NO. 13-1037

In The
Supreme Court of the United States

WFC HOLDINGS CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNTIED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF CENTER FOR THE FAIR ADMINISTRATION OF TAXES AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether an objectively profitable transaction can be disregarded for tax purposes under the judge-made economic substance doctrine because it was structured to achieve income tax deductions authorized by the plain language of the Code.

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INTEREST OF *AMICUS*

This *amicus* brief is being filed with the written consent of Respondent and pursuant to Petitioner's blanket consent to the filing of briefs as *amicus curiae.*

Amicus Center for the Fair Administration of Taxes ("CFAT") is a section 501(c)(3) non-profit organization seeking to promote fairness in the administration of the tax laws to taxpayers as a whole. Currently, the primary means utilized to achieve this goal is through the filing of briefs as *amicus curiae* in tax-related cases throughout the United States. CFAT works jointly with the Chapman University School of Law Appellate Tax Clinic, offering law students the opportunity to assist in the preparation of the *amicus curiae* briefs filed by CFAT. A. Lavar Taylor, the Director for CFAT and Adjunct Professor of Law at Chapman Law School, has over 32 years of experience in the handling of civil and criminal tax controversies, both in government and in private practice.[1]

The present case offers this Court the opportunity to resolve a clear split among the Circuit Courts of Appeal on an important issue of tax law, namely, under what circumstances can the Internal Revenue Service ("IRS") "recast" a transaction under the economic substance doctrine to deny a

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[1] No person other than the named *amicus* or their counsel authored this brief or provided financial support for this brief.

taxpayer the tax benefits associated with a transaction that, as structured, satisfies the prerequisites for obtaining those tax benefits under the Internal Revenue Code. The split in the Courts of Appeal has resulted in a lack of horizontal equity among taxpayers and thus is particularly detrimental to the fair administration of the tax laws.

Just as important, however, is the fact that the rule of law followed by the Eighth Circuit below tips the scale too far in favor of the tax authorities by giving them too much power to recast a transaction which complies with all requirements of the Tax Code. While no one disputes that the IRS should have the authority to recast a transaction for income tax purposes when that transaction is completely devoid of economic substance, the IRS ought not to have that authority in situations where there is economic substance to the transaction, notwithstanding the fact that tax savings was a motivating factor in structuring the transaction.

The Eighth Circuit's holding improperly empowers the IRS to recast a transaction for tax purposes where a taxpayer has suffered a true economic loss and thereafter engages in a transaction which yields real economic effects, merely because the form of the transaction was designed to facilitate turning the economic loss into a tax loss. This holding thus casts a cloud over what can rightfully be characterized as legitimate tax planning, which in turn creates difficulties for both tax professionals and their clients.

SUMMARY OF ARGUMENT

This Court should grant certiorari in this case to resolve a well-established split among the Circuit Courts of Appeal. The disparate treatment of similarly situated taxpayers is untenable. The issue presented in this case is important and affects a large number of taxpayers.

The holding of the Eighth Circuit improperly grants the IRS power to recast a transaction for tax purposes where that transaction has economic substance outside of the Tax Code. This point is illustrated by applying the Eight Circuit's test to some very simple fact patterns. The Eighth Circuit made important errors in its opinion below.

The enactment of section 7701(o) of the Code in 2010 does not eliminate the need for this Court to resolve the split in the Courts of Appeal. That section was very poorly drafted. A ruling by this Court in the present case will help bring clarity to what is a very confusing situation, in addition to eliminating a lack of horizontal equity for similarly situated taxpayers.

ARGUMENT

I. This Court Should Grant Review Because There is a Well-Established Split Among the Circuit Courts of Appeal on an Important Legal Issue Which Adversely Affects the Fair Administration of the Tax Laws

The question of when the IRS (and courts) may use the economic substance doctrine to recast a transaction for tax purposes to deny the tax benefits associated with that transaction is important. Taxpayers need to understand the circumstances under which transactions can be effectively recast by taxing authorities so that they can hopefully avoid having their transactions recast to deny them their statutory tax benefits. Tax advisors likewise need to understand these circumstances so that they can properly advise their client and can avoid the personal consequences of giving incorrect advice.

Circuit Courts of Appeal hopelessly disagree over the legal test to be used in deciding whether a transaction should be recast for income tax purposes. The Eighth Circuit below acknowledged this point in footnote 3 of its opinion.

These conflicting opinions all purport to apply the same test applied by this Court in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), in which this Court held that

> where, as here, there is a genuine multiple-party transaction with economic substance which is compelled

> or encouraged by business or regulatory realities, 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.

435 U.S. at 583-584.

Since that time, some Courts of Appeal have held that *either* the existence of economic substance regarding a transaction *or* a valid business purpose for a transaction requires the IRS and Courts to honor the transaction for tax purposes. *See, e.g., Horn v. Commissioner*, 968 F.2d 1229, 1236–1238 (D.C. Cir. 1992). Other Courts of Appeal permit the IRS to recast a transaction for tax purposes unless the taxpayer can show *both* a valid business purpose for the transaction *and* that the transaction has economic substance. *See, e.g., Dow Chemical Co. v. United States,* 435 F.3d 594 (6th Cir. 2006).

The difference between these two approaches is significant. Under the former approach, if a transaction has economic substance, then the fact that the transaction and/or the form of the transaction was motivated by tax considerations is irrelevant. Under this test, a taxpayer may thus claim the tax benefits associated with a particular transaction that is "real" from an economic perspective, even if the tax savings were the primary motive for entering into a transaction. Notably, this result is consistent with the statement in *Frank*

Lyon that the desire of the parties to a transaction to achieve a particular tax result is not necessarily relevant to applying the economic substance test. 435 U.S. at 573.

Under the approach that favors the IRS, a non-tax business purpose must motivate the transaction, even if the transaction has economic substance, or else the IRS may recast the transaction for tax purposes, thus denying the associated tax benefits. This test poses significant problems for taxpayers and their advisors.

Regardless of which test is the proper test, it is intolerable to have two different rules governing identically situated taxpayers based on the geographic location of the taxpayer. District Courts will of course follow the law of the Circuit to which any appeal would be taken.

The Tax Court, however, is a national court and will therefore normally issue consistent rulings on a particular issue, regardless of where the taxpayer is located. But the Tax Court follows the decisions of the Court of Appeals to which venue on appeal lies in each particular case. See 26 U.S.C. §7482(b), *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). Thus, in cases brought in the Tax Court, identically situated taxpayers who reside in different Circuits will be treated differently, depending on which test is used by the Court of Appeals for the Circuit in which the taxpayer is located.

One of the linchpins of fairness in the administration of the tax laws is that similarly situated taxpayers should be treated similarly under the tax laws. A failure to treat similarly situated taxpayers similarly under the law undermines the foundation of voluntary compliance, on which our tax system is built. This Court should grant review in this case to alleviate this problem.

The importance of establishing a uniform standard governing the ability of the IRS to recast a transaction for income tax purposes cannot be overstated. Under the economic substance doctrine, virtually every for-profit or business transaction entered into by taxpayers can potentially be examined a recast for tax purposes by the IRS, provided that the transaction affects the taxpayer's income tax liabilities. Thus, most taxpayers have a stake in the resolution of this issue. Not only does this case present an opportunity for this Court to alleviate horizontal inequity in the administrative of the tax laws, but this case also presents an opportunity for this Court to resolve an issue of utmost importance that potentially affects a large number of taxpayers.

II. The Holding of the Eighth Circuit Improperly Grants the IRS Unfettered Power to Recast a Transaction for Tax Purposes Where That Transaction has Economic Substance

The Eighth Circuit's opinion below states that the Court did not decide the question of whether taxpayers must show both that the transaction in question had economic substance and that the transaction was motivated by a meaningful non-tax purpose in order to prevent the IRS and the courts from recasting a transaction. The Eighth Circuit held that the transaction in question both lacked economic substance and was not motivated by a meaningful non-tax purpose.

But the Eighth Circuit defined "economic substance" by looking only to whether a transaction, or series of related transactions, yielded a profit. This was error, as is illustrated by the following hypothetical.

Suppose a taxpayer buys a parcel of real property with an eye towards selling it for a profit based on anticipated appreciation or with an eye towards possible commercial development of the property. Years go by, and, due to unanticipated circumstances, the property significantly declines in value. The taxpayer becomes indifferent as to whether this real property should be kept or sold to a third party.

The taxpayer then incurs a large gain in an unrelated transaction early in a particular tax year

and realizes that a sale of the undeveloped property will produce a loss which will completely offset the gain from the unrelated transaction, thereby allowing the taxpayer to avoid paying tax on the gain generated by the unrelated transaction. The only reason the taxpayer is selling the undeveloped real property is to generate a tax loss for the purpose of "sheltering" an unrelated tax gain. The property is then sold, and the taxpayer files a tax return claiming the loss from the sale of the property.

Under a literal application of the Eighth Circuit's economic substance test, the loss from the sale of the undeveloped property cannot be claimed on the taxpayer's tax return, even though there is economic reality to the sale of the property. Because the sale of the property was motivated primarily, if not exclusively, by tax considerations, and there was no way that the sale of the property could have ever generated a profit, the loss from the sale of the property should not be allowed for income tax purposes under literal application of the Eighth Circuit's test. Such a result follows under a literal application of the Eighth Circuit's test, even though there was an economic loss suffered and even though there was economic reality to the sale of the property.

Disallowance of the loss from the sale of the property in this fact pattern based on the economic substance doctrine is of course absurd. The IRS will likely proclaim that they would never think of challenging a tax loss sustained under this fact pattern based on the economic substance doctrine.

But any such proclamation would highlight the fact that the Eighth Circuit's economic substance test is functionally useless in certain fact patterns, such as the stated hypothetical, where a taxpayer legitimately turns an economic loss into a tax loss based on the provisions of the Tax Code.

It is inappropriate to use an "economic substance" test that, by its nature, is incapable of being applied to all transactions, and to all taxpayers, equally. Use of a test that is incapable of being applied to all transaction and to all taxpayers equally bestows a vast, unchecked power on the IRS to recast a transaction for tax purposes based on the whims of the IRS, whenever the IRS believes that it is "not appropriate" to apply the test to a particular fact pattern. Such unrestrained power to recast (or not) a transaction for income tax purposes is not what this Court contemplated in its ruling in *Frank Lyon.*

Giving the IRS such unrestrained power makes it impossible for taxpayers to predict when the IRS might seek to recast a transaction for tax purposes and makes it impossible for tax professionals to advise their clients on when the IRS might seek to recast a transaction for tax purposes. Tax planners have it difficult enough, even with an economic substance rule that can logically be applied to all situations and all taxpayers equally. They must structure a transaction knowing that the IRS has the power to recast the transaction for tax purposes if the transaction fails the economic substance test. Yet if tax planners seek to recast the

transaction themselves, they are typically "stuck" with the form of their own transaction. *See, e.g., Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009).

Taxpayers and their advisers need a predictable rule that can be used in the real world. They need a rule that does not, on its face, apply to a number of legitimate transactions that should not be recast for tax purposes, requiring that the IRS disregard the rule in certain situations for reasons the IRS cannot articulate, other than to state that application of the rule to that transaction "does not make sense." A rule that depends on the nearly unfettered discretion of the Tax Man is no rule at all.

Consider what happened in the present case, per the Petitioner. Wells Fargo, when it merged with First Interstate Bank, grossly underestimated the amount of "underwater" leases held by First Interstate Bank. Thus, Wells Fargo suffered a very real economic loss. What happened thereafter was designed to turn a very real economic loss into a tax loss. Leases, along with marketable securities were transferred to a subsidiary in return for stock. Those transactions were real. Ultimately stock in the subsidiary was sold to an independent third party, Lehman Brothers, for fair market value, thereby surrendering a portion of the ownership of the stock of the subsidiary. These transactions were all "real." No one engaged in transactions that had no "economic reality" that did not change the positions of the parties. In addition, millions of dollars in profit were generated after the leases were transferred to the subsidiary.

Of course, if things really did not happen as WFC says they did, a point on which *amicus* takes no position, then WFC may not get the tax benefits associated with the transacted as structured. But the Eighth Circuit did not base its holding on the premise that things did not happen as represented by Petitioner.

Per the Eighth Circuit, pursuing the plan described in its opinion was not proper because the plan was motivated by tax considerations and because the plan was not capable of producing a profit. *Amicus* has already explained why it is that a transaction need not be designed to produce a profit in order to have "economic substance." *Amicus* now explains why it is that economic substance doctrine should not concern itself with the fact that a taxpayer was motivated to enter into a transaction to save taxes but instead should focus on how the taxpayer attempts to save taxes through the transaction in question.

The Eighth Circuit erred in concluding that a transaction that is motivated primarily, or even exclusively, by tax considerations can be recast by the IRS under the economic substance doctrine solely because of such a motivation. Under a proper application of the economic substance doctrine, the question of whether the transaction in question was motivated by tax considerations is not necessarily relevant. *See Frank Lyon Co., supra*, 435 U.S. at 573.

Thus, in *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006), the taxpayer

conceded for purposes of its summary judgment motion that the motivation for entering into the transaction in question was to save taxes. The taxpayer won its summary judgment as to whether the economic substance doctrine allowed the IRS to recast the transaction for tax purposes. On appeal, the taxpayer's concession did not doom the taxpayer's case, per the Fourth Circuit.

The Fourth Circuit went on to opine that the relevant question for purposes of the economic substance test was whether there was "economically substantial value to Taxpayer in transferring its contingent liability" to a subsidiary. The fact that the transaction was motivated by tax considerations did not matter. 436 F.2d at 442. Because there were material disputed issues of fact which bore on the question of whether there was economically substantial value, however, the Fourth Circuit reversed a grant of summary judgment in the taxpayer's favor and remanded the case for trial.

The Fourth Circuit's conclusion that the taxpayer's concession regarding its motivation for entering into the transaction did not prevent the taxpayer from prevailing on the economic substance issue was the proper conclusion. The fact that someone enters into a transaction solely to save taxes does not, *ipso facto*, deprive a transaction which is economically substantive of all of its economic substance.

Furthermore, where a taxpayer has multiple motives for entering into a transaction, ascertaining the various motives, along with the comparative

strengths of those motives, is a task that will typically be fraught with difficulty. Taxpayers can do things for many reasons, some of which may make sense and some of which, at least in retrospect, make no sense. It is far more appropriate to focus on the substance of the transaction than on the motive for entering into the transaction.

Finally, the Eighth Circuit commented that, because it was possible to achieve the profits achieved Petitioner by means other than the "tax-friendly" means actually used, it was inappropriate to use the "tax friendly" transaction to achieve those profits. See App.17a. Such a rule places tax planners in an untenable position. It forces them to disregard tax-effective strategies in favor of strategies that cost their client more money in taxes. The economic substance doctrine was never intended to goad tax planners into "reverse tax planning," where they seek to *avoid* tax-friendly strategies.

III. The Enactment of §7701(o) of the Code Does Not Eliminate the Need for This Court to Resolve the Split in the Courts of Appeal

In 2010, Congress enacted section 7701(o) of the Internal Revenue Code, which "codified" the economic substance doctrine in tax cases, effective for transactions occurring on or after March 30, 2010. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(e)(1), 124 Stat. 1029, 1070.

This statute provides in part as follows:

(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.

(2) Special rule where taxpayer relies on profit potential

(A) In general

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.

* * * * * *

(4) Financial accounting benefits

For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) Definitions and special rules

For purposes of this subsection—

(A) Economic substance doctrine

The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) Exception for personal transactions of individuals

> In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.
>
> (C) Determination of application of doctrine not affected
>
> The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.
>
> (D) Transaction
>
> The term "transaction" includes a series of transactions.

The enactment of this statute does not obviate the need for this Court to resolve the split in the Circuit Courts of Appeal. First, there are numerous cases which are not affected by this legislation. Second, the meaning of this statute is far from clear. The statute contains internal contradictions. For example, the statute states that "the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted." Thus, courts must look at the case law for the periods not covered by the legislation to determine whether the economic substance doctrine is relevant to the resolution of the case.

But this case law was in disarray as of the date of enactment. Determining whether the economic substance doctrine is "relevant" to the resolution of a case depends on which cases are consulted.

At the same time, the statute provides that, if the economic substance doctrine is "relevant" to the resolution of a case, a taxpayer must establish that the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and that the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction to avoid having the transaction recast for income tax purposes. These two requirements are similar, but not identical to, the requirements adopted by some (but not all) of the courts which had addressed the economic substance doctrine as of the date of the enactment of the statute.

The first requirement is straightforward and needs no explanation. The second requirement, however, merits a comment. The second requirement does not require a *business* purpose but merely requires a "substantial purpose" of some kind. This is different from the existing case law. How the IRS and the courts will resolve the tension between the need to consult *all* prior case law to determine whether the economic substance doctrine is "relevant" and the need to resolve cases using a modified two prong approach that is similar (but not identical) to the test used only by some courts remains to be seen.

The statute also has no formal legislative history. The only "legislative history" is the post-enactment "Blue Book" report issued by the Joint Committee on Taxation. *See* Technical Explanation of the Revenue Provisions Contained in H.R. 3962, the "Affordable Health Care for America Act," as Amended (Jt. Comm. Print 2010), at pp. 80-95. This Court, however, has recently indicated that these "Blue Books" do not carry any weight in the context of construing the intent of Congress. *See United States v. Woods*, 134 S. Ct. 557, 568 (2013).

The IRS issued an internal directive on July 15, 2011 stating that application of the economic substance doctrine under section 7701(o) would probably not be appropriate to the following types of transactions:

a) The choice between capitalizing a business enterprise with debt or equity;

b) A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;

c) The choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and

d) The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied. *See* Guidance for Examiners and Managers on the Codified Economic Substance

Doctrine and Related Penalties (July 15, 2011) available at http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties (last viewed March 31, 2014).

Notably, the statute itself contains no exception for these types of transactions. Thus, what is happening is that the IRS is applying unfettered discretion to effectively exempt certain types of transactions from a rule of broad application which has no stated exceptions. This is similar to the problem being experienced in applying the economic substance test used by the Eighth Circuit below. Additional problems of this nature will proliferate as the courts attempt to grapple with what is a confusing and poorly conceived statute.

This Court, by granting review in this case, can bring some order to what has been, and will otherwise continue to be, a chaotic situation which grants the IRS too much unfettered power to recast transactions for tax purpose and which is detrimental to the fair administration of the tax laws. Such order will prove helpful for both pre-enactment and post-enactment transactions.

CONCLUSION

This case presents an excellent opportunity for this Court to eliminate a significant amount of horizontal inequity amongst taxpayers. In addition, this case presents an opportunity for this Court to

speak on the issue of the economic substance doctrine in a manner that will materially advance future case law development, notwithstanding the enactment of section 7701(o) of the Code. In speaking on this issue, the Court will have an opportunity to establish an economic substance test that is fair to the IRS, taxpayers and tax advisors, one which prevents the IRS from having almost unfettered discretion to recast a transaction for tax purposes. For the reasons set forth herein, *amicus* respectfully urges that the petition for *certiorari* be granted in this case.

Respectfully submitted,

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