There is still a chance that the doctrine will be codified.[48] In the interim, tax practitioners must continue to read the tea leaves and, in that pursuit, cases like *Countryside* are an important and hopeful part of the developing law in this area.

ENDNOTES

1. Bruce Givner, Esq., Bruce Givner, A Professional Corporation, 12100 Wilshire Blvd., Suite 445, Los Angeles, California 90025; Bruce@Givner.com.

2. *Gregory v. Helvering,* 293 U.S. 465 (1935), 14 AFTR 1191, at 1192: "Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having *no business or corporate purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance [pg. 1193] to the end last described. It was brought into existence for *no other purpose*; it performed, as it was intended from the beginning it

should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of [the reorganization section], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." [emphasis added]

Frank Lyon Co., v. U.S., 435 U.S. 561 (1978), 41 AFTR 2d 1142, at 1147: "In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded 'the simple expedient of drawing up papers,' *Commissioner v. Tower*, 327 U.S. 280, 291 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. 'In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding.' [internal citation omitted]" 41 AFTR 2d at 1150: "The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction. " [internal citation omitted] 41 AFTR 2d at 1152: "In short, we 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. "

3. The other, similar common law anti-abuse doctrines are (i) substance over form; (ii) sham transaction; (iii) step transaction; and (iv) business purpose. They overlap in many cases. "Sham in substance" and economic substance are often discussed together. See Keinan, 508 T.M., *The Economic Substance Doctrine,* ¶I.A.

4. *Jade Trading, LLC v. U.S.*, 100 AFTR 2d 2007–7123 (12/21/07), at 7124.

5. Coordinated Issue- All Industries—Redemption Bogus Optional Basis Tax Shelter, Effective Date: January 31, 2006, UIL NO: 9300.42–00.

6. See Givner, "Potential Codification Of 'Economic Substance' Doctrine," Volume 16, Number 4 California Tax Lawyer Fall 2007.

7. T.C. Memo 2008–3.

8. 7 AFTR 2d 2006–671.

9. 98 AFTR 2d 2006–5249.

10. *Coltec*, 98 AFTR 2d 2006–5263.

11. 98 AFTR 2d 2006–5211.

12. Dow Chemical was represented by Crowell Moring (350 lawyers) and McKee Nelson (200 lawyers) at trial, and McKee Nelson on appeal. On McKee Nelson's web site it crows: "The firm achieved a victory for a subsidiary of GE Capital Corporation, where the federal district court in Connecticut rejected the government's reallocation of partnership income on an economic sham theory and ordered the IRS to refund tax deposits of over $62 million." Coltec was represented by Kronish Lieb, which is now part of Cooley Godward Kronish (600 lawyers). General Electric Credit Corporation's trial counsel is unclear from the record. On appeal it was represented by Cahill Gordon & Reindell (275 lawyers); McKee Nelson (200 lawyers); King & Spalding (800 lawyers); and in-house counsel.

13. Most recently used by Chuck Rettig, Esq., the superb host of the 2007 UCLA Tax Controversy Institute.

14. For Dow Chemical, the tax years were 1989—1991, so the final resolution in 2006 meant a 15 year saga. For Coltec, the tax year was 1996, so it was a mere decade. For General Electric Credit Corporation, the tax years were 1993–1998, so it was less than 8 years.

15. *Coltec, cert. denied*, 127 S. Ct. 1261 (2007). *Dow Chemical, cert. denied*, 127 S. Ct. 1251 (2007).

16. First, that any promissory notes given by the partnership to any of its purported partners do not constitute partnership liabilities for purposes of IRC §752(a). Second, pursuant to IRC §707(a)(2)(B), the contribution of appreciated property and the distribution of the redemption note may be recharacterized as a sale governed by IRC §453

rather than a liquidating distribution governed by IRC §736. Third, the increased basis of the partnership property may be disregarded under the economic substance doctrine and the step transaction doctrine. Fourth, transaction costs are not deductible or amortizable under IRC §§162, 212 and 709(b). Fifth, the anti-abuse rule of Treas. Reg. §1.701–2 should be developed. Finally, the accuracy-related penalty under IRC §6662 for negligence or disregard of rules or regulations and/or a substantial understatement of income tax should be developed.

17. *Pasternak*, 990 F.2d 893, 898 (6th Cir. 1993).

18. *Rice's Toyota World*, 752 F.2d 89, 91–92 (4th Cir. 1993).

19. *Sochin*, 843 F.2d 351, 354 (9th Cir. 1988).

20. IRC §6662(h). For example, if the value of any property claimed on a return, e.g., for depreciation purposes, is 200% or more of the correct value, that is a gross valuation misstatement, increasing the penalty percentage to 40% of the underpayment.

21. IRC §6662(d)(2)(B).

22. Treas. Reg. §1.6662–4(g)(1)(i)(B).

23. IRC §6664(c)(1): "No penalty shall be imposed under IRC §§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."

24. Treas. Reg. §1.6664–4(b)(1), entitled "In General," eighth sentence.

25. $200,000 per year under IRC §6707A; $30,000 per year under R&T Code §19772.

26. Reportable Transaction Disclosure Statement.

27. Disclosure Statement.

28. Understatement of taxpayer's liability by tax return preparer.

29. http://www.ftb.ca.gov/professionals/taxnews/2007/0907/0907_1.shtml. On a page entitled "Tax News For Tax Professionals," the article is entitled "Section 754 Bogus Optional Basis Transactions": "What about BOB?" Taxpayers are continuing to use partnership entities to structure abusive tax avoidance transactions. The Pass-Through Entity Program has examined many types of BOB transactions in which a partnership uses an IRC §754 election to inappropriately increase the basis of its property. In some cases, the basis of assets is increased before their disposition. In other cases, taxpayers are using the additional basis to claim increased depreciation or amortization deductions. Although each type of BOB transaction may be structured in various ways, the ultimate objective is to avoid gain on asset dispositions, or to create deductions that offset income. We have observed several methods used to artificially increase partnership property basis: (i) a transaction in which a partner is redeemed out of the partnership for a redemption note, followed by a related party transfer of partnership interests, (ii) a transaction that uses related party installment sales of partnership interests for promissory notes or annuities, (iii) a transaction using the rules of IRC §734 to shift basis from a high basis asset to a low basis asset. We are closely scrutinizing IRC §754 BOB transactions. Depending upon the facts and circumstances, the transaction may be disregarded or recast to properly reflect California income, or the basis step-up might be disallowed based on one or more of these positions:

- The transactions are a sham for tax purposes.
- The substance of the transactions does not represent the form.
- Intermediate steps should be disregarded under the step transaction doctrine.
- The transactions can be recast under the partnership anti-abuse regulations of IRC §701.
- The redemption note is not a valid liability for tax purposes.
- The gain or loss can be recomputed under IRC §446 or 269.
- The relevant tax laws were not applied properly.

We may add substantial penalties to any additional tax due, depending on the facts and circumstances. For example, the 40% non-economic substance transaction penalty, the 100% interest based penalty, or the accuracy related penalty might be applicable. The California 8-year statute of limitations rule may apply to the transactions.

Taxpayers who are reconsidering their use of tax avoidance schemes to understate their tax liabilities have asked us about their options. Your clients can amend their state income tax returns at any time to restate their proper tax liability. Their self-assessed tax and appropriate interest is due, and must be paid when they file their amended return.

Substantial penalties might apply to an abusive tax scheme; however your client may avoid certain penalties by filing an amended return. If any of your clients are interested in filing an amended return, please use the address below. To ensure proper handling, write BOB TS on the top right margin of the first page.

ATTN: 341: MS F-150
Franchise Tax Board
PO Box 942867
Sacramento CA 94267–0001

30. Courtesy of Paul Marx, Esq. of Rutan & Tucker, in conversation at the USC Tax Institute, January 29, 2008.

31. http://www.irs.gov/businesses/article/0,,id=167377,00.html.

32. 100 AFTR 2d 2007–7123.

33. 100 AFTR 2d at 2007–7125.

34. The taxpayers did not invest $15 million in the spread and did not lose $15 million when exiting the partnership without exercising the options.

35. The transaction's structure limited the maximum net profit to $140,000 per LLC. Also, each LLC paid $934,100 of fees on a $150,002 investment.

36. The transaction was devised and marketed by BDO Seidman's "Tax $ells Division" and was included in the chapter of its "Tax Product Manual" entitled "Capital Gain or Ordinary Income Eliminators."

37. The requirement that the transaction be purchased outside the partnership and contributed to it had no effect on the investment's profitability, except to add cost. However, that was required to achieve the tax benefits.

38. Each taxpayer's loss was $14.9 million, ≈ 65 times greater than each LLC's $225,002 financial commitment, almost 100 times greater than each LLC's $150,002 investment in the spread transaction which generated the loss, and ≈ 100 times greater than the $140,000 potential net profit each LLC could have earned.

39. 100 AFTR 2d at 2007–7125.

40. Facts related to the privately issued notes acquired from AIG Matched Funding Corporation are not included in this article as they are not germane to the economic substance issue.

41. IRC §731(a).

42. IRC §732(b).

43. IRC §734.

44. T.C. Memo 2008–3, at 14.

45. T.C. Memo 2008–3, at 26.

46. T.C. Memo 2008–3, at 41.

47. Judge Learned Hand's decision in *Chisholm v. Commissioner*, 79 F.2d 14 [16 AFTR 585] (2d Cir. 1935), revg. 29 B.T.A. 1334 (1934); *Helvering v. Walbridge*, 70 F.2d 683 [13 AFTR 1062] (2d Cir. 1934); and *Hobby v. Commissioner*, 2 T.C. 980 (1943). Judge Hand's decision is wonderful to read. Writing of *Gregory v. Helvering*, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596, he remarks: "It was solicitous to reaffirm the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it." It is difficult to square that with the government's current obsession that the taxpayer must prove a non-tax motive for tax planning. Consider the challenge facing a taxpayer in a jurisdiction which uses the conjunctive test for economic substance.

48. BNA, Inc., Daily Tax Report, Highlights, Wednesday, January 30, 2008: "Grassley Defends Farm Bill's Language on Economic Substance Doctrine. The day after President Bush says he will not sign legislation that raises taxes, Senate Finance Committee ranking member Grassley says codifying the economic substance doctrine is a loophole-closer, not a tax-raiser. Grassley and Finance Chairman Baucus put language in the Senate-passed farm reauthorization bill (H.R. 2419) to define economic substance for courts trying to determine whether certain tax avoidance efforts may be abusive."