In *Southgate*, Economic Substance, Substance Over Form, and Penalties Are a Dangerous Mix

By Richard M. Lipton

Not all judicial doctrines using the word "substance" are the same, and the court of appeals carefully outlined the differences. In light of the significant penalty that might be involved if a transaction violates the economic substance doctrine, the recent decision by the Fifth Circuit should be very instructive.

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The recent decision in *Southgate Master Fund, L.L.C.*, 659 F.3d 466, 108 AFTR2d 2011-6488 (CA-5, 2011), *aff'g* 651 F. Supp. 2d 596, 104 AFTR2d 2009-6053 (DC Tex., 2009), makes interesting reading for anyone who is concerned about the scope of the economic substance doctrine and other judicial doctrines as well as the determination of penalties. The Fifth Circuit likely reached the correct conclusion in denying claimed tax benefits, and may even have done so for the right reason, although its opinion is self-contradictory in several aspects. On the other hand, it is hard to square the court's decision on the merits with its conclusion that the taxpayer reasonably relied on the opinion it received from counsel, especially when the applicable law (not considered by the court) is taken into account.

FACTS

The transaction in Southgate involved an attempt by a bank in China, working with an accountant in the U.S., to transfer the tax benefit of losses incurred in China to a U.S. taxpayer. To achieve this goal, a partnership (Southgate) was used, taking advantage of rules (no longer the law) that required the purchaser of a partnership interest to inherit a built-in loss applicable to the seller of a partnership interest.

There were four major players in this transaction:

- D. Andrew Beal, a Dallas billionaire who made a fortune in the banking business and owned Beal Bank ("the Bank").
- Thomas Montgomery, a CPA who worked with Beal and the Bank and specialized in locating distressed-debt investments in foreign markets.
- Cinda, a Chinese-government-owned asset management company located in China that had purchased a large portfolio of nonperforming loans (NPLs) at the behest of the Chinese government.
- DeCastro West ("DeCastro"), a large U.S. law firm.

Beal and the Bank had a history of making money by purchasing NPLs. For years the Bank had focused primarily on domestic opportunities, but as the domestic market became more competitive Beal and the Bank began to focus on identifying inefficiencies and investment opportunities in foreign markets. In 2001, Beal hired Montgomery to help him identify opportunities to invest in foreign NPLs. Over the next year, Montgomery identified NPL investment opportunities in half a dozen foreign countries, including a package of Jamaican NPLs that Beal purchased for $23 million and sold for $46 million.

About the same time that Beal and Montgomery were beginning to look for opportunities to invest in foreign NPLs, a robust market for NPLs was emerging in China. By the late 1990s, China's largest banks had become saddled with huge numbers of NPLs. In an effort to reform and modernize its banks in conjunction with its admission to the WTO, the Chinese government created four new state-owned asset-management companies to assume and resolve the banks' NPLs. Cinda was one of these asset-management companies.

The Chinese government required Cinda to purchase NPLs from the banks at face value notwithstanding the fact that the NPLs were worth far less. From the Chinese government's perspective, these transactions helped clean up the banks' balance sheets. During 2000 and 2001, the four asset-management companies purchased $168 billion of NPLs from the Chinese banks, of which $45 billion was purchased by Cinda.

The asset-management companies were charged with resolving the loans that they had purchased. Cinda was given so-called "super powers" to facilitate debt collection, including the authority to restructure and compromise debt, pursue litigation against debtors, and toll the statute of limitations.

In the Fifth Circuit, there must be objective economic reality, a subjectively genuine business purpose, and some motivation other than tax avoidance.

As the size of the Chinese asset management companies' NPL portfolios grew, investment banks and other sophisticated international investors began to enter the Chinese NPL market. For example, in 2001 both Goldman Sachs and Morgan Stanley acquired portfolios of NPLs. In those cases, China Huarong, another Chinese asset-management company, provided collection services to the owners of the NPLs.

By early 2002, Montgomery was aware of this opportunity to acquire Chinese NPLs, and researched this market over the next several months. Montgomery was then put into touch with Cinda through a contact at Deutsche Bank. Montgomery made several trips to China, where he met with Cinda and reviewed various NPL portfolios. Montgomery eventually determined that Beal should invest in a portfolio of unsecured NPLs.

At the same that he was researching the profit potential from an investment in Chinese NPLs, Montgomery began to consider the potential tax benefits. Deutsche Bank introduced Montgomery to DeCastro, which laid out a plan for the acquisition of the NPLs. Specifically, DeCastro proposed that once the desired NPLs were identified, Beal should form a partnership with Cinda and have Cinda contribute the NPLs to the partnership. Beal could then acquire a portion of Cinda's partnership interest. By purchasing a portion of Cinda's interest in the partnership instead of acquiring the NPLs directly, Beal would be entitled to claim the tax loss when the loans were eventually sold or collected (pursuant to Section 704(c)) as long as the partnership had not made an election under Section 754 to adjust basis to FMV.

Cinda was an ideal partner for Beal for purposes of this transaction. First, the Chinese government had required Cinda to acquire the NPLs at face value, so Cinda had a cost basis in these loans far in excess of FMV. Second, because it was a foreign corporation not subject to U.S. taxation, Cinda was indifferent to the tax planning involved (although even if Cinda were a U.S. taxpayer, it would have recognized a loss on the sale of its partnership interest). Most important, the transaction allowed Cinda a quicker way to dispose of a portion of the loans which it held, at a reasonable price, which was Cinda's mission.

Because the Bank was not in a position to invest in the NPLs, Beal decided to do so personally. Montgomery agreed to co-invest through his newly formed company, Montgomery Capital Advisors (MCA). Montgomery identified a portfolio of 24,000 NPLs with a face value of approximately $1.145 billion; he anticipated that the real value of the NPLs was between 1%-3% of face value (i.e., between $11 million and $33 million). Montgomery hired a Chinese valuation firm (Zhongyu) to estimate the total value of the portfolio, and also hired a Chinese law firm (Haiwen) to perform legal due diligence (confirming that the loans were valid, enforceable, and transferable by Cinda).

The transaction itself was accomplished through several steps:

1. In July 2002, Cinda formed Eastgate, a Delaware single-member LLC (SMLLC).
2. Cinda contributed the portfolio of NPLs to Eastgate.
3. MCA and Eastgate formed Southgate. Cinda's contribution, for which Cinda received a 99% interest in Southgate, was valued at $19,420,000 (1.7% of the face value of the NPLs contributed by Cinda); MCA contributed cash and a promissory note worth $196,192 for a 1% interest in Southgate.
4. Montgomery entered into a brokerage agreement with Deutsche Bank under which Deutsche Bank would serve as the exclusive placement agent for the NPLs for a fee of $50,000. Deutsche Bank, which had facilitated the transaction (i.e., it was the promoter), also received a fee of $8.5 million to be paid by Beal.
5. Southgate and Cinda signed a loan-servicing agreement under which Southgate agreed to pay Cinda 25% of the net collections on the NPLs.

These transactions positioned Southgate as a tax-friendly investment vehicle for Beal. Southgate was holding NPLs with a built-in loss of more than $1.3 billion. An investor who purchased Cinda's interest would step into its shoes and be allocated the losses under Section 704(c) if and when the losses were realized.

During the next month, Zhongyu estimated that the FMV of the portfolio of NPLs contributed by Cinda was between $44 million and $111 million; Haiwen confirmed that the NPLs were transferable. Finally, on 8/30/02, Beal (through Martel, an SMLLC he owned) paid $19.4 million to Cinda in exchange for 90% of its interest in Southgate, i.e., an 89.1% interest in the partnership. Beal also paid the $8.5 million fee to Deutsche Bank.

The fact that an economically substantial transaction came wrapped in a dubious form was not grounds to disregard the transaction under the economic substance doctrine.

Notwithstanding the due diligence that had been undertaken, Southgate's total collections on the NPLs were far less than Zhongyu had anticipated, amounting only to $10.69 million. This shortfall was primarily due to Cinda's poor performance as a loan servicer. The principal cause was that a number of the loans that were believed to have significant value were backed by a Chinese government guarantee, which the government did not honor and Cinda (because it was owned by the government) did not pursue.

In late 2002, Southgate sold approximately 22% of the NPLs in its portfolio, resulting in recognition of a built-in tax loss of $292.8 million. Because Beal had purchased 90% of Cinda's interest, 90% of the built-in loss was allocable to him. Because Beal had not contributed any equity to Southgate in excess of the cost of purchasing Cinda's interest, however, his basis in his partnership interest (around $27 million) was not nearly sufficient to allow this loss to pass through to him.

In order to increase his basis in Southgate, Beal nominally contributed to Southgate some Ginnie Mae bonds (GNMAs) that he owned, which had an FMV of $180.6 million. First, Beal contributed the GNMAs to Martel. Martel then distributed the interest in Southgate to Beal. The practical effect of these transactions was to give Beal an outside basis in his interest in Southgate equal to the sum of his purchase price (approximately $30 million) plus his basis in the contributed GNMAs (approximately $180 million). When Beal was allocated losses of $263 million by Southgate, he was able to claim a loss of $210 million due to his increased basis.

The IRS challenged Beal's claimed loss. After a 15-day trial, the district court upheld the IRS on the grounds that Southgate was a "sham partnership" for tax purposes. Nevertheless, the court disallowed the Service's proposed penalties on the grounds that the taxpayer had established reasonable cause and good faith reliance on its advisors, DeCastro and Montgomery.

THE FIFTH CIRCUIT OPINION

The Fifth Circuit looked at three different doctrines in determining whether the losses claimed by Beal should be respected. First, the court considered whether the economic substance doctrine permitted the taxpayer to reap the claimed benefits. Second, the court considered the application of the "sham partnership doctrine," which appeared to be the court's name for a determination of whether there was a partnership at all under the test enunciated in *Culbertson*, 337 U.S. 733, 37 AFTR 1391 (1949). Finally, the court considered how the transaction should be treated under the substance over form doctrine.

Economic Substance

The appellate court "[w]ith little difficulty" sustained the district court's conclusion that there was economic substance to the acquisition of the NPL portfolio. The Fifth Circuit uses a three-part test (the "*Klamath* factors") to determine whether a transaction has sufficient economic substance to be respected for tax purposes.[1] The inquiry is whether the transaction:

1. Has economic substance compelled by business or regulatory realities,
2. Is imbued with tax-independent considerations, and
3. Is not shaped totally by tax-avoidance features.

In other words, to be respected in the Fifth Circuit the transaction must exhibit objective economic reality, a subjectively genuine business purpose, and some motivation other than tax avoidance. Although the factors are phrased in the conjunctive, there is overlap between the last two factors.[2]

Southgate's acquisitions of the NPLs satisfied the first *Klamath* factor because the partnership and its members entered into the transaction with a reasonable possibility of a profit. Although it turned out in hindsight that the transaction was not profitable, this fact did not change the analysis of this factor. The investment failed because of Cinda's shortcomings as a loan servicer and due to interference from the Chinese government, but these were not foreseeable at the time the transaction was entered into. If Zhongyu's estimate of the potential collections had been correct, Southgate could have realized a substantial profit. Therefore, the objective economic reality test was satisfied.

The court then turned to the remaining two *Klamath* factors, which ask whether the transaction was motivated solely by tax-avoidance considerations or was imbued with some genuine business purposes. Basically, these factors require a subjective inquiry into the taxpayer's motivation in entering into the transaction.[3] Tax-avoidance considerations are not wholly prohibited; taxpayers who act with mixed motives to obtain both tax benefits and

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1 See Klamath Strategic Investment Fund, 568 F.3d 537, 103 AFTR2d 2009-2220 (CA-5, 2009).

2 See Lipton, "In *Klamath*, the Fifth Circuit Clarifies Its Test for Economic Substance," 111 JTAX 83 (August 2009).

3 See also Dow Chemical Co., 435 F.3d 594, 97 AFTR2d 2006-671 (CA-6, 2006).

economic profit can satisfy the business purpose test.[4]

In *Southgate*, the district court found that Southgate and its members acquired the NPLs for legitimate business purposes and that they believed they could earn a profit from the NPLs. The court emphasized that this was not a situation in which the taxpayer engaged in an exotic, one-off transaction that bore no resemblance to its usual business activity. Beal and Montgomery specialized in acquiring distressed debt, and the acquisition of the NPLs fit squarely within their core business. The district court further found that Beal and Montgomery would have done the deal even if there were no tax benefits, although Beal was certainly motivated by the potential tax benefits.

The IRS argued that the economic substance doctrine should be applied on the grounds that the profit potential found by the district court was insubstantial relative to the expected tax benefits. The Fifth Circuit rejected this argument both factually and legally. Factually, the district court made three separate findings that the acquisition of the NPLs had not just a de minimis profit potential but a reasonable profit potential.

Legally, the Fifth Circuit concluded that the Service was attempting to conflate the sham partnership argument, discussed below, with the economic substance doctrine. According to the court, the acquisition of the NPLs did not generate tax benefits; the tax benefits arose because the acquisition was structured through a partnership that transferred those tax benefits to Beal. The fact that an economically substantial transaction came wrapped in a dubious form was not grounds to disregard the transaction under the economic substance doctrine; it was reason to disregard the form of the transaction (under the substance over form doctrine). Therefore, the Fifth Circuit affirmed the district court's conclusion that the transaction had economic substance.

Valid Partnership

The next portion of the Fifth Circuit's opinion focused on whether the district court correctly determined that Southgate was a sham partnership that must be disregarded. The term "sham partnership" is somewhat unfortunate (and it was used by both the district court and the Fifth Circuit) because the court's analysis focused not on whether the transaction was a sham (which is the relevant determination under the economic substance doctrine) but, rather, on whether Southgate satisfied the *Culbertson* test.

Because so many tax-avoidance schemes exploit the Code's partnership provisions, scrutiny of a taxpayer's choice to use the partnership form is especially stringent.

Under the Supreme Court's decision, a partnership will be respected for tax purposes only if the parties in good faith and acting with a business purpose genuinely intended to join together for the purpose of carrying on a business and sharing in the profits and losses. This determination is made on the basis of all of the facts and circumstances, including the agreements, the conduct of the parties, the relationship of the parties, and any other relevant facts throwing light on their true intent.

Because so many abusive tax-avoidance schemes are designed to exploit the provisions in the Code concerning partnership taxation, the Fifth Circuit noted that its scrutiny of a taxpayer's choice to use the partnership form is especially stringent. The court stated it was not compelled to conclude that a partnership must be respected for tax purposes merely because the taxpayer can point to some business purpose or objective reality; the formation of the partnership must, on balance, display good common sense from an economic standpoint.[5]

Furthermore, the fact that a partnership's underlying business had economic substance does not, standing alone, immunize the partnership from judicial scrutiny. The parties' selection of the partnership form must have been driven by a genuine business purpose.[6] This is not to say that tax considerations cannot play any role in the decision, but tax considerations cannot be the *only* reason for a partnership's formation. If there was not a legitimate, profit-motivated reason to operate as a partnership, then the partnership will be disregarded for tax purposes even if it engaged in transactions that had economic substance.

The court then applied the *Culbertson* test to determine whether the Southgate partnership should be respected. In other words, in order to obtain the tax benefits that are derived from conducting a trade or business that has economic substance through a partnership, the partnership must itself be "real" under *Culbertson*. If the parties did not come together to jointly conduct a business—in this case, collecting on the NPLs—then the partnership form will be disregarded.

Turning first to whether the parties had an intent to join together, the court conceded that Beal and Montgomery had an intent to realize value from the NPLs. The parties' conduct, however, indicated that there was no intent to conduct business as a partnership with Cinda. In late 2003, when Cinda's failings as a loan servicer were becoming apparent, Montgomery retained an attorney to improve collections; the attorney wrote a letter to Cinda complaining about its actions. Cinda responded by

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[4] See Compaq Computer Corp., 277 F.3d 778, 88 AFTR2d 2001-7339 (CA-5, 2001).

[5] Citing TIFD-IIIE, Inc., 459 F.3d 220, 98 AFTR2d 2006-5616 (CA-2, 2006); Boca Investerings Partnership, 314 F.3d 625, 91 AFTR2d 2003-444 (CA-D.C., 2003). See Lipton and Austin, "Partner or Lender? Debt/Equity Issues Arise in Second Circuit's Reversal of Castle Harbour," 105 JTAX 236 (October 2006); Lipton and Dixon, "When Is a Partner Not a Partner? When Does a Partnership Exist?," 100 JTAX 73 (February 2004).

[6] Merryman, 873 F.2d 879, 64 AFTR2d 89-5009 (CA-5, 1989).

threatening to disclose the transaction to the IRS, which prompted an apology from Montgomery's attorney and no further efforts to goad Cinda into improving its performance. The partnership's profit potential depended on Cinda's collection efforts, but it was clear that the taxpayers were more concerned about their tax benefit than causing Cinda to perform as expected.

Cinda's post-formation conduct also was incompatible with its status as a partner. If anything, Cinda appeared intent on sabotaging and undermining Southgate's collection efforts. If Cinda had been a true partner, it would have concentrated on collecting the NPLs where possible. Instead, Cinda repeatedly sold off the most promising loans, deliberately thwarting Southgate's profit potential.

Furthermore, Cinda did not even profess publicly to view Southgate as a true partnership. In its public announcements, Cinda stated that it had completed a "package sale" of the NPLs. Regulatory approval of the transaction was predicated on Cinda's representation that it would retain a 10% interest in Southgate only "symbolically." Moreover, although Cinda had a capital account of $19.42 million, the sale price for the 90% interest sold to Beal was $19.41 million, indicating that Cinda had virtually no ongoing economic interest in Southgate. Cinda also failed to participate in the subsequent restructuring of the partnership when Beal contributed the GNMAs in order to increase his basis.

The Fifth Circuit also concluded that in light of *Culbertson*'s identification of the actual control of income and the purposes for which it is used as a measure of partnership legitimacy, the terms of the contribution of the GNMAs showed that Southgate was not a true partnership. Beal reserved for himself total control over all of the income produced by the GNMAs. At the time of their contribution, the GNMAs could have provided real economic benefits to the partnership, but the structure of the basis-build transaction ensured that Southgate would never receive those benefits, in four ways:

- When the GNMA were used as collateral for a loan, the loan proceeds were distributed to Beal and not retained by Southgate.
- Principal payments received on the GNMAs were distributed to Beal.
- All of the interest on the GNMAs was allocated to Beal.
- Although there was a theoretical possibility that Southgate could participate in fluctuation in the value of the GNMAs as interest rates moved, this could occur only if the GNMAs were sold, which was contrary to Beal's intent.

Finally, the Fifth Circuit noted that under *Culbertson,* a relevant question is whether the partners were acting with a business purpose when they made the decision to form the partnership. Although the district court found that there were six reasons why the partnership was formed, the Fifth Circuit stated that these findings did not compel the court to conclude that Southgate was formed with a genuine business purpose.[7] The business purposes claimed by Southgate, and the Fifth Circuit's responses to those claims, were as follows:

***Culbertson* identifies the actual control of income and the purposes for which it is used as a measure of partnership legitimacy.**

1. Although the formation of a non-Chinese entity into which the NPLs were transferred avoided difficulties of getting approval from the Chinese government, this purpose was accomplished through the formation of Eastgate—Southgate was not needed.

2. The confirmation of title occurred when the NPLs were transferred to Eastgate; the further transfer to Southgate was not necessary.

3. The purchase price for the NPLs did not depend on the formation of Southgate.

4. Southgate was not needed to lock-in the acquisition of the NPLs.

5. Although the formation of Southgate helped Cinda remove the NPLs from its books, a direct sale of the NPLs would have been just as effective.

6. The district court's finding that the creation of Southgate enabled Montgomery to obtain representations from Cinda was immaterial to the analysis of whether Southgate had a nontax business purpose.

Substance Over Form

Finally, the Fifth Circuit considered the application of the substance over form doctrine to this transaction. Under that doctrine, if taxpayers have taken a circuitous route to reach an end more easily accessible by a straight path, the courts will look at the substance of a transaction rather than its form.[8] The court is not bound to accept a taxpayer's formal characterization of a transaction, even if the transaction has economic substance.[9] The substance over form doctrine allows the courts to recharacterize a transaction in accordance with its true nature.

Because the court had concluded that the acquisition of the NPLs had economic substance, but that the partnership should be disregarded under the *Culbertson* test, it was necessary to determine what the true nature of the transaction really was under the substance over form doctrine. This was easy—Beal paid Cinda $19.4 million in exchange for an interest in a portfolio of NPLs. There was no partnership—the transaction was simply a sale of an ownership interest in the NPLs, which is what the Fifth Circuit found. Of course, if Beal acquired the NPLs, their basis would be stepped down to cost, thereby eliminating the claimed tax benefits.

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[7] Citing Andantech L.L.C., 331 F.3d 972, 91 AFTR2d 2003-2623 (CA-D.C., 2003).

[8] Kuper, 533 F.2d 152, 38 AFTR2d 76-5162 (CA-5, 1976).

[9] Harris, 902 F.2d 439, 66 AFTR2d 90-5104 (CA-5, 1990).

The Penalty Issue

The Fifth Circuit then turned to the question whether penalties should have been imposed in this situation. Although there was a substantial understatement of tax liability under Section 6662, the district court had found that the taxpayers qualified for the reasonable cause/good faith exception set forth in Section 6664. The Fifth Circuit agreed.

Southgate's penalty defense was predicated on its reliance on the tax opinion issued to it by DeCastro and the accounting firm Coscia Greilich & Company (CGC). Both tax opinions concluded that it was more likely than not that the IRS would uphold Southgate's tax positions. The district court found that Southgate relied on these tax opinions in good faith, and the government did not challenge that finding on appeal. The dispositive question, therefore, was whether Southgate's reliance on the DeCastro and CGC opinions constituted reasonable cause, which is a factual finding reviewed under the "clear error" standard.

The determination of whether a taxpayer acted with reasonable cause is a case-by-case analysis based on the totality of the facts and circumstances. Reg. 1.6664-4(b)(1) clarifies that reliance on the advice of a tax professional can, but does not necessarily, demonstrate reasonable cause. The advice must be based on all of the pertinent facts and circumstances and applicable law; if the tax advisor's opinion is shown to be based on unreasonable factual or legal assumptions which the taxpayer knows or has reason to know are unlikely to be true, then the taxpayer's reliance on the opinion does not constitute reasonable cause.[10]

The district court found that all of the elements of reasonable cause were present in this case. Southgate received comprehensive tax opinions from DeCastro and CGC, both of which the district court found to be qualified tax advisors not burdened by any conflict of interest. The district court also found that all pertinent facts had been disclosed to DeCastro and CGC, and that the opinions considered all of the facts and were not based on unreasonable assumptions. The transactions were carried out as set forth in the opinions. Consequently, the district court concluded that the opinions met the standards for reliance on tax advice described in Section 6664.

On appeal, the government advanced two theories as to why these findings did not establish reasonable cause. First, the government argued that Beal did not follow the advice provided by DeCastro and CGC in structuring the basis build-up. Second, the government contended that the district court had not found that the opinions were not based on unreasonable or untrue assumptions, which the government contended were present in this case.

The Fifth Circuit rejected these arguments based on the lower court's findings that the transactions were consistent with the structures recommended by DeCastro and CGC and that the opinions were not based on any unreasonable assumptions. The Fifth Circuit emphasized that its conclusion that these business purposes were not sufficient to imbue the partnership with legitimacy for tax purposes did not call into question the accuracy with which Beal and Montgomery reported the relevant facts to DeCastro and CGC. According to the Fifth Circuit, Reg. 1.6664-4(c) does not require the taxpayer to correctly anticipate the legal consequences that the IRS or the courts will attach to the facts underlying a transaction.

ANALYSIS

The Fifth Circuit's analysis in *Southgate* is very important in several respects. First, the court clearly understood the distinction between the economic substance doctrine and the substance over form doctrine, and it applied that distinction correctly. On the other hand, the Fifth Circuit accepted the "sham partnership" terminology used by the district court, where it would have been clearer if the court had simply based its decision on the conclusion that Cinda had just sold a portion of the NPLs to Beal. Finally, the court's penalty analysis did not take into account all of the relevant law or facts, which makes its analysis suspect.

Application of the economic substance doctrine. The Fifth Circuit's opinion shines in this regard. The IRS has adopted the unfortunate habit of claiming that every transaction it does not like lacks economic substance, even when the transaction is a "real" transaction that has a business purpose.

Under the substance over form doctrine, the court is not bound to accept a formal characterization of a transaction even if it has economic substance.

Beal was engaged in the business of buying distressed loans, and that is what this transaction involved. There was an actual outlay of millions of dollars to acquire the NPLs, not including the fees that were paid to Deutsche Bank. There was a reasonable appraisal of the amount that could be collected on the NPLs. In addition, after the NPLs were acquired, collection efforts were taken (albeit unsuccessfully) by an entity that had been charged by the Chinese government with this task. Although the form of the transaction could be challenged, it is very hard to see how this transaction lacked economic substance.

The Fifth Circuit's decision concerning the economic substance doctrine in *Southgate* is similar to other courts' decisions when the Service has attempted to use this doctrine to challenge "real" transactions. In *Countryside Limited Partnership*, TCM 2008-3, the Tax Court dismissed the Service's attempt to apply the economic substance doctrine because of the genuine, non-

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[10] Reg. 1.6664-4(c)(1).

tax business purpose for the transaction. The taxpayers exchanged their limited partnership interests in Countryside for notes in order to withdraw from the partnership, before the sale of the partnership's investment property. The taxpayers chose tax-motivated means in order to accomplish this legitimate, nontax business purpose. The Tax Court noted that the Service's focus on the tax-motivated means, instead of the business-oriented end, had led the IRS to an erroneous application of the doctrine.[11]

The court in *AWG Leasing Trust,* 592 F. Supp. 2d 953, 101 AFTR2d 2008-2397 (DC Ohio, 2008), rejected the government's contention that a SILO (sale-in, lease-out) transaction lacked economic substance, while applying the substance over form doctrine to deny the taxpayer's claimed depreciation deductions. The bona fide transaction involved the investment of millions of dollars, allegedly for an equity interest in a German waste factory.

In rejecting application of the economic substance doctrine, the district court focused on the investment made and whether the projections of cash flow and residual value were reasonable when the taxpayer entered into the transaction, not whether the predictions were ultimately proven true.[12] See also *Shell Petroleum Inc.,* 102 AFTR2d 2008-5085 (DC Tex., 2008).[13] In each of these decisions, the courts refused to apply the economic substance doctrine but then considered whether the transaction should be recharacterized under the substance over form doctrine.

The non-application of the economic substance doctrine in *Southgate* and other cases is important in light of the enactment of Section 7701(o) and the related no-fault penalty applicable to transactions that lack economic substance under Section 6662(d)(6).[14] Moreover, the court showed how it is possible to distinguish between the various judicial doctrines in a manner that was consistent with the Service's recent guidance in LB&I-4-0711-015 (7/15/11) ("the Directive"). The IRS specifically noted in the Directive that the economic substance doctrine is not the same as the substance over form doctrine and urged revenue agents to consider whether a transaction should be challenged on the basis of substance over form instead of economic substance.[15]

Valid partnership. It is somewhat unfortunate that the Fifth Circuit used "sham partnership" in describing its application of the *Culbertson* test to the facts in *Southgate.* The word "sham" could be understood to imply to mean that a transaction should be totally disregarded, whereas the Supreme Court's decision in *Culbertson* is better viewed as an application of the substance over form doctrine, i.e., a factual determination needs to be made whether the partnership form will be respected. Indeed, the factual nature of the *Culbertson* inquiry shows that the test is focused on the substance of the relationship between the parties and not the stated form of the transaction.

Although the Fifth Circuit's choice of language ("sham") to describe the test is somewhat unfortunate, its ultimate decision appears to be consistent with the facts. As the court noted, Cinda's role in the transaction was not that of a partner—in substance, Cinda merely sold a portion of the NPLs to Beal. There was no reason to undertake the partnership aspect of the transaction other than to shift tax losses from Cinda to Beal. In such situations, the partnership form can be disregarded if the substance of the transaction is something else.

Substance of the transaction. This leads to the third aspect of the Fifth Circuit's decision, which is its finding that the transaction at issue was, in substance, a sale of a portion of the NPLs to Beal. The court could have expanded on this aspect of the transaction by looking at the timing of the transfers that were involved, the fact that valuations did not change notwithstanding the passage of time, the pre-agreed nature of the transfer, etc., to further buttress its conclusion, although such additional points may have been viewed by the court as unnecessary. At the bottom line, the court got it right when it concluded that the substance of this transaction was a sale of the NPLs rather than the formation of a partnership, so that Beal could not benefit from Cinda's high tax basis in the portfolio of NPLs.

Practice Notes

In light of the enactment of Section 7701(o), every tax practitioner must take the economic substance doctrine into account in planning a transaction. Furthermore, every tax opinion written for a client has to consider the potential application of judicial doctrines in order to be in compliance with Circular 230. *Southgate,* as well as decisions like *AWG Leasing,* provide practitioners with useful guidance in applying the economic substance doctrine (and distinguishing it from the substance over form doctrine).

The penalty issue. The more interesting question is whether the Fifth Circuit got the penalty analysis right. Neither the district court nor the Fifth Circuit considered the test established in *Neonatology Associates, P.A.*, 115 TC 43 (2000), for determining whether a taxpayer may rely on a tax opinion to establish

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11 See Lipton, "*Countryside*: The Tax Court Rejects an IRS Challenge to the Economic Substance of a 'Real Deal,'" 108 JTAX 137 (March 2008).

12 See Lipton, "Bad Facts Result in a Taxpayer Loss in the First SILO Case to Be Adjudicated," 109 JTAX 210 (October 2008).

13 See Lipton, "Economic Substance—Two District Courts Reach Differing Conclusions in Very Different Contexts," 110 JTAX 170 (March 2009).

14 See Lipton, "'Codification' of the Economic Substance Doctrine—Much Ado About Nothing?," 112 JTAX 325 (June 2010).

15 See Lipton, "IRS Provides Helpful Guidance to Agents as to Application of the Economic Substance Doctrine," 115 JTAX 116 (September 2011).

reasonable cause. In that case, the Tax Court set forth a three-part test for determining whether a taxpayer can rely on a tax opinion to avoid penalties under Section 6662:

- Was the advisor a competent professional with sufficient expertise to justify reliance?
- Did the taxpayer provide accurate and necessary information to the advisor?
- Did the taxpayer actually rely in good faith on the advisor?

Several facts in *Southgate* suggest that the reasonable cause test set forth in *Neonatology* was not met. First, the large fee paid to Deutsche Bank in connection with this transaction shows that this was a "marketed" transaction. Second, DeCastro was not Beal's regular tax advisor—the law firm was brought into the transaction by Deutsche Bank.

Furthermore, the reasonableness of the assumptions made by the lawyers can be called into question with respect to Beal's purchase of Cinda's partnership interest. This transaction was necessary to convey the desired tax benefits to Beal, and the facts appear to indicate that this transaction was "hard wired" to occur. If the sale of the partnership interest was certain to occur at a pre-negotiated price, then the application of the substance over form doctrine is hard to avoid. The tax opinions, however, respected each of the steps in the transaction as separate events, which appears to be an unreasonable assumption.

The Fifth Circuit, however, was clearly correct in its holding that the application of Section 6664 is based on factual determinations. The district court had found in favor of the taxpayer, concluding that the taxpayer had relied reasonably and in good faith on the opinions of DeCastro and CGC. Although this conclusion seems somewhat at odds with the facts, the Fifth Circuit could reverse it only if the factual findings were clearly erroneous. This standard is applied equally to factual findings that favor the government and those that favor the taxpayer, and the Fifth Circuit should be commended for not using different standards to review factual findings on appeal.

CONCLUSION

Southgate must be added to all tax practitioners' index of cases analyzing the economic substance doctrine, particularly when clients are concerned about the potential application of the no-fault penalty under Section 6662(d)(6). The Fifth Circuit's conclusion that the transaction at issue had economic substance should be viewed as a helpful development by practitioners. ■

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