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Tax Shelters: Up Off the Canvas?

Steve R. Johnson
Florida State University College of Law

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By Steve R. Johnson*

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Recently, taxpayers prevailed at trial in two federal tax shelter cases: *TIFD III-E Inc. v. United States*, 2009 WL 3208650 (D. Conn. Oct. 7, 2009) ("*Castle Harbour III*"), and *Consolidated Edison Co. v. United States*, 2009 WL 3418533 (Fed. Cl. Oct. 21, 2009) ("*Con Ed*"). Doing full justice to these cases would require detailed descriptions of their facts, the arguments presented and the rationales in the opinions. I leave this work to the inevitable parsing and spinning in briefs in tax shelter cases to come and to more lengthy commentary. *See, e.g.,* Lee A. Sheppard, *Con Ed's Night of the Living Dead*, TAX NOTES, Nov. 9, 2009, at 619.

Instead, this article addresses two larger themes. Part I places *Castle Harbour III* and *Con Ed* in the context of current tax shelter litigation. It notes that waves of taxpayer success and government success have alternated. The recent cases show that the Service has not yet landed a knock-out punch to end the tax shelter bout. Part II suggests that *Con Ed* and *Castle Harbour III* continue one theme evident in some tax shelter decisions: that, in some courts, shelters linked to ongoing, substantial business may be more likely to be validated than "freestanding" transactions.

The Tax Shelter Battles Aren't Over

The battle between the Service and tax shelter investors over the past two decades has been like Rocky Balboa against Apollo Creed. Supporters of each combatant are alternately exhilarated or distressed by the shifting fortunes of the fight.

For example, in 2004, the Service took three heavy punches in trial-level losses in *TIFD III-E Inc. v. United States*, 342 F. Supp. 2d 94 (D. Conn. 2004) ("*Castle Harbour I*"), *Black & Decker Corp. v. United States*, 340 F. Supp. 2d 621 (D. Md. 2004), and *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716 (2004). These losses threw opponents of shelters into consternation. *E.g.*, Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1962 (2005) (proposing new legislation because "the economic substance doctrine is simply too weak a barrier to protect the collection of income tax from assault by abusive shelter planners. Recent court decisions prove that proposition beyond a doubt.").

But the Government rallied strongly in the next round, including the reversal of all three taxpayer trial court victories. *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006) ("*Castle Harbour II*"); *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007).

* E.L. Wiegand Professor of Law, William S. Boyd School of Law, University of Nevada, Las Vegas, Las Vegas, NV.

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For several years thereafter, the Service seemed to be winning. There were several taxpayer victories, to be sure. *E.g., Sala v. United States*, 552 F. Supp. 2d 1167 (D. Colo. 2008), *new trial denied*, 251 F.R.D. 614 (on appeal to 10th Cir.); *Countryside Ltd. P'ship v. Commissioner*, 95 T.C.M. (CCH) 1006 (2008). But the Government prevailed more often. With each victory, more tax officials and others forgot the lesson of experience: that a pendulum moves in one direction only for a space, after which it reverses its course. *See, e.g.*, Jeremiah Coder, *Practitioners, Government Officials Debate Codification of Economic Substance*, 2009 TNT 222-6 (Nov. 20, 2009) (citing Service attorney W lliam Sabin Jr., speaking on his own behalf, to the effect that the Service's recent successes reflect "a large shift from just a few years ago when the [economic substance] doctrine was held in low esteem by many judges" and quoting him as saying that the doctrine has "proven very effective and very reliable.").

It remains to be seen, of course, whether *Castle Harbour III* and *Con Ed* herald such a reversal. The Tenth Circuit is expected soon to issue its opinion in the *Sala* appeal; it is virtually certain that the government will appeal C*astle Harbour III*; and the Government may also appeal *Con Ed*. The results of these and other cases will tell the tale of the upcoming rounds. What can be said now, however, is that the Government has not yet achieved final victory in the tax shelter wars (if it ever will). The battle continues.

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Shelters as Part of Ongoing Business

Some taxpayers have found courts more inclined to approve their claimed tax benefits if the scheme that produced them was part of ongoing, substantial business rather than an adventitious arrangement. For example, in the *UPS* case, the Eleventh Circuit reversed the Tax Court and upheld the claimed tax benefits. In part, the circuit court reasoned: "The transaction under challenge here simply altered the form of an existing, bona fide business . . . . [T]here was a real business that served the genuine need for customers to enjoy loss coverage and for UPS to lower its liability exposure." *United Parcel Serv. of America, Inc. v. Commissioner*, 254 F.3d 1014, 1020 (11th Cir. 2001).

The ongoing, substantial business aspect was present—actually or arguably—in the recent tax shelter decisions in *Castle Harbour III* and *Con Ed*. From the time of its first trip to district court, "[s]ome observers have suggested that *Castle Harbour* fits within a line of cases upholding tax-motivated transactions in which taxpayers have demonstrated a direct relationship between the structure chosen to provide tax benefits and the

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taxpayer's ordinary course of business." Karen C. Burke, *Castle Harbour: Economic Substance and the Overall-Tax-Effect Test,* TAX NOTES, May 30, 2005, at 1163.

Con Ed concerned a leveraged lease, a "lease-in, lease-out" transaction as to a facility located in the Netherlands. This was not the taxpayer's core business, but the court viewed it as a reasonable extension of its business, stating that the taxpayer's purposes included "the ability to pursue new opportunities and alternatives in a deregulated market; the expectation of making a pretax profit . . . ; plaintiff's entry into Western European energy markets; . . . technical benefits to Con Ed of operating a state of the art plant in its own field of expertise; the ability to further develop and share Con Ed's own cutting edge technology; and environmental [and public relations] benefits." *Con Ed*, 2009 WL 3418533, at *88. The court also was impressed with the extensive nature of the taxpayer's engineering, accounting, financial, environmental, and legal analyses and documentation. *See id*. at *95.

The arrangements in question need not rise to the level of a "trade or business" as those terms are understood for purposes of section 162. For example, in *Sala*, the upheld arrangement involved foreign currency options transactions, which the court viewed as being part of a long-term investment strategy. *Sala*, 552 F. Supp. 2d at 1179. Not even this long-term investment is indispensable. Each shelter must be evaluated on its own terms, and some shelters not involving long-term arrangements have been upheld by the courts. *E.g., Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001). Nonetheless, for some courts, the connection of the shelter to ongoing business is a plus factor, a connection that was actually or arguably present in *Castle Harbour III* and *Con Ed.*

Conceptually, though not yet empirically, the "connected to ongoing business" theme might appear to link more naturally to one of the multiple versions of the economic substance doctrine employed by the courts. The current, uncodified doctrine is applied in numerous inconsistent ways by the courts. One dimension of the inconsistency entails the relationship between the subjective business purpose component of the doctrine and the objective economic reality component.

There are at least four views of the relationship between these components. The disjunctive view holds that the taxpayer passes economic substance muster by winning either the subjective or the objective component. The conjunctive view requires the taxpayer to carry both components. The unitary test offers that the two components "do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM P'ship v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). *Con Ed* followed a fourth view, under which both components are considered but "the lack of economic reality of the transaction itself is the primary consideration …." *Con Ed*, 2009 WL 3418533, at *41.

A connection to ongoing business arguably could relate to either the subjective component or the objective component. It seems to fit most comfortably, however, in the overall inquiry called for by the unitary test. Thus far, however, there does not appear to be a close correlation between the courts referring to the connection theme and the version of the economic substance doctrine generally followed by those courts.

Conclusion

Two swallows do not a Spring make. *Castle Harbour III* and *Con Ed* are not revolutionary cases, and only time will tell whether they survive appeal. Nonetheless, the cases remind us of the occasional theme of connection of the shelter with ongoing business. Most importantly perhaps, the cases remind us that the bell has not yet tolled the end of the final round of the tax shelter fight. If some had thought that shelters were down for the count, the recent cases show that at least some shelters have risen from the canvas. ■