No. 13-1037

IN THE

Supreme Court of the United States

WFC HOLDINGS CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA.
Respondent.

On Writ of Certiorari to
the United States Court of Appeals
for the Eighth Circuit

BRIEF OF GIVNER & KAYE, APC AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

BRUCE GIVNER*
NEDA BARKHORDAR
GIVNER & KAYE, APC
12100 Wilshire Blvd,
Suite 445
Los Angeles, CA 90025
(310) 207-8008
Bruce@GivnerKaye.com

*Counsel of Record

Counsel for Amicus Curiae

March 31, 2014

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES

REVENUE RULINGS

STATUTES AND REGULATIONS

Internal Revenue Code (26 U.S.C.):

ADMINISTRATIVE MATERIALS

Page

OTHER MATERIALS

INTEREST OF AMICUS CURIAE[1]

Givner & Kaye, A Professional Corporation ("Givner & Kaye") is a private law firm that represents individuals and closely held businesses in the area of tax law. Givner & Kaye regularly advises individuals and small businesses on how to plan their affairs in a tax efficient way within the boundaries of the Internal Revenue Code ("IRC").

In this case, the Eighth Circuit ruled that an economically profitable lease restructuring transaction that complied with the IRC lacked economic substance. In reaching its conclusion, the court adopted an unprecedented and sweeping version of the judicially created economic substance doctrine. In light of the number of business transactions that fall within the realm of the economic substance doctrine and the strict liability penalty that apply if a taxpayer misjudges its uncertain requirements, Givner & Kaye, has a direct and substantial interest in determining *how* and *when* the economic substance doctrine should apply. Taxpayers, practitioners and judges would benefit from clarity and finality of the Court's guidance in what is an otherwise unpredictable area of tax law.

This brief is filed with the written consent of all parties pursuant to this Court's Rule 37.2(a). Copies

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[1] No counsel for any party has authored this brief in whole or in part, and no party or counsel for a party has made a monetary contribution to the preparation or submission of this brief. All parties have been timely notified of the undersigned's intent to file this brief; both Petitioner and Respondent have consented to the filing of this brief. Petitioner's written consent for the submission of this brief is on file with the Clerk of the Court. A letter of consent from Respondent accompanies this brief.

of the requisite consent letters have been filed with the Clerk.

SUMMARY OF ARGUMENT

The correct application and interpretation of the economic substance doctrine is critical to the future of legitimate tax planning by individuals and small businesses, which constitute the core of amicus's clientele. Although the Eighth Circuit's decision deals with a large corporate taxpayer, its sweeping interpretation of the economic substance doctrine equally jeopardizes legitimate estate planning techniques commonly used by individuals. The Court should grant certiorari because that decision, if left unreviewed, will deter individuals and small businesses from engaging in valid business transactions and will make it extremely difficult for tax advisors and practitioners to advise such clients about the risks associated with such transactions.

The Eighth Circuit, in clear violation of the two fundamental principles established by this Court in *Gregory v. Helvering*,[2] 293 U.S. 465 (1935) and *Knetsch v. United States*, 364 U.S. 361 (1960),[3] held that a business transaction generating millions of dollars in profit lacked economic substance because the taxpayer structured the transaction to achieve efficient tax results. This decision unjustifiably allows the courts and IRS to use the economic substance doctrine as a sword to attack legitimate and

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[2] *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) established the principle that it is "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

[3] *Knetsch v. United States*, 364 U.S. 361, 366 (1960) established the principle that the economic substance doctrine applies only where "there is nothing of substance to be realized by [the taxpayer] from the[e] transaction beyond a tax deduction."

tax-efficient business transactions commonly employed by individuals and closely held businesses. This decision, if upheld, will hinder, if not prevent, legitimate business planning due to the increased tax risk.

Further, the Eighth Circuit's decision will, if unreviewed, severely impair tax planning because the codified economic substance doctrine relies on prior case law to determine *when* and *how* the doctrine could apply.[4] The current state of uncertainty about the scope of the codified economic substance doctrine along with the onerous strict liability penalties created by the IRC amplifies the need for the Court's guidance in this case.

ARGUMENT

I. A PROFITABLE TRANSACTION WITH ANY MEANINGFUL ECONOMIC EFFECT CANNOT LACK ECONOMIC SUBSTANCE, EVEN IF TAX PLANNING IS A MAJOR MOTIVE.

The Eighth Circuit has improperly broadened and applied the economic substance doctrine to reach a conclusion that is irreconcilable with the past 75 years of precedent established by this Court. It is a long-standing principle that the economic substance doctrine applies to disallow tax benefits only where "there was nothing of substance to be realized by [taxpayer] from this transaction beyond a tax deduc-

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[4] IRC § 7701(o)(5)(C) provides 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." *See also* Notice 2010-62: "The IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1)."

tion." *Knetsch v. United States*, 364 U.S. 361, 366 (1960).

In other words, if "as a practical matter those transactions ha[d] *any economic impact* outside of the creation of tax deductions," then the transactions had economic substance. *Massengill v. C.I.R.,* 876 F.2d 616, 619 (8th Cir. 1989) (emphasis added). In *Gregory v. Helvering*, 293, U.S. 465, 469 (1935), this Court held that a reorganization was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character… [A corporation] was brought into existence for *no other purpose* [than tax benefits] … When the limited function had been exercised, it immediately was put to death." *Id.* at 468-69 (emphasis added).

In this case, the lease restructuring transaction generated millions of dollars of profits and relieved taxpayer of a genuine and time-sensitive regulatory constraint. Further, in contrast to *Gregory v. Helvering*, 293 U.S. 465, (1935) the transaction was not consummated only to obtain tax benefits but also to generate inherent gains in the real estate leases that would otherwise be forgone due to the regulatory constraints. Lastly, once the tax benefits were realized the subsidiary set up to administer the leases was not "put to death," but continued many years thereafter for the taxpayer to reap the benefits of the less stringent regulations and generate millions of dollars in profits.[5] Therefore, the lease restructuring transaction that gave rise to a substan-

[5] For example, Charter entered into a ten-year lease extension for Garland in 2009, more than a decade after the transaction that generated more than $30,000,000 of additional profits as of the time of trial. See Pet. at 9 and Pet. App. 84a (citing A1871-72, (reproduced at Petitioner's App. 139a-140a)).

tial profit was not a "pure paper shuffle"[6] but has had a meaningful effect on the taxpayer's economic position.

Moreover, in reaching its decision, the Eighth Circuit inappropriately focused its attention on only one of the taxpayer's intents -to structure the transaction to achieve efficient tax results- instead of the economic realities of the whole transaction. This Court has made it clear, in multiple instances,[7] that the existence of a tax motive, even a "major motive to reduce taxes will not vitiate an otherwise substantial transaction" *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 455 (1950). However, the Eighth Circuit, misapplying the precedent of this Court, endorsed the district court finding that the generation of millions of dollars of profits and relief from regulatory constraints were "thin and tenuous" because the transaction was structured to achieve a tax efficient result. *WFC Holdings Corp. v. U.S.*, 728 F.3d 736, 747 (8th Cir. 2013).

The Eighth Circuit ignored the fact that most sophisticated and intelligent taxpayers *do* and *should* consider the tax implications of a transaction before to its execution. Judge Learned Hand, may have best expressed this proposition:

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[6] *Yosha v. Commissioner*, 861 F.2d 494, 497-98 (7th Cir. 1998) held that the "transfer of assets from one corporation owned wholly by … [taxpayer] to another newly created solely to be the vessel for the assets was a pure paper shuffle, having no potential consequences for the business in which the corporations engaged."

[7] *See United States v. Consumer Life Insurance Co.,* 430 U.S. 725, 739 (1977): "Tax considerations well may have had a good deal to do with the specific terms of the treaties, but even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction."

> "A transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade taxation. Any one may so arrange that his taxes shall be as low as possible, he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one's taxes…" *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

The same sentiment was echoed by this Court in *Gregory v. Helvering*, 293 U.S. 465 (1935): a taxpayer has the "legal right … to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits." Therefore, an economically profitable transaction with tax efficient results should not be found to lack economic substance.

II. THE EIGHTH CIRCUIT'S BROAD INTERPRETATION OF THE ECONOMIC SUBSTANCE DOCTRINE THREATENS LEGITIMATE AND TRADITIONALLY ACCEPTED BUSINESS PLANNING EMPLOYED BY INDIVIDUALS AND CLOSELY HELD BUSINESSES.

The Eighth Circuit's broad application of the economic substance doctrine combined with the doctrine's uncertain reach as codified in IRC §7701(o) unjustifiably increases the tax risk associated with common and legitimate business transactions and thereby discourages taxpayers from engaging in such transactions. The Eighth Circuit, agreeing with the government, found that the transfer of real estate leases to the chartered subsidiary to remove the stringent regulatory constraints "did not impart economic substance to the larger LRT/stock transac-

tion." *WFC Holdings Corp. v. United States*, 728 F.3d 736, 746 (8th Cir. 2013). Effectively, the Eighth Circuit separated the lease restructuring transaction into a series of steps and tested each step for economic substance rather than analyzing the transaction as a whole.

Further, demonstrating the Eighth Circuit's narrow interpretation of the transaction, the Eighth Circuit endorsed the government's argument that "the creation and sale to Lehman Brothers of the Charter stock … had no practical economic effect on WFC's ability to remove the … property …and develop its profit potential." *Id.* In other words, the Eighth Circuit held that each step in a complex transaction must have economic substance.

Lastly, the Eighth Circuit concluded that the district court did not engage in improper 'slicing and dicing,' when it found that "If WFC wanted to escape OCC supervision, it could have simply transferred the leases to a non-banking subsidiary without accepting the administrative burdens and transactions costs of creating a new class of stock and subsequently selling it." *Id.* at 748. The court's statement that it was looking at the "LRT/stock transfer as a whole" is one of the most confounding aspects of its decision, which, labels notwithstanding, plainly stands for the proposition that each step in a multi-step transaction must have economic substance to reap the tax benefits expressly provided for by the IRC. *Id.* at 746.

Allowing the Eighth Circuit to disaggregate an interrelated transaction and test each step for economic substance substantially (i) contravenes a taxpayer's right to "arrange that his taxes shall be as low as possible," *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) and (ii) abolishes common and

traditionally accepted tax planning techniques employed by individuals and closely held businesses.

By applying the economic substance doctrine to each step of a transaction rather than the transaction as the whole, the Eighth Circuit disregards the widely accepted truism in tax law, established by this Court in *Gregory v. Helvering,* 293 U.S. 465 (1935): a taxpayer has the "legal right" to "decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits." Many transactions with legitimate business motivations contain steps that serve no non-tax purpose other than to achieve a tax result.[8] For example, "nonrecognition treatment afforded to like-kind exchanges under Code Sec. 1031 could arguably be denied under E[conomic] S[ubstance] D[octrine], as structuring a transaction as a sale versus a like-kind exchange does not... have a nontax business purpose or a nontax impact on the taxpayer's economic position." *Id.* at 124. Therefore, the economic substance doctrine would invalidate common and acceptable business transactions "that are structured so as to take advantage of tax benefits expressly provided for in the Code." *Id.*

Further, the Eighth Circuit's decision substantially increases the tax risk associated with future transactions since the codified economic substance doctrine relies on the common law to determine *when* and *how* the doctrine should apply. In 2010, Congress incorporated the economic substance doctrine into

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[8] Jodi J. Schwartz: *Economic-Substance Doctrine and Subchapter C: What, Me Worry?* TAXES-THE TAX MAGAZINE, March 2011, at 123 stating that in many transactions there are "particular steps in an overall business-motivated transaction" that serve no other purpose than to "achieve a tax result."

new subsection IRC § 7701(o) with the goal of eliminating differences among courts in its application and providing "clarification." However, the codification has introduced more controversy and confusion as practitioners are uncertain as to what extent it may apply to disregard traditionally accepted tax planning. [9]

The codified § 7701(o)(1) adopts a conjunctive or "two-prong" test for applying the economic substance doctrine. It provides that for "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."[10]

Unfortunately, in defining the scope of the codified economic substance doctrine Congress relied on prior case law: "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."[11] (Emphasis added).

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[9] Jodi J. Schwartz: *Economic-Substance Doctrine and Subchapter C: What, Me Worry?* TAXES-THE TAX MAGAZINE, March 2011, at 113 states "… codification has generally caused significant concern among practitioners and taxpayers as to whether and to what extent it might apply to traditionally acceptable tax planning and not merely to artificial abuse transactions."

[10] IRC § 7701(o)(1). The statute, however, does contain a special "profit potential" rule that "shall be taken into account" in determing whether both prongs of the two tests are met. IRC § 7701(o)(2)(A).

[11] IRC § 7701(o)(5)(C).

Interestingly enough, the courts neither have applied the economic substance doctrine consistently nor have they always determined, expressly or implicitly, when the economic substance doctrine is "relevant" to a transaction, more often than not merely deciding that the doctrine is satisfied or it is not.[12] Therefore, the reliance on common law does not provide a clear answer as to the doctrine's boundaries. To make matters worse, Congress left a number of key terms

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[12] Jodi J. Schwartz: *Economic-Substance Doctrine and Subchapter C: What, Me Worry?* TAXES-THE TAX MAGAZINE, March 2011, at 115: "Without any guidance in the statutory text and limited guidance in the relevant reports, however, it remains highly unclear how a court is to make this determination, especially since, pre-codification, it was not always clear where the courts ever actually considered whether the ESD was 'relevant' to a particular transaction before applying the two-prong test." Ironically, although the courts have not provided any guidance, both the Joint Committee on Taxation and the IRS have done so in a limited manner. In the context of providing explanatory guidance about the types of business decisions that should fall outside the scope of the economic substance doctrine under § 7701(o), the Joint Committee listed four specific types of transactions, including two transaction steps the lower courts in this case put under an economic substance microscope, the choice between capitalizing a business with debt or equity and the choice to enter into a transaction or series of transactions that constitute a corporate organization (i.e., such as a § 351 transaction). Staff of the Joint Committee On Taxation, Technical Explanation Of The Revenue Provisions Of The "Reconciliation Act Of 2010," As Amended, In Combination With The "Patient Protection And Affordable Care Act". Although this Court has recently noted in *United States v. Woods*, 134 S.Ct. 557, 568 (2013), that the so-called "Blue Book" explanation of the Joint Committee is not a reflection of statutory interpretation, the IRS has published the exact same guidance in a July 2011 announcement. I.R.S. Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties (July 15, 2011).

in IRC §7701(o) undefined. The IRS, therefore, relies on the common law to determine how much of a change in the taxpayer's economic position is required for it to be "meaningful" and what constitutes a "substantial" non-tax business purpose.[13] Given the great deal of emphasis placed on the common law and the IRS' clear refusal to provide guidance as to the types of transactions to which the economic substance doctrine applies,[14] this case is an apt platform for the Court to bring finality and certainty to an otherwise ambiguous area of tax law.

III. THE EIGHTH CIRCUIT'S EXPANSIVE INTERPRETATION OF THE ECONOMIC SUBSTANCE DOCTRINE JEOPARDIZES COMMON AND WELL-ACCEPTED ESTATE PLANNING TECHNIQUES.

The doctrine's broad reach as enunciated by the Eighth Circuit is problematic in the area of estate

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[13] Notice 2010-62: "The IRS will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1). Accordingly, in determining whether a transaction sufficiently affects the taxpayer's economic position to satisfy the requirements of section 7701(o)(1)(A), the IRS will apply cases under the common-law economic substance doctrine …pertaining to whether the tax benefits of a transaction are not allowable because the transaction does not satisfy the economic substance prong of the economic substance doctrine. Similarity, in determining whether a transaction has a sufficient nontax purpose to satisfy the requirements of section 7701(o)(1)(B), the IRS will apply cases under the common-law economic substance doctrine pertaining to whether the tax benefits of a transaction are not allowable because the transaction lacks a business purpose."

[14] Notice 2010-62: "The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply."

tax planning, an area of interest to individuals, as illustrated by the intra-family sale examples below.

Facts: Example 1

Mom and Dad have a taxable estate. They have an apartment building with a $1,000,000 fair market value, and a $150,000 adjusted basis, not subject to debt, which generates $30,000 per year in net cash flow. They do not wish to give it to their two children because they want to keep the income for themselves but they want to reduce their taxable estate. Therefore, with the help of Mr. EP, their estate planning attorney, they decide to (i) create an irrevocable grantor trust for the benefit of their children; (ii) make a gift of $150,000 to the trust as "seed money;" (iii) sell the apartment building to the irrevocable grantor trust for a (a) $150,000 deposit and (b) 30 year, interest-only, $850,000 promissory note at the March 2014, long-term applicable federal rate of 3.36%.[15] The irrevocable grantor trust annually pays $28,560 to Mom and Dad as a payment on the note.

The first issue that must be addressed is whether the economic substance doctrine (as codified) is "relevant" to the above transaction.

As discussed above, the codified economic substance doctrine does not expressly define *when* or *what* causes the economic substance doctrine to apply. Instead, the statute relies on prior case law,[16] which, in turn, does not provide a clear answer. As acknowledged by Congress, the economic substance doctrine has been applied inconsistently from Circuit to Circuit. Further, the courts have not systematically or expressly determined when the doctrine is

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[15] Rev. Rul 2014-8.

[16] IRC § 7701(o)(5)(C).

"relevant" to a transaction.[17] Therefore practitioners are uncertain about the scope of IRC §7701(o)(1). However, there are hints in the statute that lead us to believe that the economic substance doctrine may apply in the estate tax context.

Although the economic substance doctrine arose in the context of income tax,[18] there is nothing in the statute that limits its application to the income tax.[19] "First, … section 7701(o) is in the section of the Code that provides definitions for the entire Internal Revenue Code, not simply Subtitle A, Income Taxes. Second, the new penalty… was added to a section that already applied to estate and gift taxes before the addition of the E[conomic] S[ubstance] D[octrine] penalty. Third, in IRC Section 6662 [which includes the economic substance doctrine penalty provision] it is clear that when Congress means to limit a provision to the income tax, it knows how to do so.[20] Fourth "…the common law E[conomic] S[substance] D[octrine] and a 'similar rule of law'- the step transaction doctrine- have been applied historically to estate tax planning cases and continue to be applied today.."[21] Finally, this transaction does not qualify

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[17]Jodi J. Schwartz: *Economic-Substance Doctrine and Subchapter C: What, Me Worry?* TAXES-THE TAX MAGAZINE, March 2011, at 124: "[T]he courts' application of the ESD is not consistent and the cases are not, as a practical matter, susceptible to a systemic finding that ESD is or is not 'relevant' to a category of transactions."

[18] Bruce Givner, Esq., and Owen Kaye, Esq.: *Estate Tax Planning And The Codified Economic Substance Doctrine: An Uneasy Connection,* California Trusts and Estates Quarterly, 17, 2 (Summer 2011), at 6.

[19] *Id.*

[20] *See* IRC § 6662(b)(2) (providing a penalty for "substantial understatement of income tax").

[21] Bruce Givner, Esq., and Owen Kaye, Esq.: *Estate Tax Planning And The Codified Economic Substance Doctrine: An*

for the "exception for personal transaction of individuals" [22] since it was a sale that was engaged in for the production of income. Therefore, the economic substance doctrine may apply to the transaction.

The second issue is whether the transaction (a) changes in a "meaningful way" Mom and Dad's economic position; and (b) was consummated for a "substantial purpose" other than income taxes.

Applying the Eighth Circuit's rationale, the creation of the irrevocable grantor trust to which the sale of the apartment was made is a "crucial step" of the sale transaction that must satisfy the economic substance doctrine independent of the whole transaction. Therefore taking a narrow view of the transaction we must determine whether the creation of the irrevocable grantor trust to which the apartment was sold, has economic substance.

There appears not to be a meaningful change in Mom's and Dad's economic position because a grantor trust treats the grantors- Mom and Dad- as the owners of all trust income and/or principal for Federal income tax purposes. This means that Mom and Dad must include in their individual tax returns all items of "income, deduction, and credit against tax of the trust," attributable to them as owners of the grantor trust.[23] In other words, all of the taxable

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Uneasy Connection, California Trusts and Estates Quarterly, 17, 2 (Summer 2011), at 6.

[22] IRC § 7701(o)(5)(B): "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."

[23] IRC § 671: "… the grantor … shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income, and credits of the grantor … those items of income, deductions, and credits against tax of the trust …" *See also* Treas. Reg. § 1.671-2(d).

income of the irrevocable grantor trust is taxed to Mom and Dad on their individual tax returns.

Further, the creation of the irrevocable grantor trust does not have a "substantial purpose" other than the avoidance of income tax. The main reason a grantor trust is used as opposed to a complex trust or simple trust, which have a separate existence for income tax purposes, is to avoid the $850,000 ($1,000,000 fair market value minus $150,000 adjusted basis) of inherent gain that would otherwise be subject to capital gain tax were the sale directly to a child or to a complex trust. This is because transactions between a grantor and a grantor trust are disregarded for federal income tax purposes.[24]

Therefore, similar to the government's argument in the Eighth Circuit that the "creation and sale to Lehman Brothers of the Charter stock were crucial steps of the LRT/stock transaction that had no practical economic effect on WFC's ability to …develop its profit potential,"[25] the creation of the irrevocable grantor trust did not have any practical effect on Mom and Dad's ability to remove the apartment from their estate and consummate the sale. Hence, under the Eighth Circuit's narrow framing of a transaction for economic substance analysis, a commonly used and traditionally accepted estate tax planning technique could lack economic substance.

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[24] Rev. Rul. 85-13: a transfer of grantor's interest in a corporation to a grantor trust for a promissory note is "not recognized as a sale for federal income purposes because … [Grantor] is both the maker and the owner of the promissory note. A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction."

[25] *WFC Holdings Corp. v. U.S.*, 728 F.3d 736, 746 (8th Circuit 2013).

Further, analyzing the transaction as a whole under the codified economic substance doctrine creates even greater uncertainty as to the doctrine's scope. Does the transaction as a whole change Mom and Dad's economic position in a "meaningful way" and did it have a "substantial" purpose other than the Federal income tax effect?

As discussed above, there is no change in the income tax consequences to Mom and Dad due to the trust being characterized as a grantor trust. Is the change from owners of the apartment building to secured lenders a "meaningful change" in economic position? It is unclear. Arguably, Mom and Dad no longer benefit from the future appreciation or risk of future decline in value. However, they have apparently retained the building's current benefits, namely the income, since the payments on the note are 95.2% ($28,560/ $30,000) of the net income. Does the note constitute a bona fide sale when the interest rate used is the March, 2014, AFR of 3.36% when the market interest rate for a comparable loan might be 4%?

Further, assume the irrevocable grantor trust has a "Protector," a provision found in many irrevocable trusts that allows the grantor to appoint an individual to serve in a non-fiduciary capacity. The Protector can have the power to (i) add or remove a beneficiary; (ii) remove and replace a trustee and (iii) change the beneficial interest of a beneficiary, etc. In essence, the Grantors can, through their influence with the protector, effect the removal of the current beneficiaries and have themselves added as beneficiaries. Does the Protector provision cause the transaction to lack a meaningful change in economic position since Mom and Dad can become beneficiaries? The answer is unclear.

Facts: Example 2

Mom and Dad have a taxable estate. They have an apartment building with a $2,000,000 fair market value, and a $250,000 adjusted basis. They want to (i) reduce the value of their estate and (ii) sell the apartment building to increase their cash flow. However, they want to avoid the large capital gains tax on the $1,750,000 of gain inherent in the apartment building. Therefore Mom and Dad retain Mr. EP, their estate planning attorney, to (i) create an irrevocable complex trust for the benefit of their children;[26] (ii) sell the apartment building to the irrevocable complex trust using the IRC §453 installment method to defer the $1,750,00 capital gain in 2014. The complex trust gets a step-up in basis to fair market value, $2,000,000; and (iii) then the complex trust sells the apartment building, in 2017, to a third-party, in an arm's length transaction, for $2,100,000 its then fair market value, recognizing $100,000 of capital gain.[27]

The first issue is whether the economic substance doctrine (as confided) is "relevant" to example 2.

As discussed in example 1, the determination of whether the economic substance doctrine is "relevant" to a transaction is unclear since it relies on prior case law that did not systematically define when it is "relevant" and, as a result, the doctrine was applied inconsistently. However, the courts have historically applied the economic substance

[26] A complex trust is a trust taxed in accordance with IRC § 661 and § 663.
[27] IRC § 453(e).

doctrine to installment sales transactions under IRC §453.[28]

Further, the transaction does not fall within the IRC §7701(o)(5)(B), "exception for personal transactions of individuals" since the sale of the apartment building was for the "production of income." Therefore, the codified economic substance doctrine is likely "relevant" to the above transaction.

The second issue is whether the transaction (a) changes in a "meaningful way" Mom and Dad's economic position; and (b) was consummated for a "substantial purpose" other than income taxes.

Applying the Eighth Circuit's reasoning we must determine whether steps (ii) and (iii) of the interconnected transaction satisfy the two-prong codified economic substance test. In other words, did the sale of the building to an irrevocable complex trust using the installment method blessed under IRC § 453 change Mom and Dad's economic position in a "meaningful way" and serve a "substantial" purpose other than income tax avoidance?

The answer is arguably no. Granted the purpose of the transaction was to transfer wealth to their children and reduce the value of their estate, Mom and Dad specifically sold the apartment building to a related party, the complex trust for the benefit of their children. In return Mom and Dad received an installment agreement for the express purpose of (i) deferring the capital gain under the installment method and (ii) allowing the complex trust to take a step-up in basis to $2,000,000. Hence the question is

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[28] In *ACM Partnership v. C.I.R.*, 1997 WL 93314 (U.S.Tax Ct. 1997), the court applied the economic substance doctrine to a contingent payment sale under IRC § 453.

whether the estate planning motive is "substantial" enough to justify the transaction given the Federal income tax effect?

Also, did the economic position of Mom and Dad change in a meaningful way? Yes, their position changed from title owners to creditors. Is that enough to constitute a meaningful change? It is unclear. The apartment building was sold to an "entity that is separate" from Mom and Dad for purposes of income tax. However, Mom and Dad created the complex trust and designated the Trustee, the person who controls the trust. Therefore, they can still control the Trust through their influence over the Trustee. Further, Mom and Dad have retained virtually all of the current income from the apartment building by means of the complex trust's obligation to pay the installment agreement. Therefore, it is unclear whether their economic position changed enough for it to be regarded as "meaningful." Therefore we cannot be certain if there is economic substance and that lack of certainty will make it difficult for taxpayers to engage in what are otherwise common transactions.

Assuming the sale changed their economic position and was consummated for a substantial purpose other than Federal income tax effects, does the later sale of the apartment building by the complex trust have economic substance?

IRC § 453(e)(1) provides that if a person transfers a property to a related person ("first disposition") and the related person disposes of the property before all payments on the installment agreement are made ("second disposition"), then the amount of gain deferred due to the installment agreement is accelerated to the extent of the amount realized on the

second disposition.[29] The purpose of this subsection is to prevent a person selling a property to a related party from deferring the gain and having the related party receive a step up in basis to fair market value, allowing an instantaneous resale of the property at no taxable gain. However, IRC §453(e)(2) provides a "2 year cutoff for property other than marketable securities." If the date of the second disposition is more than two years from the date of the first disposition, then Mom and Dad can continue to defer the gain due to the second disposition in accordance with the installment method. In other words there is no acceleration of the inherent gain as a result of the second disposition. Therefore, the complex trust, a related party, was clearly within the boundaries of the IRC when it sold the apartment building more than two years after its acquisition with very little taxable gain.

However, applying the same "slicing and dicing" approach applied by the district court and approved by the Eighth Circuit, a transaction that is structured to take advantage of a benefit expressly provided by the IRC lacks economic substance. Under the Eighth Circuit's rationale, the transaction should be disregarded because the estate planning motive does not explain the creation of the complex trust, installment sale by Mom and Dad and later sale to an independent third party. Under the Eighth Circuit's logic, Mom and Dad should have sold the

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[29] IRC § 453(e)(1): "If (A) any person disposes of property to a related person (…first disposition), and (B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (… second disposition), then… the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition."

apartment building to a third party directly and then transferred the proceeds to a trust for their children, thereby, reducing the "administrative burdens and transaction costs" of creating the new complex trust and documenting the installment agreement.[30] Further, the estate planning motives in this transaction appear to be "thin or tenuous," and the only "substantive one" is the deferral of the apartment building's inherent gain.

Lastly, this result is particularly disturbing because IRC § 453(e)(7) specifically provides that IRC § 453(e)(1) should not apply to accelerate the gain if "neither the first disposition nor second disposition had as one of principal purposes the avoidance of Federal Income Tax.[31] In other words, even if the second disposition was engaged in for the purpose of avoiding the Federal income tax, as long as the IRC § 453(e)(2) 2 year cutoff is satisfied Mom and Dad should be able to defer the gain. Therefore, the Eighth Circuit's "slicing and dicing" approach might be used to prevent the use of a specifically permitted tax planning technique.

* * *

CONCLUSION

In sum, the Eighth Circuit's "slicing and dicing" approach, the uncertainty regarding the doctrine's scope and the strict liability penalties will have a chilling effect on legitimate and traditionally accepted transactions that extend far beyond the corporate

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[30] *WFC Holdings Corp. v. U.S.*, 728 F.3d 736, 747 (8th Circuit 2013) stated: "If WFC wanted to escape OCC supervision, it could have simply transferred the leases to a non-banking subsidiary without accepting the administrative burdens and transaction costs of creating a new class of stock and subsequently selling it."

[31] IRC § 453(e)(7).

tax arena. For that reason the Supreme Court should decide to rule in this case.

Respectfully submitted,

BRUCE GIVNER*
NEDA BARKHORDAR
GIVNER & KAYE, APC
12100 Wilshire Blvd,
Suite 445
Los Angeles, CA 90025
(310) 207-8008
Bruce@GivnerKaye.com

*Counsel of Record

Counsel for Amicus Curiae

March 31, 2014