

## **LEASE STRIPS AND VIRAL STOCK: ARE THEY DEAD YET?**

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# Lease Strips and Viral Stock: Are They Dead Yet?

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## Major References:

*Black & Decker Corp. v. U.S.*, 340 F. Supp. 2d 621 (D. Md. 2004); *Long Term Capital Holdings v. U.S.*, 330 F. Supp. 2d 122 (D. Conn. 2004).

## Introduction

For comedians, timing is everything. The IRS, however, probably was not amused when the decision in *Black & Decker Corp. v. U.S.*<sup>2</sup> was announced on the same day that the IRS announced its settlement guidelines for lease strips<sup>3</sup> in the wake of the *Long Term Capital Holdings*<sup>4</sup> decision. The image of the IRS trying to mop up lease strips as a significant taxpayer victory occurs in a contingent liability shelter invokes a similar image from *Monty Python's Holy Grail*, where a person arises from a pile of bodies to claim "I'm not dead yet!" This memorandum explores some of the implications of the *Long Term Capital Holdings* decision for the analysis of not only lease strips and their progeny, known as "viral stock," but also other shelters that similarly involve a transfer of high-basis assets to an entity in a purported tax-free transaction followed by a sale of an interest in the entity.

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<sup>2</sup> 340 F. Supp. 2d 621 (D. Md. 2004). The *Black & Decker* decision was closely followed by two additional government losses involving the government's challenge of alleged tax avoidance transactions on economic substance grounds. *Coltec Indus. Inc. v. U.S.*, 62 Fed. Cl. 716 (2004); *TIFD III-E Inc. v. U.S.*, 94 A.F.T.R.2d 2004-6635 (D. Conn. 2004). Only the *Black & Decker* decision is discussed herein.

<sup>3</sup> IRS News Release IR-2004-128 (10/20/04). Under these guidelines, the IRS will not settle unless taxpayers concede 100% of the claimed losses or deductions, reduced by transaction costs of up to 10% of the amount of such losses or deductions, and 50% of the accuracy-related penalty at issue.

<sup>4</sup> 330 F. Supp. 2d 122 (D. Conn. 2004).

## **THE LONG TERM CAPITAL HOLDINGS DECISION**

### **The Long Term Capital Holdings Transactions**

At the core of the *Long Term Capital Holdings* case is the lease strip, from which all the subsequent tax benefits emanate. A foreign corporation, Onslow Trading and Commercial LLC (OTC), presumably owned by non-U.S. persons but no one in particular, acquired rights to lease computer equipment or trucks as a lessee. OTC then immediately subleased its rights as lessee to another party, with the sublessee prepaying 92.5% of the rent due under the sublease. As a foreign corporation, OTC paid no U.S. taxes on the prepayment, nor did it pay taxes in any other country. OTC deposited the prepayment in the bank, and then pledged the bank account as security for its own lease obligation.

At that point the lease strip was perfected. OTC received approximately \$100 million in prepayments, on which no U.S. tax was paid. The \$100 million was pledged to pay OTC's own lease obligations. OTC claimed it had a basis of \$100 million in the pledged account. The net value of OTC's rights in the pledged account, the sublease and its own lease obligations was approximately \$1 million. Hence, OTC claimed it owned an asset with a \$99 million built-in loss.

The stage was then set to begin distributing the \$99 million loss to multiple taxpayers, multiple times. This phenomenon results from tax rules that permit basis to be duplicated when property is transferred tax-free to a corporation or partnership. That is, the transferee corporation or partnership carries over the transferor's basis as inside basis in the asset and the transferor converts the asset basis into outside basis in the corporate stock or partnership interest.

The first transactions to duplicate basis occurred in 1995 when OTC transferred its positions in the lease and sublease and its rights in the bank deposit to U.S. subsidiaries of two large U.S. corporations in exchange for preferred stock, in transactions designed to qualify as tax-free under § 351.<sup>5</sup> These transactions occurred shortly after the lease strip. Presumably the U.S. parent companies contributed sufficient assets to their subsidiaries so that they, together with OTC, could be treated as transferor groups that met the control requirement of § 351. While the U.S. subsidiaries assumed OTC's obligations to pay rent under its own lease, OTC apparently claimed that such assumption did not reduce its basis in the preferred stock under § 358(d) because the payment of such liability would give rise to a deduction and, therefore, the liability is not taken into account pursuant to § 357(c).<sup>6</sup> Thus, OTC claimed a \$100 million basis in the preferred

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<sup>5</sup> Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

<sup>6</sup> Literally, § 358(d) says to ignore an assumed liability for purposes of reducing outside basis only where the liability is "excluded under § 357(c)(3)," and § 357(c)(3), by its terms,

stock. The U.S. subsidiaries claimed a \$100 million basis in the lease positions and bank deposits, and then claimed deductions as the monies in the deposit account were used to make rental payments. In effect, the income from the rent prepayments, which was never taxed in the U.S., had been stripped away from the corresponding deductions.

The second transactions to duplicate basis occurred in 1996 when OTC transferred the preferred stock to Long-Term Capital Partnership, which in turn contributed the preferred stock to a lower-tier partnership called Portfolio. These transactions occurred more than a year after OTC received the preferred stock. Both Long-Term Capital Partnership and Portfolio claimed that OTC's \$100 million basis in the preferred stock carried over to them in tax-free § 721 transactions. Approximately one year later, in 1997, OTC sold its partnership interest in Long-Term Capital Partnership to Long-Term Capital Management, a partnership that itself was a partner in Long-Term Capital Partnership, pursuant to put options that OTC acquired from Long-Term Capital Management at the time it contributed the preferred stock in the § 721 transactions. The purchase price was substantially less than \$100 million. Then, two months later, at the end of 1997, Portfolio sold the preferred stock in the two U.S. corporations to an investment bank.

Portfolio allocated the capital loss from the sale of the preferred stock to Long-Term Capital Partnership, as it was required to do under § 704(c).<sup>7</sup> Long-Term Capital Partnership then allocated the capital loss it received from Portfolio to Long-Term Capital Management, again as required under § 704(c). That is, when OTC contributed the preferred stock to Long-Term Capital Partnership, § 704(c) principles required that any capital loss from the sale of the preferred stock be allocated to OTC. However, when OTC sold its interest to Long-Term Capital Management, the purchaser stepped into the shoes of OTC with respect to the § 704(c) loss. If a § 754 election had been in place for Long-Term Capital Partnership, then the capital loss that shot out to Long-Term Capital Management would have been offset by the purchaser's negative

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excludes certain liabilities from the application of the "liabilities over basis" rule in § 357(c)(1). Where, as in *Long Term Capital Holdings*, the liabilities assumed did not exceed the alleged basis, it would seem that the transferor should not get the benefit of the special rule in § 358(d) that excludes certain liabilities from being taken into account for outside basis. However, the IRS ruled in Rev. Rul. 95-74, 1995-2 C.B. 36, that deductible liabilities are not taken into account whether or not they exceed the basis of the transferred property. Taxpayers also have relied on that position to support high outside basis in other tax shelter contexts, such as the contingent liability transaction described in Notice 2001-17, 2001-9 I.R.B. 730. It is not clear if § 358(h), effective after October 18, 1999, would require that OTC's basis in the preferred stock be reduced by the assumed liability. An exception applies if substantially all the assets with which the liability is associated are transferred to the corporation. Note, however, applicable for transactions entered into after Oct. 22, 2004, the American Jobs Creation Act of 2004 (2004 AJCA), P.L. 108-357, § 836, amends § 362 to limit the U.S. subsidiary's carryover basis in the built-in loss assets to their fair market value. See § 362(e), as amended by the 2004 AJCA, P.L. 108-357, § 836.

<sup>7</sup> Note that § 704(c)(1)(C), as added by the 2004 AJCA, P.L. 108-357, § 833(a), would prohibit OTC's § 704(c) gain from being transferred to Long-Term Capital Management. See § 704(c)(1)(C), as added by the 2004 AJCA, P.L. 108-357, § 833(a), applicable to contributions made after Oct. 22, 2004.

§ 743 adjustment, and effectively denied.<sup>8</sup> Not surprisingly, there was no § 754 election in effect for Long-Term Capital Management.

### **The U.S. District Court’s Opinion**

This case was only about the capital loss claimed by Long-Term Capital Management from Portfolio’s sale of the preferred stock. Effectively, for purposes of deciding the case, the court assumed that the various assets contributed by OTC to the U.S. subsidiaries had an aggregate basis of \$100 million at the time, and that OTC converted that basis into basis in preferred stock in a tax-free § 351 transaction. The ability of the U.S. subsidiaries to claim \$100 million of deductions without recognizing income was not before the court. The real analysis for the court began at OTC’s contribution of the preferred stock to Long-Term Capital Partnership.

The U.S. District Court for the District of Connecticut held that OTC’s contribution of the preferred stock to Long-Term Capital Partnership, OTC’s sale of its partnership interest to Long-Term Capital Management, and Portfolio’s subsequent sale of the preferred stock to an investment bank lacked economic substance and must be disregarded for federal income tax purposes. The court held in the alternative that the transactions must be recast under the step transaction doctrine as a taxable sale by OTC directly to Long-Term Capital Management. The court also upheld a 40% penalty for gross valuation misstatement and, in the alternative, 20% substantial understatement penalties.<sup>9</sup>

The district court, citing *Gilman v. Comm’r*,<sup>10</sup> suggested it would use a “flexible” conjunctive test for applying the economic substance doctrine, that is, that “a finding of either a lack of a business purpose other than tax avoidance or an absence of economic substance beyond the creation of tax benefits can be but is not necessarily sufficient to conclude the transaction is a sham.” Nevertheless, since it found that both were lacking, it did not decide whether the test is conjunctive or disjunctive in the Second Circuit. Long Term Capital argued that the transactions should be recognized as having economic substance if the transactions caused a change in their economic positions. The court, however, believed that the law of the Second Circuit required that the court determine whether there was a “reasonable opportunity for economic profit, that is, profit exclusive of tax benefits.”

In applying the economic substance requirement, the *Long Term Capital Holdings* court concluded that it was not reasonable for the taxpayer to expect a non-tax-based profit from the

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<sup>8</sup> Section 743(b), as amended by the 2004 AJCA, P.L. 108-357, § 833(b), would mandate a § 743(b) adjustment in these circumstances. See § 743(b), as amended by the 2004 AJCA, P.L. 108-357, § 833(b), applicable to transfers after Oct. 22, 2004.

<sup>9</sup> The implications of the *Long Term Capital Holdings* decision on penalties and reliance on opinions of professional advisors are discussed in detail in the companion White Paper by Miriam L. Fisher, “*Long Term Capital Holdings v. United States*, The End of Penalty Protection?”.

<sup>10</sup> 933 F.2d 143 (2d Cir. 1991).

transactions considering the hefty transactional costs intended to be incurred. For instance, Long Term Capital decision to close the fund to new investors and forgo additional fees would not follow business logic without an expectation of simultaneous tax benefits. The court compared the potential profit to the sizeable amounts paid as attorney fees, consultant fees, partnership distributions, bonuses, and related-party loans. While the court took notice and generously assumed that the above-market returns would continue for potential profits, it also aggressively excluded certain management fees and chose to ignore the economic value of partner relationships. The court's analysis of such profits and costs led to its conclusion that the transaction lacked economic substance simply because no prudent investor would knowingly and intentionally incur costs above a reasonable gain.

The court in *Long Term Capital Holdings* reinforced its implosion of the tax shelter by also relying on the "end result" version of the step transaction doctrine. OTC's transfer of the preferred shares to Long-Term Care followed by OTC's put of the Long-Term Capital Partnership interest to Long-Term Capital Management was considered a prearranged series of transactions by all the parties who had complete control over all of the steps. Distinguishing *Grove v. Comm'r.*<sup>11</sup> and *Esmark v. Comm'r.*,<sup>12</sup> the court characterized the transaction as simply a premeditated sale of preferred shares by OTC to Long-Term Capital Management followed by a transfer of those shares to Long-Term Capital Partnership.

Much already has been (and still more will be) written about the impact of the particular facts on the court's application of the economic substance and step transaction doctrines. Empowered by the sheer force of the *Long Term Capital Holdings* decision, the IRS's recent "no mas" settlement policy on lease strips closely follows the approach it took with the "Son of BOSS" shelter. However, the Son of BOSS shelters done on or after October 18, 1999<sup>13</sup> are subject to statutory and regulatory limitations that, barring a successful challenge to the validity of the regulations, effectively eliminate the taxpayer's hope for a favorable decision.<sup>14</sup>

The government does not have the same silver bullet in cases involving lease strips and the successive multiplication of basis through so-called "viral stock" transfers.<sup>15</sup> Instead, it has to

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<sup>11</sup> 490 F.2d 241 (2d Cir. 1973).

<sup>12</sup> *Esmark, Inc. v. Comm'r.*, 90 T.C. 171 (1988), *aff'd in unpub. opin.*, 886 F.2d 1318 (7th Cir. 1989).

<sup>13</sup> That is, those described in the second fact pattern of Notice 2000-44, 2000-36 I.R.B. 255.

<sup>14</sup> § 358(h); Regs. § 1.752-6T; Chief Counsel's Notice CC-2003-020.

<sup>15</sup> Notice 2003-55, 2003-34 I.R.B. 395 (the IRS will attack lease strips by applying "various judicial doctrines, such as the doctrines of assignment-of-income, business purpose, substance-over-form, step transaction, or sham"); Rev. Rul. 2003-96, 2003-34 I.R.B. 386 (application of § 482 to lease strips is limited). On Nov. 10, 2003, proposed regulations under § 7701(l), issued in 1995, which recharacterized lease strips to prevent tax avoidance, were withdrawn because "the complexity presented by these proposed regulations is not necessary to prevent tax avoidance in these transactions," in light of government's victories in *Anadantech* and *Nicole Rose*. The IRS Coordinated Issue Paper on Lease-Stripping Transactions, issued on July 21, 2000, does not reflect the IRS's current positions.

wade through the thicket of the economic substance and other judicial doctrines in order to successfully challenge these transactions. Occasionally the government is presented with facts so egregious that the particular legal theory at play is almost irrelevant. It becomes obvious that the court is looking for a way to hold in favor of the government. Practitioners saw that in another lease stripping case, *Andantech L.L.C. v. Comm'r.*,<sup>16</sup> from which it is almost impossible to draw cohesive legal principles for application in other contexts, even though the decision represents a resounding victory for the government.

The *Long Term Capital Holdings* case is similarly driven by bad facts rather than a cohesive application of the law. As we know, bad facts often make bad law. A key question going forward is what does this case really mean for the application of the economic substance and step transaction doctrines under other fact patterns and other shelters? For example, does it mean that every tax-driven § 351 contribution or § 721 contribution will be subject to an economic substance analysis? Surely not. Sometimes a court will conclude that a particular transaction has economic substance even though it seems obvious that the decision is more conclusory than analytical. The recent *Black & Decker* decision is a good example. The challenge going forward for both the government and private practitioners is to determine up front whether a transaction lends itself to an economic analysis before wading into the thicket. More often than not, there is a far more sensible and appropriate means than economic substance to judge the transaction's validity.

## **ECONOMIC SUBSTANCE DOCTRINE IN OTHER CONTEXTS**

The economic substance doctrine historically has been used by courts in cases involving individual tax shelters such as leases and straddles. These courts have adopted a two-pronged test for analyzing whether a tax shelter transaction is a "sham." The first factor focuses on the taxpayer's subjective motive for choosing to enter the transaction and is thus an intent test. The second factor is whether the transaction has economic substance. This factor is an objective determination of whether there existed any possibility of an economic profit other than tax benefits. A transaction motivated solely by tax avoidance is not characterized as a sham unless the court also finds that the transaction lacks economic substance.<sup>17</sup>

This two-pronged analysis for tax shelters generally has been applied only to tax shelters and other closed investments where the taxpayer is not already engaged in the particular subject of the investment and stands to profit, if at all, only from the particular investment. Most of the recent corporate tax shelter cases involve isolated transactions outside the taxpayer's trade or business that are specifically identified to generate a tax loss or deduction item.<sup>18</sup>

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<sup>16</sup> 331 F.3d 972 (D.C. Cir. 2003), *aff'g in part & remanding for consideration of other issues* T.C. Memo 2002-97.

<sup>17</sup> *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978); *Rice's Toyota World, Inc. v. Comm'r.*, 752 F.2d 89, 91 (4th Cir. 1985).

<sup>18</sup> *See, e.g., ACM P'ship v. Comm'r.*, 157 F.3d 231 (3d Cir. 1998).

For example, the courts have rejected the IRS's repeated attempts to argue sham transaction theory or *Tax Management Memorandum* the economic substance doctrine in the context of inter company financing transactions. The seminal case on this topic, *Kraft Food Co. v. Comm'r.*,<sup>19</sup> was decided nearly 50 years ago. In that case, a parent corporation operating at a loss owned a highly profitable subsidiary. At that time, the consolidated return provisions had been abolished. Faced with the prospect of not being able to offset the subsidiary's income with the parent's losses, the parent caused the subsidiary to distribute a \$30 million interest-bearing note to the parent as a dividend. The interest deduction on the note reduced the subsidiary's taxable income, while the interest income to the parent was offset by the parent's losses. Both the Tax Court and the Second Circuit found that the transaction was driven primarily by tax savings. The Tax Court disallowed the subsidiary's interest deduction because the only purpose of issuing the notes was to obtain the interest deduction, the parent's economic interests were unaffected by the issuance of the note, and the transaction was not arm's length because the parties involved were related.

The Second Circuit in *Kraft* reversed in favor of the taxpayer, holding that the notes could not be disregarded since they created legal rights and duties with genuine commercial law effects, including the effects on priority of rights in bankruptcy. It did not matter to the Second Circuit that the notes were distributed primarily to achieve a tax benefit: "The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact . . . . We think that the occurrence of these acts affected their legal relations."

Another area in which the economic substance doctrine has been considered inappropriate is the tax treatment of back-to-back loans involving a Netherlands Antilles subsidiary. The back-to-back loan authorities primarily involve financing transactions designed to take advantage of a U.S. income tax treaty. Before the enactment of the portfolio interest provisions of the Code in 1984, U.S. companies formed Netherlands Antilles subsidiaries which borrowed money from a foreign person and then on-lent the proceeds to their U.S. parent on back-to-back terms. This was done solely to qualify the payment of interest by the U.S. parent under the U.S./Netherlands Antilles treaty and avoid the U.S. withholding tax that would otherwise be imposed on interest paid directly to the foreign investors. When the portfolio interest provisions, which exempt most borrowings from foreign investors from U.S. withholding tax, were enacted in 1984, Congress grandfathered all prior back-to-back arrangements where the Netherlands Antilles subsidiary maintained no more than a five-to-one debt-to-equity ratio.

The IRS has since challenged several pre-1984 Netherlands Antilles financing arrangements that did not qualify for grandfather relief because of a higher than five-to-one debt-to-equity ratio. In *Northern Indiana Public Serv. Co. v. Comm'r.*,<sup>20</sup> the IRS first argued in the Tax Court that the arrangement failed under the early back-to-back loan case, *Aiken Indus., Inc. v. Comm'r.*,<sup>21</sup> in which a back-to-back loan was collapsed and treated as a "conduit" where the intermediary had no equity, made no profit, and otherwise had no dominion and control over the interest income it

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<sup>19</sup> 232 F.2d 118 (2d Cir. 1955), *rev'g* 21 T.C. 513 (1954).

<sup>20</sup> 115 F.3d 506 (7th Cir. 1997).

<sup>21</sup> 56 T.C. 925 (1971).

received. The Tax Court rejected that argument because the Netherlands Antilles subsidiary did have equity capital apart from its loan receivable and loan payable, and it also earned a 1% profit (borrowing at 17.5% and on-lending at 18.5%).

On appeal, the IRS argued that the arrangement should be ignored based on the economic substance doctrine. The Seventh Circuit held that the various cases applying the economic substance doctrine to tax shelters, such as *Goldstein*,<sup>22</sup> *Sheldon*,<sup>23</sup> and *Knetsch*,<sup>24</sup> were not applicable because those cases involved borrowing transactions unrelated to any economic activity, where the taxpayer's pre-tax interest outlay was greater than the pre-tax interest received. In the case of *Northern Indiana*, the borrowing transaction, while clearly using a tax-motivated structure designed to take advantage of treaty benefits, was otherwise effected pursuant to a bona fide business objective of obtaining capital. Moreover, the Seventh Circuit concluded that the arrangement *had* economic substance because the finance subsidiary earned a profit when it borrowed at 17.5% and on-lent at 18.5%. It did not matter to the court that the profit was earned inside a wholly owned subsidiary of the U.S. parent.

The IRS challenged a back-to-back loan arrangement a second time in *Del Commercial Properties, Inc. v. Comm'r.*,<sup>25</sup> and this time won in the Tax Court. The court's reasoning is not well articulated. It mentions not only the step transaction doctrine but also the "conduit" theory, the general sham transaction doctrine, and the substance over form doctrine, without indicating on which principle the decision rests. What is clear, however, is that the taxpayer had a particularly egregious fact pattern. There were direct links between the ultimate borrower and a third-party lender in the form of covenants, guaranties and mortgages. After several years, the ultimate borrower began to bypass the intermediary and make payments directly to the intermediary's lender. Also, after several years, the interest spread earned by the intermediary was reduced to zero. It is not at all surprising that the taxpayer lost on those facts, regardless of which legal theory supported the decision.

*United Parcel Serv. v. Comm'r.*,<sup>26</sup> recently confirmed that the economic substance doctrine traditionally used to analyze tax shelters is not applicable when analyzing a transaction entered into as part of a company's ongoing business activities. UPS had been receiving excess value charges (EVCs) from its customers for insuring parcels worth more than \$100 (UPS is liable only for the first \$100 of loss). UPS restructured its EVC program by insuring the risks with an unrelated insurer; as a result, UPS paid the entire premiums over to the insurer and deducted the payment as an expense. The unrelated insurer then reinsured the risk with a Bermuda company that had been formed by UPS and then distributed to the UPS shareholders. As a result, the EVC income that UPS previously reported in its income was now being reported by an offshore

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<sup>22</sup> 364 F.2d 734 (2d Cir. 1966).

<sup>23</sup> 94 T.C. 738 (1990).

<sup>24</sup> 364 U.S. 361 (1960).

<sup>25</sup> T.C. Memo 1999-411.

<sup>26</sup> 254 F.3d 1014 (11th Cir. 2001).

insurance company that was owned by the UPS shareholders. The Tax Court held for the IRS, relying on some murky combination of the sham and economic substance doctrines and factual findings that the restructuring of the EVC program had no defensible business purpose.

The Eleventh Circuit reversed in favor of the taxpayer, holding that the restructuring should be respected for tax purposes. The issue before the court was whether the EVC restructuring had the kind of economic substance that removes it from “sham-hood.” Given how the issue was presented, the court proceeded with an analysis of the transaction under the economic substance doctrine to determine (1) whether it had “economic effects other than the creation of tax avoidance,” and (2) whether it had “no business purpose and its motive is tax avoidance.” The restructuring had the necessary “economic effects” because UPS was obligated to pay the unrelated insurer and the insurer could proceed against UPS if the insurer defaulted. The insurer also bore the risk of default by the Bermuda company on its obligations under the reinsurance treaty. The restructuring had the necessary business purpose because, “when we are talking about a going concern like UPS,” the transaction has a business purpose “as long as it figures in a bona fide, profit-seeking business.” The court compared the EVC restructuring to a corporation’s choice between debt and equity; that is, a taxpayer does not lack a business purpose when it chooses between “different ways of financing a business.” The court distinguished the business purpose analysis that is applied to individual tax shelters or those corporate tax shelters such as in *ACM P’ship*<sup>27</sup> where the transactions “would not have occurred, in any form, but for tax avoidance reasons.”

The IRS in recent years also has discouraged use of the economic substance doctrine in cases where it is more appropriate to analyze the transaction under substance-over-form principles. For example, in Rev. Rul. 99-14,<sup>28</sup> the IRS ruled that a “lease-in/lease-out” or so-called LILO transaction should be disregarded on the grounds that it lacked economic substance. In a LILO transaction, a tax-exempt entity leases property to a U.S. taxpayer for a period of years and the U.S. taxpayer leases the property back to the tax-exempt entity for a lesser period of years. The obligations of the tax-exempt entity to pay rent as well as to exercise a purchase option at the end of the sublease term are economically defeased. The transaction is designed to provide the U.S. taxpayer an immediate and substantial rent deduction while deferring rent income. The IRS later acknowledged that the economic substance doctrine was inappropriate because the U.S. taxpayer actually earns a modest pre-tax profit from engaging in the transaction. As a result, the IRS issued Rev. Rul. 2002-69,<sup>29</sup> which relies on a more traditional substance-over-form analysis to challenge the transaction and supersedes Rev. Rul. 99-14.

## **STEP TRANSACTION DOCTRINE IN OTHER CONTEXTS**

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<sup>27</sup> *ACM P’ship v. Comm’r.*, 157 F.3d 231 (3d Cir. 1998), *aff’g, rev’g, and rem’g* 73 T.C.M. 2189 (1997).

<sup>28</sup> 1999-13 I.R.B. 3, *superseded* by Rev. Rul. 2002-69, 2002-44 I.R.B. 760.

<sup>29</sup> 2002-44 I.R.B. 760.

The step transaction doctrine treats a series of formally separate steps as a single transaction if the steps are in substance integrated and focused toward a particular result. The courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular transaction, namely the “end result” test, the “mutual interdependence” test, and the “binding commitment” test.<sup>30</sup> The cases need to be analyzed carefully to understand the particular circumstances in which this doctrine should be applied. It is not enough in a given case to simply cite the general principles and then claim that a particular step taken by the taxpayer should be ignored because it occurred closely in time to another step, or it does not have economic justification, or that the taxpayer could have structured the transaction a different way.

Unfortunately, the courts and the IRS have not delineated the particular circumstances in which the step transaction doctrine is applicable. Its application in simple cases is obvious. For example, if a corporation acquires stock of a target corporation in a purported tax-free “B” reorganization and then immediately liquidates the target pursuant to a prearranged plan, it is well accepted that the intermediate steps of acquiring target stock and then liquidating the target will be ignored and the transaction will be viewed as an acquisition of target’s assets for purposes of determining whether the transaction qualifies as a tax-free reorganization.<sup>31</sup>

In other cases, the steps taken are respected as having occurred, but may not have the effect under the tax laws intended by the taxpayer if the step transaction doctrine is applied. For example, if B and C transfer property to Newco in exchange for all of Newco’s stock in a purported § 351 transaction and then, pursuant to a binding contract, sell a portion of the Newco stock to a third party in a taxable sale that results in B and C owning less than 80% of Newco stock, B and C will still be treated as having transferred property to Newco for stock and then selling that stock in a taxable sale. However, the requirement under the Code that B and C acquire “control” of Newco will not be satisfied and, therefore, B’s and C’s transfer of property to Newco will be taxable.<sup>32</sup>

When faced with a more complex transaction such as the one in *Long Term Capital Holdings*, it is helpful to first understand when the application of the step transaction doctrine is inappropriate. The IRS generally is prohibited from substituting steps for the steps actually consummated or resequencing steps under the guise of the step transaction doctrine where the steps taken have enduring economic consequences. Where there are two ways to achieve a particular transaction, one being tax favorable and the other being tax adverse, the courts will not apply the step transaction doctrine to “generate events which never took place just so additional tax liability may be asserted.”<sup>33</sup> Nor will the courts resequence steps in a way more burdensome

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<sup>30</sup> See *Penrod v. Comm’r.*, 88 T.C. 1415, 1428-30 (1987).

<sup>31</sup> E.g., Rev. Rul. 67-274, 1967-2 C.B. 141.

<sup>32</sup> E.g., Rev. Rul. 79-70, 1979-1 C.B. 144.

<sup>33</sup> See *Grove v. Comm’r.*, 490 F.2d 241 (2d Cir. 1973).

from a tax perspective (e.g., IRS treating taxpayer's second step as occurring before the first step) unless the particular steps taken by the taxpayer are "meaningless or unnecessary."<sup>34</sup>

These principles are well illustrated by the transaction in *Comm'r. v. Gilmore Est.*<sup>35</sup> In that case, a holding company was merged into its 51%-owned subsidiary because the shareholders desired to eliminate the holding company. The shareholders claimed that the surrender of their holding company shares for subsidiary shares was a tax-free exchange pursuant to an "A" reorganization. The IRS argued that since the transaction had the same economic effect as a liquidation of the holding company, the transaction should be treated as if the holding company had distributed its subsidiary stock to its shareholders in a taxable liquidation, since the taxpayer did not have a business purpose for the method chosen. The court refused to recharacterize the transaction and it held for the taxpayers, stating:

We think this gets down to the proposition that if there are two ways of accomplishing a legitimate business result, one of which clearly creates a taxable transaction, one is equally subject to liability if he chooses the other unless there is an adequate reason for the particular method used. We do not think this is the rule of the statute, the Regulations, nor, as we read them, the decisions.<sup>36</sup>

In *Esmark v. Comm'r.*, Mobil wanted to acquire Vickers, a subsidiary of Esmark. If Esmark just sold Vickers to Mobil for cash, Esmark would recognize taxable gain. However, Esmark would avoid recognizing taxable gain under the Code if Vickers were transferred to an Esmark shareholder pursuant to a redemption of the shareholder's stock. In order to permit Esmark to rely on the favorable Code provision, Mobil acquired 54% of Esmark's stock through a cash tender offer. Immediately thereafter, Esmark redeemed Mobil's Esmark shares by transferring Vickers to Mobil. The IRS argued that, under the step transaction doctrine, the transaction should be recharacterized as if Esmark sold Vickers to Esmark for cash and then used the cash to purchase the tendered shares from the shareholders. The Tax Court faulted the IRS for not respecting Mobil's purchase of Esmark stock from Esmark shareholders, and held for the taxpayer. That transaction was meaningfully different from a corporate and legal perspective than a tender offer made by Esmark. While the overall plan of Esmark and Mobil to achieve a favorable tax result was not in dispute, the IRS "pointed to no meaningless or unnecessary steps that should be ignored."<sup>37</sup>

It is relatively rare for a transfer of property to either a corporation or partnership followed by a prearranged transfer of the corporate stock or partnership interest to a third party to be

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<sup>34</sup> *Esmark, Inc. v. Comm'r.*, 90 T. C. 171 (1988), *aff'd in unpub. opin.*, 886 F.2d 1318 (7th Cir. 1989); *Turner Broad. Sys. Inc. v. Comm'r.*, 111 T.C. 315 (1998).

<sup>35</sup> 130 F.2d 791 (3d Cir. 1942), *acq.*, 1946-2 C.B. 2.

<sup>36</sup> *Id.*

<sup>37</sup> *Esmark, Inc. v. Comm'r.*, 90 T.C. 171, 195 (1988).

recharacterized as if the property had been sold directly to the third party followed by the third party's contribution of the property to the corporation or partnership, at least where the transferor retains a meaningful interest in the corporation or partnership. The IRS has prevailed in having such a recharacterization adopted in a few cases where the transferor retained no direct interest in the transferee entity (although the transferor received stock in the acquiring entity), such entity was subsequently liquidated by the entity acquiring the transferee entity, and there was no purpose other than tax avoidance for the transferee entity's formation.<sup>38</sup> Recently, the IRS effectively ruled that it would take that position only in a situation where the initial transfer of property to a transferee corporation is needed in order to ensure the tax-free treatment of the subsequent transfer of the transferee corporation stock to the acquiring corporation in exchange for stock of the acquiring corporation; otherwise, the initial transfer of property to the transferee corporation would be respected even if there is a binding contract to transfer stock in the transferee corporation for stock of the acquiring corporation.<sup>39</sup>

In addition, it is generally accepted that parties forming a partnership have a great deal of flexibility in structuring the transaction. Assume B desires to contribute property to a partnership in which B and C share 50/50, and receive cash for 50% of the property's value. If B contributed property to the partnership and C contributed cash equal to 50% of the property's value and the cash was immediately distributed to B, B would be treated as having sold 50% of the property to the partnership and contributed the other 50%. Alternatively, B could first sell 50% of the property to C for cash and then each could transfer a 50% interest in the property to the partnership, and that transaction would be respected as such.<sup>40</sup>

On the other hand, if a taxpayer transfers property to a corporation or partnership and then sells the stock or partnership interest to a third party for cash or other non-equity consideration, and retains no direct or indirect equity interest in the transferred property, the authorities that provide flexibility in choosing how to organize a corporation or partnership are not applicable on their face. In that case, the real question is whether the transferor ever acquired an ownership interest in the transferee entity. The court's recasting of the transaction in *Long Term Capital Holdings* as a taxable sale by the contributing partner directly to the other partner might have been more persuasive had the court engaged in a pure tax ownership analysis rather than an application of the step transaction doctrine.

## **IMPACT OF THE *BLACK & DECKER* DECISION**

The *Black & Decker* case involved a contingent liability transaction that is described in Notice 2001-17<sup>41</sup> as a listed transaction and was the subject of a settlement initiative in the fall of

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<sup>38</sup> *West Coast Mktg. Corp. v. Comm'r.*, 46 T.C. 32 (1966).

<sup>39</sup> Rev. Rul. 2003-51, 2003-21 I.R.B. 938.

<sup>40</sup> Cf. Regs. § 1.197-2(k), Exs. 17, 18, and 19.

<sup>41</sup> 2001-9 I.R.B. 730. See also Notice 2004-67, 2004-41 I.R.B. 600, which includes this transaction as a listed transaction on the updated list of listed transactions.

2002.<sup>42</sup> In 1998, Black & Decker (B&D) sold three of its businesses, realizing significant capital gains. That same year, B&D transferred \$561 million in cash along with \$560 million in contingent employee healthcare claims to a newly formed subsidiary in exchange for stock. B&D then sold the stock to an independent third party for \$1 million and claimed a capital loss of \$560 million. It was undisputed that the subsidiary became responsible for managing and servicing the healthcare claims of B&D employees through the efforts of its own salaried employees and that the claims were paid with the subsidiary's assets. The government argued that the transaction was a tax-avoidance vehicle that must be disregarded for tax purposes, and asserted \$41 million in accuracy-related penalties.<sup>43</sup> Apparently, the government did not contend, as it did in *Long Term Capital Holdings*, that B&D's transfer of property and liabilities to the subsidiary followed by a sale of the subsidiary stock to a third party should be recharacterized under the step transaction doctrine as a sale of the property and liabilities directly to the third party followed by that party's contribution of the same to the subsidiary.

The U.S. District Court for the District of Maryland ruled for the taxpayer on its motion for summary judgment. For this purpose, B&D conceded that "tax evasion" was its sole motivation. (The record was later corrected to reflect that B&D meant "tax avoidance.") In applying the two-pronged test in *Rice's Toyota World v. Comm'r.*<sup>44</sup> to determine whether the transaction should be treated as a sham, the court acknowledged that the "business purpose" prong was not met in light of the taxpayer's concession. The second prong was described as an examination of the transaction's "objective reasonableness," which looks to whether "the corporations engages in bona fide economically-based business transactions," without a citation to the *Northern Indiana* case. The court held that on the basis of the undisputed evidence, the transaction "had very real economic implications for every beneficiary of B&D's employee benefits program, as well as for the parties to the transaction," and, therefore, could not be disregarded as a sham.

The contrast between the three-page decision in *Black & Decker* and the exhaustive, nearly 100-page decision in *Long-Term Capital Holdings* is indeed striking. The *Black & Decker* court engaged in no analysis of the pre-tax profit potential relative to the tax benefits. It concluded, as a matter of law, that the transaction engaged in by B&D and its subsidiary had real economic consequences. This approach resembles the approach taken in other cases where the transaction

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<sup>42</sup> Rev. Proc. 2002-67, 2002-43 I.R.B. 733.

<sup>43</sup> On Aug. 3, 2004, the government's motion for summary judgment on statutory grounds was denied. The government argued that the assumed liabilities may not be excluded under §§ 357(c)(3)(A) and 358(d)(2) on the grounds that the related expenses are the transferor's business expenses and should not be deductible by the transferee. The court found no support in the legislative history to § 357(c) for such interpretation, and concluded that the IRS's own revenue ruling, Rev. Rul. 95-74, 1995-2 C.B. 36, focused on the *transferor's* deductibility when applying § 357(c)(3)(A). See also Chief Counsel's Notice CC-2001-033a, which describes the government's position.

<sup>44</sup> 752 F.2d 89 (4th Cir. 1985).

engaged in by the taxpayer was closely connected with the taxpayer's ongoing business operations, such as *United Parcel Serv.*, *Northern Indiana*, and *Kraft*. In fact, the court's citation to *Northern Indiana* is a fairly clear indication that the court put this transaction in the category of a transaction that carries out the business of the taxpayer.

## CONCLUSION

The most difficult question for any court when analyzing a particular tax shelter is the first one: Will the transaction be tested under the rigorous version of the economic substance test as illustrated by *Long Term Capital Holdings* or the more lenient version of the economic substance test as illustrated by *Black & Decker* and *United Parcel Serv.*<sup>45</sup> Once that decision is made, it seems as though the court ends up being driven to a particular result, with the more rigorous approach resulting in a government victory and the more lenient approach resulting in a taxpayer victory. As long as there is no clearly established jurisprudence for placing a particular transaction in one category or the other, it may be wishful thinking on the government's part to conclude that any particular shelter with some connection to the taxpayer's business is in the bag.

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<sup>45</sup> In footnote 89 of the *Long Term Capital Holding* decision, the court distinguished the OTC investment from the transactions in *United Parcel Serv.* The OTC investment "was a one-time purchase of a tax product by Long Term and different in almost every way from Long Term's core investment business."