No. 13-1037

In the Supreme Court of the United States

WFC HOLDINGS CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

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

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the tax shelter that petitioner used to claim a tax basis of $427 million in $4 million worth of its subsidiary's stock lacked economic substance.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-24a) is reported at 728 F.3d 736. The opinion of the district court (Pet. App. 26a-125a) is unreported but is available at 2011 WL 4583817.

JURISDICTION

The judgment of the court of appeals was entered on August 22, 2013. A petition for rehearing was denied on October 29, 2013 (Pet. App. 126a). On January 20, 2014, Justice Alito extended the time within which to file a petition for a writ of certiorari to and including February 26, 2014. The petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. This case arises from an abusive tax shelter that petitioner, a financial-services company, used to generate an enormous artificial tax loss. Pet. App. 4a-5a, 33a-36a. Petitioner purchased the "tax product," referred to here as the "LRT/stock transaction," for $3 million from the accounting firm KPMG, LLC. *Id.* at 4a, 17a-18a, 33a-36a. Like a number of other tax shelters that proliferated during the late 1990s and early 2000s, the LRT/stock transaction produces a paper loss by artificially inflating the taxpayer's basis in a particular asset. See, *e.g.*, *United States* v. *Woods*, 134 S. Ct. 557, 560-561 (2013). When the asset is sold for significantly less than the asserted basis, the taxpayer claims a large loss on that sale that can be used to offset real gains from other transactions. Pet. App. 5a, 33a.

To create the artificial loss, the LRT/stock transaction requires the taxpayer to complete a series of prearranged steps designed to imbue low-value stock with a high tax basis. Pet. App. 4a-5a, 33a, 118a-119a; Gov't C.A. Br. 4-5. First, the taxpayer reorganizes an inactive subsidiary corporation. See Pet. App. 4a. Second, the taxpayer (through another subsidiary) transfers to the newly reorganized subsidiary valuable property—plus, critically, a nearly offsetting amount of contingent liabilities—in exchange for stock in the subsidiary. *Id.* at 4a-5a, 33a. Third, the taxpayer sells the stock to a third party for its fair market value, which is invariably far less than the value of the property transferred to the subsidiary to acquire the stock. *Id.* at 5a, 33a, 118a-121a.

Finally, the taxpayer claims that the stock has a tax basis equal to the basis of the property trans-

ferred to the subsidiary, unreduced by the nearly offsetting contingent liabilities assumed by the subsidiary. When the stock is sold, the taxpayer claims a significant tax loss measured by the difference between the stock's low fair market value and the stock's artificially inflated basis. Pet. App. 5a. The resulting capital loss then can be used to offset any capital gain realized by the taxpayer during the relevant tax year or carried back to shelter gain in prior tax years. *Id.* at 5a, 30a, 33a.[1]

By way of illustration, assume that the taxpayer's Subsidiary A transfers $400 million in treasury notes (with a tax basis of $400 million) to taxpayer's Subsidiary B in exchange for Subsidiary B's stock and Subsidiary B's assumption of $399 million of Subsidiary A's contingent, future environmental liabilities. For economic purposes, the transaction between Subsidiary A and Subsidiary B is practically a wash—a $400 million asset (the treasury notes) is exchanged for the assumption of a $399 million liability (the future environmental liabilities). Thus, Subsidiary A has effectively paid $1 million for the stock. For tax purposes, however, Subsidiary A claims that its basis in the stock is $400 million, ignoring Subsidiary B's offsetting assumption of Subsidiary A's future liabilities. When Subsidiary A then sells that high-basis stock for

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[1] KPMG's version of this tax-avoidance scheme had a further dimension: It was designed to allow taxpayers to claim deductions for the same liabilities at two different points in time. First, as described above, when the taxpayer sold the stock, the sale would produce an enormous capital loss that was wholly artificial. Pet. App. 33a, 118a-121a. Second, when the subsidiary corporation that had assumed the contingent liabilities paid off the liabilities as they accrued, the taxpayer could (through its consolidated return) deduct the payments. *Id.* at 33a, 120a-121a.

its effective purchase price of $1 million, the taxpayer claims a tax loss of $399 million, even though it did not incur a real economic loss.

The LRT/stock transaction scheme rested on an interpretation of certain provisions of Sections 357 and 358 of the Internal Revenue Code, 26 U.S.C. 357, 358. See Pet. App. 4a-5a, 85a-87a; see also *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340, 1347-1349 (Fed. Cir. 2006), cert. denied, 549 U.S. 1206 (2007). In 2000, Congress amended those provisions to ensure that shelters like the LRT/stock transaction would be prohibited prospectively. See Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 309(a), 114 Stat. 2763A-638; see also *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 434-435 (4th Cir. 2006). Congress left to the IRS the task of challenging prior transactions that the amendments did not reach, using "judicial doctrines (such as business purpose and economic substance)." 1 Joint Comm. on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* 128 (2003). Under the economic-substance doctrine, a longstanding common-law principle codified by Congress in 2010, a transaction will be disregarded altogether for tax purposes—and any associated tax benefits therefore will be disallowed—if the transaction does not have economic substance. See 26 U.S.C. 7701(*o*)(5)(A). The IRS has concluded that the LRT/stock transaction shelter lacks economic substance.

b. Petitioner employed the LRT/stock transaction to generate an artificial loss of more than $400 million, which it used to offset gains in several tax years. Pet.

App. 8a-9a, 29a-30a. To execute the shelter, petitioner selected an inactive non-banking subsidiary, renamed it Charter Holdings, Inc. (Charter), and directed Charter to issue 20,000 shares of preferred stock. *Id.* at 4a, 33a-36a, 50a. Petitioner then directed two of its banking subsidiaries to transfer to Charter government securities worth approximately $430 million, as well as leasehold interests in 21 properties that were valued by KPMG at approximately *negative* $426 million, for a net transfer of $4 million. In exchange, the subsidiaries received 4000 shares of Charter's preferred stock. *Id.* at 8a-9a, 29a, 51a. Finally, the banking subsidiaries sold the Charter stock to petitioner for $4 million,[2] and approximately two months later petitioner sold that stock to Lehman Brothers, Inc. for $3.7 million. *Id.* at 8a-9a, 29a, 53a.

In accordance with the LRT/stock transaction strategy, petitioner claimed that, for tax purposes, the banking subsidiaries' basis in the Charter stock equaled their basis in the government securities (approximately $427 million), unreduced by the amount of lease liabilities assumed by Charter ($426 million). Petitioner therefore claimed on its 1999 consolidated tax return that it had realized roughly a $423 million tax loss on the stock sale, when in reality its banking subsidiaries had merely sold the stock for the same price ($4 million) that they had paid for it.[3] Pet. App.

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[2] Because federal banking laws prohibited the banking subsidiaries from holding the Charter stock, their acquisition of the stock was unlawful. See Gov't C.A. App. 315-316, 336-337, 883-886.

[3] The loss was realized when the banking subsidiaries sold the Charter stock to petitioner. Because the banking subsidiaries and petitioner were members of a consolidated group, the loss was not

8a-9a, 29a, 51a, 53a. Petitioner attempted to use the $423 million loss to offset gains in prior tax years, including 1996 (the year at issue here), by filing refund claims for those years. *Id.* at 9a, 29a-30a. On its consolidated returns, petitioner continued to deduct the rent payments on the leases transferred to Charter as they actually were paid. *Id.* at 120a-121a.

2. The IRS disallowed petitioner's tax treatment of the LRT/stock transaction on various grounds, including that the transaction lacked economic substance and had no valid business purpose. See Pet. App. 9a, 26a. The IRS determined that petitioner had entered into the LRT/stock transaction solely to create stock with an artificially inflated basis in order to offset other unrelated taxable income. The IRS therefore denied petitioner's refund claims based on the LRT/stock transaction, including petitioner's $82 million refund claim for the 1996 tax year. See *id.* at 26a.

3. Petitioner filed a refund suit for the 1996 tax year in the United States District Court for the District of Minnesota. Pet. App. 26a. After holding a bench trial and making extensive factual findings, the court concluded that the LRT/stock transaction was a sham and therefore granted judgment to the government. See *id.* at 88a-125a.

The district court first determined that petitioner lacked a subjective business purpose—that is, a purpose unrelated to tax considerations—for entering into the LRT/stock transaction. Pet. App. 91a-116a. As relevant here, petitioner argued that its primary reason for the transaction was to achieve regulatory

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recognized until the stock was sold outside the group to Lehman Brothers.

benefits by transferring the 21 leases from banking subsidiaries to a non-banking subsidiary, which freed those properties from certain regulatory requirements enforced by the Office of the Comptroller of the Currency (OCC). *Id.* at 98a. The court found, however, that "the evidence compels the conclusion that [petitioner] chose the selected leases without regard to regulatory concerns" and had "developed the non-tax justification of regulatory benefits after [its tax director] expressed concerns about an audit." *Id.* at 103a. The court further found that the asserted regulatory purpose did "not explain the issuance of the [Charter] Stock and sale of the stock to Lehman" because "[i]f [petitioner] 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." *Id.* at 98a. Those steps, the district court held, were motivated solely by petitioner's effort to create a $423 million artificial tax loss. *Id.* at 115a-116a.

For similar reasons, the district court also determined that the LRT/stock transaction objectively lacked economic substance. See Pet. App. 116a-124a. The court found that petitioner had "suffered no real loss, but solely a paper one." *Id.* at 119a (internal quotation marks and citation omitted). The court rejected petitioner's argument that the potential for profit from the transfer of one of the 21 leases (the "Garland" property) to a non-banking subsidiary was sufficient to legitimize the entire scheme. See *id.* at 119a-120a, 123a-124a. The court explained that it was not proper to "isolate one part, or even a few parts, of one step of a large, complex transaction and find that

its profit potential imbues the entire transaction with substance which is otherwise lacking." *Id.* at 124a; see *ibid.* (explaining that petitioner was seeking "to justify a large, multi-step, multi-property transaction" by "isolat[ing] a kernel of prospective profitability"). Based on its finding that the LRT/stock transaction "viewed as a whole" lacked "economic substance or a real purpose other than tax avoidance," the district court rejected petitioner's argument that the deduction could be sustained on the ground that the transfer of one of the 21 leases had profit potential. *Ibid.*

4. The court of appeals affirmed. Pet. App. 1a-24a. The court explained that, "[u]nder the common law 'sham transaction' or 'economic substance' doctrine" that this Court has adopted, "even if a transaction is in formal compliance with Code provisions, a deduction will be disallowed if the transaction is an economic sham." *Id.* at 10a (internal quotation marks and citations omitted). The court of appeals stated that, "[a]lthough taxpayers may structure their business transactions in a manner that produces the least amount of tax," a court must "disregard a transaction that a taxpayer enters into without a valid business purpose in order to claim tax benefits not contemplated by a reasonable application of the language and the purpose of the Code or the regulations thereunder." *Ibid.* (citations omitted). The court of appeals further explained that its own precedents had not resolved the question whether a taxpayer must demonstrate *both* objective economic substance *and* a subjective business purpose in order to establish that a transaction was not a sham. See *id.* at 12a-13a. The court declined to resolve that question because it concluded

that "[petitioner's] LRT/stock transfer has *neither* economic substance nor business purpose." *Id.* at 13a.

The court of appeals rejected petitioner's argument that the alleged regulatory benefits of transferring the Garland property to a non-banking subsidiary sufficed to confer economic substance on the entire LRT/stock transaction. Pet. App. 16a-18a. The court explained that petitioner could have obtained the same regulatory benefits by making that transfer without also directing the stock issuance and sale at the heart of the shelter—steps that "had no practical economic effect on [petitioner's] ability to remove the Garland property from OCC oversight and develop its profit potential." *Id.* at 17a. The court accordingly concluded that petitioner's "transfer of the Garland lease to Charter—one economically beneficial component of a much larger, complex transaction—does not impart economic substance to the larger LRT/stock transaction." *Ibid.*

The court of appeals also found no error in the district court's factual finding that petitioner lacked a subjective non-tax business purpose for entering into the LRT/stock transaction. See Pet. App. 18a-24a. "Given our conclusion that the LRT/stock transaction had no real potential for profit," the court stated, "[petitioner] faces an uphill battle to establish that it had a subjective intent to treat the LRT/stock transfer as a money-making transaction." *Id.* at 19a. Based on the evidence adduced by the district court, the court of appeals concluded that petitioner had failed to establish by a preponderance of the evidence that the LRT/stock transaction was motivated by any of the business purposes petitioner had proffered,

including "avoidance of OCC regulations." *Id.* at 19a-24a.

ARGUMENT

The court of appeals correctly held that the "tax product" that petitioner used to generate a $423 million paper loss was a sham. The court's case-specific application of the economic-substance doctrine does not conflict with any decision of another court of appeals. To the contrary, the two other circuits to consider similar shelters have reached decisions entirely consistent with the decision below. Further review is not warranted.

1. The court of appeals correctly held that the LRT/stock transaction lacked economic substance.

a. Like many abusive tax shelters, petitioner's LRT/stock transaction was intended to establish an artificially high basis in property (Charter stock) by counting for tax purposes only one side of offsetting assets and liabilities used to acquire the property. Petitioner's subsidiaries effectively paid $4 million to acquire the Charter stock ($430 million worth of government securities minus $426 million worth of liabilities on the transferred leases). Petitioner nevertheless claimed a basis in the Charter stock equal to the subsidiaries' basis in the government securities only ($427 million), without reducing the basis by the nearly offsetting liabilities transferred to Charter. Then, when the stock was sold, petitioner claimed a $423 million tax loss, reducing its taxes by more than $80 million in 1996 alone, even though petitioner's subsidiaries had sold the stock for the same amount ($4 million) that they had paid for it. Pet. App. 8a-9a, 29a-30a, 51a, 53a.

In light of those factual findings, undisputed here, the district court correctly held that the LRT/stock transaction lacked economic substance and therefore could not be recognized for tax purposes. See Pet. App. 116a-124a; see also, *e.g.*, *Crispin* v. *Commissioner*, 708 F.3d 507, 515 (3d Cir.) ("Indicia of objective economic substance include whether the loss claimed was real or artificial, whether the transaction was part of a prepackaged strategy marketed to shelter taxable gain, and whether the transaction has any practicable economic effects other than the creation of income tax losses.") (internal citations and quotation marks omitted), cert. denied, 134 S. Ct. 784 (2013). As the district court held, putting aside the $423 million tax loss that the transaction produced by inflating petitioner's basis in Charter stock, petitioner did not have "a reasonable expectation of profit" in the LRT/stock transaction. Pet. App. 121a.

Petitioner does not contend in this Court that any economic purpose was served through the stock manipulation at the core of the LRT/stock transaction, which involved the issuance of stock by petitioner's previously inactive subsidiary Charter and the transfer and sale of that stock in a way that made it appear to have a very large basis that corresponded to no actual costs in the real world. Petitioner argues, however, that the transaction nevertheless had economic substance. That argument is premised on the district court's finding that the transfer of the Garland property, one of the 21 leases transferred to Charter at the relevant step of the shelter, had the potential for profit. See Pet. App. 123a-124a.

Petitioner's argument is flawed. Both courts below correctly held that, even when one step of a much

broader, multi-step transaction has profit potential, the transaction *as a whole* may lack economic substance—particularly where, as here, the remaining steps of the transaction that generated the tax loss had no role whatever in effectuating the single profit-producing step. Pet. App. 17a-18a, 123a-124a. The stock manipulation central to the LRT/stock transaction had no economic effect on petitioner's ability to transfer the Garland property or any of the other properties to a non-banking subsidiary. Rather, in real economic terms, the steps needed to effect the stock manipulation only "increased transaction costs" and added "administrative burdens." *Id.* at 98a, 117a. Even if, as petitioner claims (Pet. 18), the transfer of the Garland property "generated millions of dollars" in profit, nothing about that transfer justified embedding it in the much larger LRT/stock transaction, which was designed solely to create an enormous tax loss by generating a $427 million basis in stock that was both purchased and sold for $4 million.

Thus, as the court of appeals held, petitioner's "transfer of the Garland lease to Charter—one economically beneficial component of a much larger, complex transaction—does not impart economic substance to the larger LRT/stock transaction." Pet. App. 17a. If the rule were otherwise, taxpayers could readily circumvent the economic-substance doctrine by adding a single profit-making step to a complex tax shelter. For example, on petitioner's view, a taxpayer could immunize a multi-step tax shelter from invalidation by temporarily transferring the funds used in the transaction to an interest-bearing account. That cannot be correct.

Petitioner's theory cannot be satisfactorily reconciled with this Court's foundational economic-substance decision in *Gregory* v. *Helvering*, 293 U.S. 465 (1935). In *Gregory*, the taxpayer had created a corporation for the sole purpose of transferring valuable stock to herself at the capital-gains tax rate, rather than at the higher ordinary-income tax rate. *Id.* at 467. This Court disregarded the corporation, holding that it "was nothing more than a contrivance" designed to transfer property at a reduced tax rate. *Id.* at 469. As here, the fact that the underlying stock transfer generated a profit for the taxpayer did not imbue the corporate transaction with economic substance, because the taxpayer could just as readily have transferred the stock to herself without the corporation. See *id.* at 469-470.

Petitioner does not contest the district court's finding, rendered after a bench trial and affirmed by the court of appeals, that petitioner lacked any non-tax purpose for entering into the LRT/stock transaction. See Pet. App. 18a-24a, 91a-116a. The record shows that KPMG promoted the LRT/stock transaction to petitioner as a "tax product" that would create hundreds of millions of dollars of artificial losses. *Id.* at 33a-36a, 92a-97a, 117a; Gov't C.A. App. 1-52, 264, 805. As the district court concluded, "[a] review of the evolution and development of the LRT strongly suggests that it was designed and understood as a tax shelter." Pet. App. 92a.

The LRT/stock transaction "was designed, packaged and sold to [petitioner] by KPMG * * * as a mechanism for sheltering [petitioner's] taxable gain"; "[t]he non-tax benefits of the transaction were not quantified until [one of petitioner's executives] re-

quired it"; "Charter did not exist in its current form until it was altered * * * simply to facilitate the LRT"; and "KPMG and [petitioner] structured the transaction to generate an enormous loss of over $400 million." Pet. App. 92a, 94a-96a. The record evidence also disclosed "several instances of [petitioner] attempting to alter or recharacterize its work, sometimes in a misleading manner, to bolster its business purposes and the integrity of the form of the LRT retroactively." *Id.* at 97a.[4] The district court's uncontested finding that petitioner lacked any legitimate business purpose for purchasing the LRT/stock transaction "tax product" from KPMG fortifies the court of appeals' conclusion that the LRT/stock transaction was a sham.

b. Petitioner contends (Pet. 1, 14-19) that the decision below departs from this Court's precedents by disregarding an "objectively profitable transaction" with "demonstrated non-tax economic benefits" under the economic-substance doctrine. Pet. 1, 19. That argument reflects a misunderstanding of the court of appeals' holding. The court held that the "LRT/stock transaction did *not* create 'a real potential for profit,'" and that petitioner's contrary arguments had "misconstrued the district court's findings." Pet. App. 17a-

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[4] With respect to the transfer of the Garland property specifically, the record shows that petitioner transferred that property because it was deeply underwater and, as such, would accommodate petitioner's tax-avoidance purposes, not because petitioner wanted to remove the Garland property from the OCC's disposal rules. See Pet. App. 98a-103a; Gov't C.A. App. 288-289, 299, 752, 792, 801-802. Indeed, the official who picked the 21 properties to be transferred to Charter did so *before* petitioner developed its regulatory rationale. Pet. App. 22a; Gov't C.A. App. 129, 265, 274, 751.

18a (emphasis added). In so concluding, the court of appeals appropriately recognized that a transaction "should be respected for tax purposes" where it is "compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features." *Id.* at 11a-12a (quoting *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 583-584 (1978)). The court simply determined that, in light of the district court's factual findings, that standard was not satisfied in this case.

Petitioner appears to read this Court's precedents to establish that a complex transaction may not be disregarded under the economic-substance doctrine if a single step, considered in isolation, had the potential for profit. As discussed, that reasoning is foreclosed by *Gregory*. And petitioner cites no decision of this Court that casts doubt on the common-sense proposition that embedding a single legitimate transaction in a larger, multi-step sham transaction does not automatically give the larger transaction economic substance—particularly where, as here, the discrete step could have been accomplished independently of the subsequent steps.

Petitioner relies (Pet. 15-17) on this Court's decisions in *Frank Lyon*, *supra*, and *United States* v. *Consumer Life Insurance Co.*, 430 U.S. 725 (1977) (*Consumer Life*). But neither decision addressed, much less credited, a taxpayer's argument that because a particular step in a "much larger, complex transaction" had profit potential, the transaction as a whole must be deemed to have economic substance. Pet. App. 17a. The question in *Frank Lyon* was whether a sale-and-leaseback arrangement gave the

purchaser a legitimate ownership interest in a building, or whether instead the arrangement was merely a means of transforming mortgage payments into rent payments, which had different tax implications. See 435 U.S. at 573-574. For a number of case-specific reasons—such as the fact that the purchaser was liable on notes to the mortgagee bank—the Court concluded that the transaction had economic substance. See *id.* at 576-582. The Court found it significant that "the Government [was] likely to lose little revenue, if any, as a result of the shape given the transaction by the parties." *Id.* at 580. The sale-and-leaseback arrangement at issue in *Frank Lyon* has no resemblance to the prefabricated "tax product" that petitioner purchased to create a paper loss of $423 million.

Consumer Life is similarly inapposite. In that case, this Court's conclusion that certain reinsurance agreements had economic substance was based in part on findings that the taxpayer had "entered into them only after arm's-length negotiation with unrelated companies" and that the agreements "served most of the basic business purposes commonly claimed for reinsurance [agreements]." 430 U.S. at 736-739. The Court noted briefly that "[t]ax considerations well may have had a good deal to do with the specific terms of the [agreements]," but it did not elaborate on what those terms were or suggest that they resembled the sort of abusive tax shelter at issue here. *Id.* at 739.[5]

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[5] Petitioner cites *Commissioner* v. *First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972), as an example of a decision "honor[ing] tax benefits generated by the transfer of a business from a banking subsidiary to a non-banking subsidiary that freed the business from banking regulations." Pet. 18 & n.8. That decision did not

Nor do the other decisions of this Court that petitioner cites cast doubt on the court of appeals' holding. See, *e.g.*, *Knetsch* v. *United States*, 364 U.S. 361 (1960); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945). Rather, in each of those decisions, the Court articulated, and applied to the particular arrangements before it, general economic-substance principles that fully comport with the court of appeals' holding in this case. Petitioner identifies no decision of this Court holding that, because one discrete component of a transaction would produce some economic profit on its own, the entire transaction should be recognized for tax purposes even though it would otherwise be deemed a sham.

c. Petitioner also contends (Pet. 19-23) that the decision below "contravenes taxpayers' long-recognized right to structure business transactions to be tax efficient." Pet. 19 (capitalization altered). Again, petitioner misunderstands the scope of the court of appeals' holding. The court of appeals did not cast doubt on the well-settled principle that a taxpayer may structure a legitimate transaction to achieve tax benefits. To the contrary, the court embraced that principle. See Pet. App. 10a ("[T]axpayers may structure their business transactions in a manner that produces the least amount of tax.") (citations omitted). The court concluded, however, that petitioner had situated one transaction that had some profit potential—the transfer of the Garland property—within a much broader sham transaction designed solely to generate a phony $423 million tax loss, and that such games-

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apply or address the economic-substance doctrine, and in any event did not concern the sort of complex tax shelter at issue here.

manship could not convert the larger transaction into a legitimate one.

The LRT/stock transaction thus was a far cry from "an objectively profitable transaction" for which "certain aspects of its structure are intended specifically to obtain tax benefits in addition to non-tax profits." Pet. 20. Taxpayers may engage in "tax-efficient transaction[s]" that have "features that are not necessary to achieve the economic benefits generated by the transaction." Pet. 22-23. But they may not legitimize abusive tax shelters like the one that KPMG sold to petitioner simply by incorporating a single profit-producing step. Although in some cases it may be difficult to determine which of those principles is controlling, this case does not present a close question.

2. a. The decision below does not conflict with the decision of any other court of appeals. In fact, the two other circuits that have considered a similar tax shelter have each reversed a district court's determination that the transaction had economic substance. See *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340, 1352-1360 (Fed. Cir. 2006) (disallowing tax benefits from similar shelter under economic-substance doctrine), cert. denied, 549 U.S. 1206 (2007); *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 442-443 (4th Cir. 2006) (reversing a trial court's summary-judgment ruling that similar shelter had economic substance after finding that IRS had "adduced sufficient facts to go to trial on its argument that Taxpayer lacked 'any reasonable expectation of a profit' from the transaction"); accord *Gerdau Macsteel, Inc.* v. *Commissioner*, 139 T.C. 67 (2012) (disallowing tax benefits from similar shelter under economic-

substance doctrine). Those decisions are fully consistent with the court of appeals' affirmance of the district court's judgment here.

Petitioner contends (Pet. 23-26) that a circuit conflict exists because "the Second, Third, Fourth, Ninth, and Eleventh Circuits[ ] have held that the central test under the economic substance doctrine is 'whether the transaction had any practical economic effects other than the creation of income tax losses.'" Pet. 23 (quoting *Sochin* v. *Commissioner*, 843 F.2d 351, 354 (9th Cir.), cert. denied, 488 U.S. 824 (1988)). But the court of appeals articulated a standard that does not materially differ from that standard. See Pet. App. 12a ("[A] transaction will be characterized as a sham if it is not motivated by any economic purpose outside of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test).") (internal quotation marks and citation omitted); *id.* at 15a ("[A] transaction will be characterized as a sham if . . . it is without economic substance because no real potential for profit exists.") (alterations in original; internal quotation marks and citations omitted). So did the district court. See *id.* at 116a-117a. The courts below merely held that the LRT/stock transaction as a whole did not have sufficient practical economic effects to be recognized for tax purposes, and that the profit potential of one isolated step in the transaction could not legitimize the remainder of the much larger "tax product."

Petitioner cites no decision that conflicts with that holding. Indeed, petitioner discusses (Pet. 24) only one court of appeals decision holding that a transaction challenged by the IRS on economic-substance

grounds was not a sham: *United Parcel Service of America, Inc.* v. *Commissioner*, 254 F.3d 1014 (11th Cir. 2001) (*United Parcel Service*). In that decision, the Eleventh Circuit held that the taxpayer's decision to restructure its profit-making program of charging customers for insurance on packages by shifting the program to an overseas affiliate had economic substance. *Id.* at 1020. The court held that the restructuring was legitimate in part because the overseas affiliate was "an independently taxable entity that [was] not under [the taxpayer's] control," so that the taxpayer lost "the stream of income it had earlier reaped" before the restructuring. *Id.* at 1019-1020.

The Eleventh Circuit in *United Parcel Service* did not address a shelter remotely resembling the LRT/stock transaction, and it did not accept an argument that a transaction that would otherwise be deemed a sham becomes valid merely because one step, taken in isolation, has profit-making potential. The court in *United Parcel Service* held, moreover, that "[e]ven if [a] transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance." 254 F.3d at 1018; see *id.* at 1019. Here, the court of appeals affirmed the district court's finding that petitioner had no valid business purpose in entering into the LRT/stock transaction, and petitioner does not challenge that factual finding in this Court.

As examples of recent appellate rulings that petitioner views as incorrect, petitioner cites (Pet. 25-26) decisions of the Sixth and Tenth Circuits finding that particular tax shelters lacked economic substance. See *Sala* v. *United States*, 613 F.3d 1249 (10th Cir. 2010), cert. denied, 132 S. Ct. 91 (2011); *Dow Chem.*

Co. v. *United States*, 435 F.3d 594 (6th Cir. 2006), cert. denied, 549 U.S. 1205 (2007). Those decisions correctly applied the economic-substance doctrine to the tax shelters at issue. And one of the cited decisions articulated precisely the legal standard that petitioner advances. Compare Pet. 23, with *Dow Chem.*, 435 F.3d at 599 ("The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses." (citation omitted)). Those decisions do not support petitioner's contention that pronounced disagreement exists among the circuits regarding the circumstances in which tax-motivated transactions should be disregarded as lacking economic substance.

b. This case presents no occasion to consider any disagreement among the circuits over the general standard for determining whether a transaction is a sham for tax purposes. The decision below explained that the Eighth Circuit "has not yet adopted a particular approach to the sham transaction test," and that the court did not need to resolve that question in this case because the LRT/stock transaction was a sham under any of the standards that it understood other circuits to have adopted. Pet. App. 13a & n.3.

Congress recently codified the economic-substance doctrine for transactions entered into after March 30, 2010. See Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1067 (26 U.S.C. 7701(*o*)). That legislation provides that a transaction "shall be treated as having economic substance only if" it "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, *and* * * * the taxpayer has a

substantial purpose (apart from Federal income tax effects) for entering into such transaction." 26 U.S.C. 7701(*o*)(1) (emphasis added); see Pet. 33 ("[T]he statute was intended to adopt a 'conjunctive' test, rather than the 'disjunctive' test adopted by some circuits."). That codification and definition of the doctrine may resolve any disagreement among lower courts.

3. a. Petitioner argues (Pet. 27-34) that the question presented has significant prospective importance. That view rests on the mistaken premise that, under the court of appeals' decision, "a profitable transaction can be disregarded for tax purposes on the ground that certain aspects of its structure were designed solely to make it tax-efficient." Pet. 27. As discussed, the court of appeals expressly recognized that taxpayers are permitted to conduct transactions in a way that minimizes taxes.

This case, however, does not involve ordinary tax planning. Rather, petitioner purchased from KPMG an abusive "tax product" that consisted of a series of prearranged steps designed to make it appear that petitioner had a $427 million basis in stock that was both bought and sold for $4 million. The court of appeals' determination that such an egregious attempt to underpay taxes must be disregarded does not cast doubt on ordinary tax-planning strategies. By contrast, adopting petitioner's view would effectively immunize tax shelters from administrative and judicial scrutiny whenever one discrete step in the transaction (such as depositing funds in an interest-bearing account) has the potential for profit.

Petitioner has identified no sound reason to believe that the court of appeals' case-specific application of the economic-substance doctrine "calls into doubt the

proper tax treatment of many kinds of transactions that have long been accepted as legitimate." Pet. 31. The IRS and courts have long condemned tax shelters like the one petitioner purchased from KPMG, which manipulate tax rules to generate phony losses of hundreds of millions of dollars.

b. The 2010 statutory codification of the economic-substance doctrine clarifies that "[t]he potential for profit of a transaction shall be taken into account in determining whether [a transaction has economic substance] *only* if the present value of the reasonably expected pre-tax profit from the transaction is *substantial* in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." 26 U.S.C. 7701(*o*)(2)(A) (emphases added). That provision applies "to transactions entered into after the date of the enactment of" the 2010 statute. Pub. L. No. 111-152, § 1409(e)(1), 124 Stat. 1070. In cases involving post-enactment transactions, courts will ask whether the profit potential of the discrete part of a larger transaction was "substantial" in relation to the tax benefits to be realized from the transaction as a whole—here, more than $80 million in tax benefits in 1996 alone. Now that Congress has clarified the applicable rule going forward, there is no sound reason for this Court to address the proper application of pre-existing law to tax shelters like the LRT/stock transaction.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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