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 United States Court of Appeals for the Eighth Circuit

REPLY BRIEF FOR PETITIONER

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CORPORATE DISCLOSURE STATEMENT

Petitioner WFC Holdings Corporation's Rule 29.6 Statement was set forth at p. ii of the petition for a writ of certiorari, and there are no amendments to that Statement.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES

CONSTITUTION, STATUTES, AND REGULATIONS

ADMINISTRATIVE MATERIALS

OTHER MATERIALS

Far from seeking fact-bound error correction, this case implicates the fundamental limits of the economic substance doctrine. This Court's longstanding economic substance precedents establish two basic legal principles that should have resolved this case. First, transactions that generate non-tax economic profits cannot lack economic substance. Second, taxpayers have the right to structure economically profitable transactions so they also achieve tax benefits authorized by the Code. According to the government, however, these principles should yield to a new exception that permits the IRS to disregard even profitable transactions by characterizing them as "abusive tax shelters" rather than "ordinary tax planning."

This Court has never embraced such a sweeping, standardless inquiry. Such an exception undermines the constitutional separation of powers by authorizing the IRS and the courts to ignore the Code whenever they dislike a tax-efficient transaction. It also vitiates the long-recognized "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." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

This Court has not addressed the economic substance doctrine in more than 35 years. In that time, as the decision below illustrates, the doctrine has metastasized in certain circuits into a broad and unprincipled "smell test." The government defends that state of affairs. But the resulting uncertainty severely impairs lawful tax planning and creates a significant drag on the U.S. economy. Especially given that Congress's recent codification perpetuates pre-codification judicial standards, this Court's intervention is urgently needed to restore the doctrine's proper limits.

ARGUMENT

I. THE DECISION BELOW TRANSGRESSES THIS COURT'S LIMITS ON THE ECONOMIC SUBSTANCE DOCTRINE

A. By deciding that a transaction that generated millions of dollars in non-tax profits was nevertheless a sham, the decision below expanded the economic substance doctrine beyond a clear boundary set by this Court. The government does not contest that the lease transfer at the heart of the LRT produced significant non-tax economic profits for WFC, even after accounting for transaction costs. Opp. 11-12.[1] Moreover, the government acknowledges that "[t]axpayers may engage in 'tax-efficient transaction[s]' that have 'features that are not necessary to achieve the economic benefits generated by the transaction.'" Opp. 18 (quoting Pet. 22-23) (second alteration in original).

The government nonetheless defends the decision below on the ground that the doctrine creates broad discretion to disregard even a profitable transaction if it is deemed an "abusive tax shelter" rather than

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[1] The government's suggestion (at 7) that WFC profited only from the Garland lease transfer contradicts the record. While the district court "focus[ed]" on Garland, App. 80a, it explained more generally why transferring underwater leases to a non-bank subsidiary improved WFC's ability to manage them, Pet. 5-9, and the record shows that WFC realized profits from transferring other leases. *See*, *e.g.*, Appellant's C.A. Br. 19-20 (summarizing profits from Lakewood, citing A852-53, A1548.4). WFC continued to transfer leases to Charter profitably long after the LRT. *See id.* at 21 (citing A1779-80, A1896-97, A1900-02, A1916). Moreover, given that Garland accounted for more than $193 million (nearly 50%) of the transferred liabilities, *see* A575, the Garland profits amply establish the LRT's economic substance.

"ordinary tax planning." The Code recognizes no such distinction, and the government offers no standard for distinguishing "abusive" from "ordinary," or "tax shelters" from "tax-efficient transactions." Indeed, the government all but admits that such distinctions are in the eye of the beholder. Opp. 18 (acknowledging that the distinction often will be "difficult" to make).

This Court has never authorized such a standardless extra-statutory inquiry. Rather, courts may disregard the effect of the Code only when a transaction is a sham – a pure paper shuffle that has no economic effects apart from tax benefits. The doctrine's narrowness is crucial to its legitimacy. Congress has constitutional authority to make tax law, *see* U.S. Const. art. I, § 8, cl. 1, and neither the courts nor the IRS have authority to override the Code based on their own unaccountable views of sound tax policy. Given the pervasive impact of federal taxation as a form of government regulation, *see National Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2594-95 (2012), the government's position that an unelected administrative agency like the IRS should be entrusted with sweeping lawmaking authority should not be countenanced.[2]

B. The government asserts that this Court has never held a transaction to have economic substance

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[2] *See* Treasury Inspector Gen. for Tax Admin., *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* 5-6 (May 14, 2013) (documenting IRS abuses); *EPA v. EME Homer City Generation, L.P.*, 134 S. Ct. 1584, 1610 (2014) (Scalia, J., dissenting) ("Too many important decisions of the Federal Government are made nowadays by unelected agency officials exercising broad lawmaking authority, rather than by the people's representatives in Congress.").

where certain aspects of the transaction were designed solely to achieve tax benefits. That is incorrect. In *United States v. Consumer Life Insurance Co.*, 430 U.S. 725 (1977), this Court upheld several "complicated" reinsurance transactions on the ground that the transfer of insurance reserves off the insurer's books had meaningful economic effects. *Id.* at 734. It did so even though "[t]ax considerations may well have had a good deal to do with the specific terms" of the transactions. *Id.* at 739.

The government (at 16) dismisses *Consumer Life* on the ground that this Court "did not elaborate on what those terms were." But in fact the opinion explained in detail that the transactions were intentionally structured to transfer only reserves for accident-and-health premiums, and not life-insurance reserves, so that the taxpayers could remain qualifying life-insurance companies under the Code and thus reap "substantial tax savings" due to "preferential tax treatment." 430 U.S. at 727-36. *Consumer Life* thus stands squarely for the proposition that a substantial profit-generating transaction must be respected even if other aspects of the transaction are designed solely to obtain tax benefits. *See also Boulware v. United States*, 552 U.S. 421, 429 n.7 (2008).

The government also says (at 16) that the reinsurance contracts were not "abusive tax shelter[s]." Again, however, the government offers no meaningful standard – much less one found in the Code – for determining what is "abusive." The government's "tax shelter" mantra is also undermined by *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), which found a complex, multi-step sale-leaseback transaction to have economic substance even though the

taxpayer admittedly intended it as a "tax shelter." *Id.* at 570; *see also Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 557 (1991) (ruling for taxpayer even though the "acknowledged purpose" of the transactions was to "generate tax losses"). The Court upheld the sale-leaseback transaction in *Frank Lyon* because it meaningfully changed the taxpayer's economic position; consistent with *Consumer Life*, the fact that the transaction was also designed to achieve tax benefits provided by the Code did not alter that conclusion.[3]

Finally, the government misreads *Gregory*. Contrary to the government's assertion (at 13), *Gregory* did not invalidate the stock-transfer transaction at issue on the ground that Ms. Gregory "could just as readily" have achieved non-tax profits through an alternative transaction structure. The stock transfer in *Gregory* did not generate any non-tax profit at all. It was a pure fiction – a paper transaction that did not increase the value of the underlying securities or otherwise create any economic value. *See* 293 U.S. at 467. Here, by contrast, the transfer of leases to Charter indisputably occurred and generated millions of dollars in additional revenue for WFC wholly apart from any tax benefits.

C. The government's arguments why the LRT lacks economic substance highlight the need for this Court's review, because they inappropriately seek to

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[3] The government's suggestion (at 12) that taxpayers could "circumvent" the economic substance doctrine by adding a trivial and unrelated profit-making step to an otherwise meaningless transaction is a red herring. Far from an unrelated add-on, the lease transfer was the central element of an "integrated exchange agreement" that generated non-tax profits and tax benefits under the Code. App. 88a.

override the Code and impair taxpayers' right to reduce their tax burden.

1. The government's principal argument (at 10-11) is that WFC's claimed capital loss was "artificial[]" because, when WFC's banking subsidiaries transferred the leases and securities to Charter in exchange for Charter stock under Code § 351, they did not reduce their basis in that stock by the amount of liabilities Charter assumed.[4] But that basis calculation is dictated by Code § 358(d), which provides that, in a § 351 exchange, the transferor's basis in the stock received "shall not" be reduced by the amount of any liabilities assumed by the transferee corporation if those liabilities would, as is undisputed here, give rise to a deduction under the Code. 26 U.S.C. § 358(d)(2) (1994 & Supp. III 1998).[5] Every court to address the issue has agreed that § 358(d) is unambiguous on this point. *See* Pet. 9-10. The government's characterization of WFC's capital loss as "artificial[]" thus runs directly contrary to the Code's plain language.[6]

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[4] Code § 351 provides that no gain or loss need be recognized where a transferor (here, WFC's banking subsidiaries) transfers property (government securities) to a corporation (Charter) in exchange for stock, and the transferor thereafter controls the corporation. *See* 26 U.S.C. § 351 (1994 & Supp. III 1998).

[5] Specifically, the transferor's basis in stock received in a § 351 exchange equals its basis in the property transferred, reduced by the amount of any liabilities assumed by the transferee corporation, unless they would give rise to a deduction under the Code. *See* 26 U.S.C. § 358(a)(1)(A)(ii), (d) (1994 & Supp. III 1998).

[6] The Code also permits deduction of lease payments as business expenses as they are made. *See* 26 U.S.C. § 162(a). The government's criticism of that feature of the LRT is also contrary to the Code and this Court's precedents. *See Gitlitz v. Commis-*

The government argues (at 4) that Congress amended § 358 in 2000 to prohibit transactions like the LRT. As the government acknowledges, however, that amendment is irrelevant to this case, which involves a 1998 transaction. Moreover, the LRT complies with § 358 as amended. Even today, § 358 provides that the transferor corporation shall not reduce its basis by the amount of liabilities assumed if "the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange." 26 U.S.C. § 358(h)(2)(A). The government stipulated that that condition was satisfied here. App. 52a; Pet. 29 & n.16.[7]

The government apparently dislikes § 358(d) and believes Congress should have done more to change it in 2000. But the economic substance doctrine does not give the IRS or the courts a license to ignore the Code whenever they disagree with Congress's tax-policy choices. *See* Pet. 28-29 & n.15. The government's assertion that the LRT lacked economic substance because WFC's capital loss was "artificial[]" directly contravenes the Code and exceeds the doctrine's bounds.

2. The government's repeated suggestion that the LRT lacked economic substance because it was a "tax

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sioner, 531 U.S. 206, 219-20 (2001) (courts may not disregard the Code's plain language based on a "policy concern" that taxpayers will "wrongly experience a 'double windfall'").

[7] The government characterizes the stock transaction as "manipulation," Opp. 11, 12, but Congress enacted § 351 precisely to facilitate tax-free internal corporate reorganizations through the transfer of property in exchange for stock. *See*, *e.g.*, *Helvering v. Cement Investors, Inc.*, 316 U.S. 527, 533-34 (1942) (discussing predecessor to § 351).

product" designed by outside tax advisors to reduce WFC's tax burden is also contrary to the Code and this Court's precedents. Corporate tax departments across the country rely on outside tax advisors to provide sophisticated tax advice, including strategies to reduce the company's effective tax rate. *See* Atlantic Legal Found. Br. 15; Am. Bankers Ass'n Br. 12-19. Similarly, individuals and small businesses routinely obtain tax advice from outside professionals regarding ways to reduce their tax liability consistent with the Code. *See*, *e.g.*, Taxpayer Advocate Service, *2012 Annual Report to Congress – Executive Summary* vii (Dec. 31, 2012) (noting that nearly 90% of individual taxpayers hire tax preparers or purchase tax-return software). Such tax planning is not nefarious or unlawful.[8] In fact, the Code permits taxpayers to deduct the expenses associated with obtaining outside tax advice. *See* 26 U.S.C. §§ 162, 212; 26 C.F.R. § 1.212-1(*l*). The government's arguments strike at the heart of lawful tax planning and thus highlight the need for this Court's review.

II. REVIEW IS WARRANTED TO RESOLVE THE CONFLICT IN THE LOWER COURTS REGARDING THE ECONOMIC SUBSTANCE DOCTRINE'S SCOPE

A. The decision below conflicts with the two other courts of appeals to address contingent liability transactions like the LRT. Both courts held, contrary to the court below, that such a transaction

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[8] Contrary to the government's insinuation (at 6-7), a taxpayer's assessment of whether a proposed transaction generates non-tax economic benefits is an indication of sound tax planning, not abuse. The government's claim (at 5 n.2) that the LRT violated federal banking regulations is inaccurate, and neither court below credited it.

has economic substance if the transfer of liabilities has non-tax economic effects. *See Black & Decker Corp. v. United States*, 436 F.3d 431, 442 (4th Cir. 2006) (holding that transaction had economic substance if there was "economically substantial value to Taxpayer in transferring its contingent liability"); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1358 (Fed. Cir. 2006) (holding that whether the liability transfer had non-tax economic effects was dispositive). Neither case suggested, as the government now does, that the issuance or sale of stock had to create independent non-tax economic benefits.

Had the Eighth Circuit applied the legal rule adopted by the Fourth and Federal Circuits, the LRT would have been determined to have economic substance. Although the government notes (at 18-19) that *Coltec* and *Black & Decker* reversed judgments for the taxpayer, based on the particular factual record before them, that does not diminish the split. The legal standard adopted by those courts is squarely in conflict with the decision below.

B. The decision below also deepens a broader split on the scope of the economic substance doctrine. Although the government denies a conflict, it has been widely recognized by judges and scholars. *See United States v. Coplan*, 703 F.3d 46, 91 (2d Cir. 2012) ("Since *Gregory*, the economic substance doctrine 'has been applied differently from circuit to circuit and sometimes inconsistently within circuits.'") (citation omitted); Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts* ¶ 4.3.1 & n.8 (2013) (calling the doctrine "exquisitely uncertain") (internal quotations omitted); Prof. Grewal Br. 24 ("[T]he lower courts

have achieved a startling level of inconsistency on economic substance matters.").

The government's effort to reconcile the lower-court cases rests on cherry-picked language that merely pays lip service to this Court's precedents. For example, although *Dow Chemical Co. v. United States*, 435 F.3d 594 (6th Cir. 2006), recited the "any practicable economic effects" test, it went on to disregard a transaction with genuine profit potential based on a newly minted rule that such profit must be "consistent with the taxpayer's actual past conduct." *Id.* at 599, 601 (internal quotations omitted); *see id.* at 605 (Ryan, J., dissenting) ("[T]here is no such precedential rule of law and no warrant for creating one in this case."). Likewise, in this case, the court below at times appeared to acknowledge the doctrine's strictures, *see* App. 15a, but then disregarded a transaction that generated millions of dollars in non-tax profits.

As these cases illustrate, numerous lower courts have ignored this Court's basic teachings and turned the doctrine into what one dissenting judge described as a mere "smell test." *See ACM P'ship v. Commissioner*, 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J., dissenting). This Court's intervention is needed to resolve the conflict in the lower courts and restore the well-established limitations on the economic substance doctrine.

III. THE SCOPE OF THE ECONOMIC SUBSTANCE DOCTRINE IS AN ISSUE OF NATIONAL IMPORTANCE WARRANTING REVIEW

As the petition and petitioner's *amici* establish, the uncertainty created by the lower courts' expansive and unprincipled economic substance jurisprudence

impairs rational tax planning, imposes significant costs on American businesses, and creates a significant drag on the U.S. economy. Pet. 27-32; Cato Inst. et al. Br. 6-11; Private Practitioners Br. 13-20.

Neither of the government's responses justifies declining review. First, the government assures us (at 22) that its position "does not cast doubt on ordinary tax-planning strategies." That assurance is empty, however, given its embrace of the lower courts' malleable "smell test," which gives the IRS unbounded discretion and leaves taxpayers without meaningful guidance regarding how to ensure that tax planning will be respected as "ordinary" rather than "abusive."

Second, the government suggests (at 22) that Congress's 2010 codification "may resolve" the problem. As the government successfully argued in support of certiorari in *United States v. Woods*, 134 S. Ct. 557 (2013), however, the new statute does not render the question presented "obsolete." U.S. Cert. Reply Br. at 1-3, No. 12-562 (U.S. filed Feb. 20, 2013). Indeed, thousands of economic substance cases implicating billions of dollars of taxes will be governed by pre-codification standards "for years to come." *Id.* at 3. Thus, consistent with this Court's grant of certiorari in *Woods*, the issue presented is worthy of review even assuming a different standard were to apply to post-2010 transactions.

In all events, the only new provision cited by the government – 26 U.S.C. § 7701(*o*)(2)(A) – is irrelevant because that "[s]pecial rule" applies only where the taxpayer relies on "potential" profit. *Id.* It does not change the standard for assessing transactions like the LRT, which generated millions of dollars of *actual* profit for WFC. In fact, Congress's

codification heightens the need for review because, as the government has acknowledged, the statute largely incorporates pre-codification law. *See id.* § 7701(*o*)(5)(A), (C); I.R.S. Notice 2010-62, at 5 (Oct. 4, 2010); Cato Inst. et al. Br. 11-12. It thus remains critical for this Court to resolve the confusion in the lower courts and restore the proper limits of the economic substance doctrine.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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