Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201515020**
Release Date: 4/10/2015

CC:FIP:Br1:RAMartin
POSTS-117317-14

UILC: 9300.00-00

date: December 04, 2014

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subject: Leveraged Forward Contract

This Supplemental Chief Counsel Advice ("CCA") responds to your request for assistance dated April 25, 2014, and addresses an additional issue not addressed in our CCA to your office, dated July 25, 2014. This advice may not be used or cited as precedent.

<u>LEGEND</u>

Taxpayers =
Promoter =
HoldingCo =
Advisor =
HoldingSPE =
BrokerSPE =
Year 1 =
Year 5 =
Year 6 =
<u>W</u> =
<u>AA</u> =
<u>CC</u> =
<u>GG</u> =
<u>NN</u> =

Oo =
PP =
TT =
UU =

ISSUE

Whether Taxpayers' participation in a transaction with an offsetting loan and contractual rights may be disregarded under the common law economic substance doctrine?

CONCLUSION

The Service may disregard Taxpayers' participation in the transaction under the common law economic substance doctrine. Applicable case law analyzes two factors in determining whether a transaction lacks economic substance: (1) whether the transaction changes the taxpayer's objective economic position apart from tax benefits; and (2) whether the taxpayer has a subjective non-tax purpose for entering into the transaction. Taxpayers have failed to satisfy either prong of this analysis. In reaching this conclusion, we have considered relevant case law and the criteria, derived from the case law, enumerated in Directive LB&I-4-0711-015 (issued July 15, 2011). Although the transaction had a remote possibility for earning a profit, this factor is outweighed by the transaction's expected tax benefits relative to that profit potential, and by the inflated cost that Taxpayers paid for the potentially profitable component of the transaction. Taxpayers entered into the transaction to generate cash flow through expected tax benefits, rather than through the expectation of a profit.

FACTS

This memorandum addresses a transaction marketed and sold under the label, "Leveraged Forward Contract," or, alternatively, the "[Promoter] Shield" (hereafter the "Transaction"). The Transaction consists of two legs: a loan obligation (hereafter the "Loan") and prepaid derivative contracts (hereafter the "Contracts"). The Loan and the Contracts are designed to create offsetting rights and obligations over a period of twenty years. The Contracts were designed so that they would make periodic "Bond Delivery Face Amount Payments" that were tied to a guaranteed "Protected Rate," such that payments from the Contracts were certain to offset, dollar for dollar, payments due on the Loan. The Contracts also provided for potential "Additional Payments" if the "Market Rate" were to exceed the "Protected Rate" during the term of the Contracts.

The Transaction was planned with the assistance of Advisor, and entered into in Year 1. The original parties to the Transaction were HoldingSPE, who was the borrower under the Loan and the recipient of payments under the Contracts, and BrokerSPE, who was the lender under the Loan and the obligor to make payments under the Contracts. HoldingSPE made an out-of-pocket payment at the outset of the Transaction to pay for a swaption that BrokerSPE could use to fund its obligation to make Additional Payments under the Contracts. The value of the swaption was only .W% of the original principal amount of the Loan Thus, the amount of offsetting payments between the Loan and the Contracts were far greater than the value of any potential Additional Payments.

In Years 5 and 6, Promoter purchased both the Loan and Contract elements of the Transaction, and then marketed the Transaction to individuals for the Transaction's "tax efficiency." Promoter marketed the Transaction so that investors would currently deduct interest on the Loan against ordinary income, while deferring the offsetting payments from the Contracts and reporting any resulting gain as long-term capital gain. Taxpayers in this case are among the investors who purchased an interest in the Transaction. This memorandum considers the purported tax benefits arising from the Transaction as claimed by Taxpayers, a married couple filing jointly, on their return for taxable Year 6.

Please refer to our prior CCA, dated July 25, 2014, for a more detailed description of the facts.

LAW AND ANALYSIS

The Economic Substance Doctrine[1]

Courts have long recognized that a taxpayer may not deduct losses resulting from a transaction that lacks economic substance, even if the transaction literally complies with the Code. See Knetsch v. United States, 364 U.S. 361, 365-66 (1960); Bank of New York Mellon Corp. v. Commissioner, 140 T.C. 15, 31 (2013). Courts have applied the economic substance doctrine by employing an analysis that considers the following two prongs: (1) whether the transaction had economic substance beyond tax benefits (the objective prong); and (2) whether the taxpayer has demonstrated a non-tax business purpose for entering into the disputed transaction (the subjective prong). ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3rd Cir. 1998); Karr v. Commissioner, 924 F.2d 1018, 1023 (11th Cir. 1991). In applying this analysis to a transaction that may be connected to otherwise legitimate transactions, courts have focused on the transaction "that gave rise to the alleged tax benefit." Coltec v. United States, 454 F.3d 1340, 1357 (Fed. Cir. 2006); Schering-Plough Corp. v. United States, 651 F.Supp.2d 219, 265 (D. N.J. 2009), aff'd sub nom. Merck & Co. v. United States, 652 F.3d 475 (3d Cir. 2011).

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[1] Congress codified the economic substance doctrine in I.R.C. § 7701(o), which is effective for transactions entered into on or after March 31, 2010. See Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409. The Transaction (including the Loan and the Contracts) predates enactment of § 7701(o). Consequently, the common law standard applies in this case.

We will first discuss the relevant case law, and then turn to application of the objective and subjective prongs of the common law economic substance doctrine.

A. Applicable Case Law

1. Application of the Economic Substance Doctrine in Cases Addressing Circular Flows of "Borrowed" Funds

Courts have employed the economic substance doctrine to deny claimed interest deductions on borrowed funds, particularly where the taxpayer used the borrowed funds as part of a larger transaction involving circular cash flows and offsetting rights and obligations.

In Knetsch, supra, the Supreme Court denied interest deductions on amounts that a taxpayer borrowed from an insurance company at an interest rate of 3.5% where the taxpayer invested the borrowed proceeds in annuity contracts issued by the same insurance company. The cash value of the annuity contracts increased at a rate of 2.5%, and the taxpayer borrowed from increases in the cash value of the annuity to make annual interest payments on the 3.5% loan, such that the taxpayer would incur a pre-tax cost equal to a net 1% interest rate paid on the borrowed funds. The Court explained that the taxpayer was willing to incur such a net pre-tax cost because the taxpayer expected to receive an even greater tax benefit by fully deducting the interest paid on the 3.5% loan. Knetsch, 364 U.S. at 366. The Court, in concluding that the transaction was a "sham," noted that "there was nothing of substance to be realized by [the taxpayer] from this transaction beyond a tax deduction."[2] Id. Accordingly, the Court denied the taxpayer's claimed interest deductions, since a sham transaction could not create a genuine indebtedness for purposes of section 163(a). Id.

In Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), the Court of Appeals for the Second Circuit denied interest deductions on amounts that a taxpayer had borrowed to purchase Treasury securities that the taxpayer pledged as collateral for the loans. As in Knetsch, the taxpayer in Goldstein paid a higher rate of interest on the amounts she borrowed than the rate she earned on the Treasury securities, but she was willing to do so because of the tax benefits generated from the claimed interest deductions. Id. at 739. The court concluded that the taxpayer was not permitted a deduction under section 163(a) for interest paid or accrued on loan arrangements that lack "purpose, substance, or utility apart from their anticipated tax consequences."[3] Id. at 740.

[2] The taxpayer in Knetsch borrowed all but $1,000 of the annuities' cash value, and the Court observed that $1,000 would provide a monthly annuity of $43 at maturity. Despite this "real" element of the transaction, the Court labeled the $1,000 as a "relative pittance," and explained that the transaction, even considering the $1,000 remaining with the insurance company, did not "appreciably affect [the taxpayer's] beneficial interest in the transaction." Knetsch, 364 U.S. at 366 (emphasis added) (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, C.J., dissenting)).

[3] The taxpayer argued that she held the Treasury securities because she viewed the market as depressed and "realistically anticipated" that the securities would increase in value. The court rejected that argument, noting that the taxpayer's computations prior to the transaction reflected an expected pre-

In Winn-Dixie v. Commissioner, 113 T.C. 254 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001), the Tax Court denied deductions claimed with regard to interest on amounts borrowed from the cash value of corporate-owned life insurance ("COLI") policies that the taxpayer purchased on approximately 36,000 of its employees. The court discussed the detailed projections of the transaction's expected costs and benefits, both pretax and after tax, and noted that tax benefits generated by interest deductions were the "dominant element" of the plan. Id. at 281. The court explained that, "[v]iewing the COLI plan as a whole, we find that the only function of the plan was to produce tax deductions in order to reduce [the taxpayer's] income tax liabilities." Id. at 285. In so doing, the court recognized that one may justifiably incur a cost for life insurance with the expectation of protection against the consequences of an expected death (as opposed to an expectation of earning a pretax profit from holding the policy), but the likelihood that the taxpayer would receive death benefits due to an unexpected catastrophe was "so improbable as to be unrealistic and therefore had no economic significance." Id. at 284.

2. Application of the Economic Substance Doctrine in Cases Addressing the Possibility of Pre-Tax Profit

Courts addressing the applicability of the economic substance doctrine have addressed taxpayer arguments that the potential for profit inherent in a transaction precludes the doctrine's application. Courts have explained, however, that the doctrine may apply even where some minimal risk of loss or profit exists. See Knetsch, 364 U.S. at 366 (explaining that a $1,000 investment did not "appreciably" change the taxpayer's interest in the transaction); Sala v. United States, 2010 U.S. App. LEXIS 26910, at *16 (10th Cir. 2010) (noting that "some" profit potential does not necessarily impute substance); Goldstein, 364 F.2d at 739-40 (rejecting taxpayer's opportunity to sell securities in excess of par as "remote").

Courts have recently clarified this principle in cases involving a transaction referred to as the Offshore Portfolio Investment Strategy ("OPIS"). In Blum v. Commissioner, 737 F.3d 1303 (10th Cir. 2013), the Court of Appeals for the Tenth Circuit concluded that the taxpayer's OPIS transaction lacked economic substance, despite acknowledging that "[i]ndividual components of [the] transaction presented the possibility of a profit." Id. at 1307. The court explained that application of the economic substance doctrine is not reduced to "one overriding consideration [of] whether [taxpayer's] OPIS investment had substantial economic effects in the form of a probability of generating a pre-tax profit." Id. at 1312. Despite the possibility of a profit, the Court of Appeals in affirming the Tax Court pointed to the following factors that the Tax Court employed to determine that the transaction lacked substance: (1) the transaction generated $45 million in "fictional" losses that the taxpayer did not actually incur out-of-pocket; (2) there was evidence that

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tax loss, and that the possibility that the Treasury securities could be sold considerably in excess of par was "remote." Goldstein, 364 F.2d at 739-40.

the transaction was designed to produce a tax loss; (3) the net present value of any profit possibility was less than the cost incurred by the taxpayer, and included overpriced elements, which indicated that no prudent investor would enter such a transaction based on its non-tax characteristics; and (4) the profit potential was de mimimus when compared to the tax benefits of claiming capital losses of $45 million.[4] Id. at 1311-12.

Likewise, in Reddam v. Commissioner, 755 F.3d 1051 (9th Cir. 2014), the Court of Appeals for the Ninth Circuit similarly rejected an OPIS transaction for lacking economic substance. The court noted that the question of objective substance turns first on whether a reasonable investor would have entered into the transaction for its investment gains, looking at the "overall structure" of the transaction. Id. at 1060-61. The court further explained:

> The application of the economic substance doctrine turns not only on the percentage of possible profit or loss . . . but also on the likely corresponding magnitude of those possible profits or losses and how would they be reported for tax purposes. There was some theoretical possibility that [taxpayer's] OPIS transaction would create a net economic gain. But the magnitude of even the most optimistic gain is dwarfed by the magnitude of the tax loss it was *designed* to generate and the strong possibility of a pretax loss.

Id. at 1061 (citations omitted). The court then pointed out that the transaction was certain to create a tax loss of $42,000,000, no matter how the potentially profitable portion of the transaction performed. The court agreed with the Tax Court that the opportunity for gain within the OPIS transaction did not "infuse substance into what was clearly a tax loss scheme." Id. at 1062.

B. Whether the Economic Substance Doctrine Applies to Taxpayers' Investment in the Transaction

Each of the legal opinions provided to Taxpayers in this case conclude that it is "more likely than not" that the Transaction will not be disregarded under the economic substance doctrine.[5] In so doing, each of the opinions contains the following identical language in arguing that the holdings in Knetsch and Goldstein are not applicable to the Transaction:

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[4] The Court of Appeals for the Tenth Circuit employed a similar comparison of potential profits to tax benefits in Sala. The court rejected the idea that the potential to earn $550,000 in profits conferred substance upon a transaction that was expected to produce a tax benefit of $24,000,000. 2010 U.S. App. LEXIS 26910, at *15. The court explained that "[t]he existence of some potential profit is 'insufficient to impute substance into an otherwise sham transaction' where 'a common-sense examination of the evidence as a whole' indicates the transaction lacked economic substance." Id at *16 (quoting Keeler v. Commissioner, 243 F.3d 1212, 1219 (10th Cir. 2001)).

[5] The legal opinions do not address Taxpayers' specific reasons for entering into the Transaction. Thus, the opinions are only useful insofar as they raise arguments that Taxpayers (and other investors who received the opinions) may raise.

> Your approach to this transaction stands in sharp contrast to the behavior of purely tax motivated investors. The taxpayers in Knetsch and Goldstein entered into transactions virtually certain to lose money except for tax savings. After careful consideration you proceeded with this transaction only after concluding that it made economic sense.

In using the term "economic sense," the legal opinions are referring the potential that the Contracts will make Additional Payments if Market Rates exceed the Protected Rate. The legal opinions fail to address the possibility that the profit potential inherent in the Contracts does not prevent application of the economic substance doctrine because the profit potential is too small relative to the Transaction's costs and expected tax benefits, or because the possibility of profit is too remote. Consequently, we disagree with the position set forth in the legal opinions.

1. The Objective Prong as Applied to the Transaction

Under case law, a transaction is treated as having economic substance if the transaction changes in a meaningful way (apart from tax benefits) the taxpayer's economic position. See Knetsch, 364 U.S. at 366. We will address the objective prong by considering the relevant factors set forth in Directive LB&I-4-0711-015, which, in turn, are gleaned from the case law.

a. The transaction is promoted/developed/administered by outside advisors and is highly structured

The Transaction was carefully planned so that the Loan and the Contracts would offset over a period of many years. Although the Contracts offset the Loan, dollar for dollar, the Transaction was planned so that interest on the Loan would be deducted against ordinary income in earlier years, while gains from the Contract would be reported as long-term capital gain in later years. This enabled Promoter to prepare slides projecting predictable after-tax cash flows that would allow investors to recoup their investment in the Transaction "after one year," even if "interest rates never rise" (i.e., Promoter's projections assumed no Additional Payments from the Contracts and were solely attributable to tax benefits). No investor would ever be expected to make actual payments on the Loan, and there was no investment risk.

The Transaction was further designed to create a real, albeit remote, opportunity for a pre-tax profit; the value of that profit potential was reflected in the value of a swaption purchased by HoldingSPE and held by BrokerSPE, and which cost only a small fraction (i.e., .W%) of the initial principal amount on the Loan that generated the purportedly deductible interest. Promoter marketed and administered the Transaction, and, given the Transaction's supposed tax benefits, Promoter was able to sell interests in the Transaction to investors for more than ten times the amount that Promoter paid for the Transaction. The interest rate protection inherent in the swaption component of the

Transaction, however, was no different for the investors than it was for Promoter. This indicates that the Transaction was primarily structured and sold to investors to generate tax benefits, rather than for its purported purpose of protecting against increases in interest rates.

b. The transaction includes unnecessary steps

If we are to believe the legal opinions, the purpose of the Transaction was to provide protection for investors in case interest rates increased. The Transaction was structured so that an investor would borrow money in order to purchase an asset that repaid the Loan and offered potential Additional Payments if the Market Rate substantially increased. Although the potential for Additional Payments was real, that potential was also embodied in a swaption contract that the original borrower, HoldingSPE, had paid for out-of-pocket at the outset of the transaction. Thus, the Transaction used a circuitous and costly scheme to accomplish a purported goal that Taxpayers (or any objective investor) could have accomplished more directly, and with less cost, by simply purchasing and holding the swaption directly. This is an indication that the Transaction lacks economic substance and was truly motivated to create tax benefits. See Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 182-83 (D. Conn. 2004), aff'd, 150 F.App'x. 40 (2d Cir. 2005) (finding a transaction lacked economic substance where taxpayer forfeited profit by rejecting a direct investment).

c. The transaction is not at arm's length with unrelated third parties

Taxpayers' purchase price for their TT% interest in the Transaction was $UU, yet just five months prior to Taxpayer's commitment to participate in the Transaction, Promoter and its affiliated companies completed a purchase of the entire Transaction for $NN. Accordingly, Taxpayers' purchase price for their ratable share of the Transaction is more than ten times what Promoter and its affiliates paid for the Transaction. Whereas Promoter paid a price for the Transaction that reflected that possibility of Additional Payments (i.e., Promoter paid for the value of the swaption), Promoter sold the Transaction to Taxpayers and other investors for the Transaction's purported tax benefits. That Taxpayers paid far greater than arm's length for the value of the Transaction's possibility of generating Additional Payments is an indication that Taxpayers were purchasing tax benefits, rather than the opportunity for a return on their investment. This is an indication that the Transaction lacks economic substance. See Stobie Creek Investments v. United States, 608 F.3d 1366, 1378-79 (Fed. Cir. 2010) (suggesting that overpaying for options indicates lack of "economic reality").

d. The transaction generates a deduction that is not matched by an equivalent economic loss or expense

The Transaction was designed so that amounts due on the Loan would be paid, dollar for dollar, from the Contracts' Bond Delivery Face Amounts. Those who Promoter successfully convinced to invest in the Transaction, such as Taxpayers, would make an upfront payment that was mostly allocated to advisory fees, with only a small portion allocated toward an actual interest in the Transaction. The Transaction was designed so that an investor could claim interest deductions without actually paying any portion of the interest out-of-pocket. Moreover, the Transaction was structured so that investors could claim AA% of the interest deductions within the Transaction's first ten years, while reporting CC% of the offsetting capital gain from the Contracts during Transaction years eight through twenty. As the court observed in Blum, "fictional" losses representing amounts that a taxpayer did not actually lose or expend are an indication that a transaction lacks economic substance.[6] Blum, 737 F.3d at 1311.

e. The taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction

Taxpayers bore no risk of loss, since the Contracts were carefully designed to make all of the Loan payments. The Transaction's combination of the Loan, secured by Contracts designed to provide a return that makes all Loan payments, is reminiscent of the circular transactions that the courts rejected in Knetsch, Goldstein, and Winn-Dixie. Indeed, Promoter's promotional slides made it clear to potential investors that the Transaction was "[n]ot an investment'" and carried "[n]o market risk." This is also why the Loan balance from the outset of the Transaction in Year 1 was so large relative to the value of potential Additional Payments from the Contract (i.e., the value of the swaption); since obligations under the Loan were designed to be offset by payments from the Contracts, investors such as Taxpayers never had to repay anything and were indifferent to the amount they nominally owed on their share of the Loan, except that a higher Loan balance would generate higher interest deductions. That the Transaction was designed so that investors could "borrow" and then "invest" the borrowed proceeds in a planned circular structure such that all Loan payments were certain to be repaid from the Contracts, free from market risk, is further indication that the Loan is part of a transaction that lacks economic substance.

f. The transaction has no meaningful potential for profit apart from tax benefits

The legal opinions provided to Taxpayers base their conclusion on the idea that a transaction with some potential for profit, however remote, is not subject to the economic substance doctrine. In this regard, the opinions point solely to the potential that the Contracts may make Additional Payments (if Market Rates exceed the Protected Rate) as indication that the Transaction possesses economic substance. Though the legal opinions attempt to contrast the profit potential arising from the Transaction with the facts in Knetsch, Goldstein, and Winn-Dixie, the opinions fail to explore whether the Transaction's profit potential is sufficient when viewing the Transaction as a whole.

[6] The Tax Court opinion in Blum, noting that the taxpayer paid $6 million out-of-pocket while claiming $45 million in losses, explained that "[t]he absence of economic reality is a hallmark of a transaction lacking economic substance." T.C. Memo 2012-16.

A mere possibility of profit is not enough for Taxpayers to prevail on this issue; a transaction that has a possibility for profit may lack economic substance where the cost of the transaction exceeds the present value of any profit possibility. Blum, 737 F.3d at 1312. In this vein, we consider that the present value of the Transaction's profit possibility is reflected by the value of the swaption. Taxpayers' cost for its share of the Transaction is more than seven times what HoldingSPE had paid in Year 1, and more than ten times what Promoter paid in Years 5 and 6. Thus, it appears that Taxpayers grossly overpaid for the Transaction's potential pre-tax return. Given Taxpayers' costs, it is highly unlikely that Taxpayers will ever recoup their investment through potential Additional Payments from the Contracts. The Market Rate would have to exceed the Protected Rate by a significant amount for a significant period of time for Taxpayers to have any chance of receiving enough Additional Payments to recover their investment, except through expected tax benefits. Such a scenario is even more unlikely because the Protected Rate was set in excess of the Market Rate at the inception of the Transaction, and remained so through the time in which Taxpayers decided to invest. Taxpayers' high transaction costs relative to the value of any profit potential indicates that no prudent investor would have entered into the Transaction based on its non-tax characteristics. Id.; Stobie Creek, 608 F.3d at 1378-79.

The promotional slides also marketed the Transaction's anticipated tax savings even if there is no pre-tax profit, i.e., if the Market Rate never increases above the Protected Rate. One slide touts the Transaction's "Positive Cash Flow after one year," "Even if interest rates never rise." The same slide refers to the possibility of rates increasing above the Protected Rate as "Hit lottery." Another slide sets forth projections of "Net After-Tax Cash Flow (if interest rates never exceed Oo%)," and then projects net cash flow of $PP, an amount solely attributable to tax benefits and an amount far in excess of the value of Taxpayers' share of the Transaction's profit potential. What the designers of the Transaction attempted to do is what other taxpayers, such as those in Sala, Blum, and Reddam, have tried and failed to do; they inserted a peppercorn of isolated profit potential into a large, complex transaction in order to confer the appearance of economic substance upon the entire transaction. See WFC Holdings v. United States, 2011 U.S. Dist. LEXIS 113382, at *138-39 (D. Minn. 2011), aff'd, 728 F.3d 736 (8th Cir. 2013).[7] That the Transaction functioned to produce a large and inevitable tax loss without regard to the profitability of the Contracts is further indication that Taxpayers were motivated by tax benefits, and not profit potential. See Reddam, 755 F.3d at 1062.

Lastly, whatever profit potential was inherent in the Transaction was minimal relative to the expected tax benefits. Although Taxpayers, net of "Legal and professional fees," did purchase the right to receive the Transaction's potential Additional Payments, the expected tax benefits arising from the Transaction in the first four years far exceed the cost that Taxpayers allocated to it. See Table IV of the CCA dated July 25, 2014.

[7] In WFC, the United States District Court for the District of Minnesota explained: " [I]t is [the taxpayer] that seeks to isolate a kernel of prospective profitability to justify a large, multi-step, multi-property transaction. This the Court cannot do." U.S. Dist. Ct. LEXIS 113382, at *139.

Moreover, the Transaction was designed so that any possibility for profit would be "dwarfed" by the expected tax benefits; the original value of the swaption (paid for by HoldingSPE) was only .W% of the principal amount of the Loan that was generating the interest deductions. This broad disparity between the present value of the Transaction's profit potential and the present value of its expected tax benefits is further indication that the Transaction lacks economic substance. Reddam, 755 F.3d at 1061-62; Sala, 2010 U.S. App. LEXIS at *15.

For the foregoing reasons, we conclude that the Transaction lacks objective economic substance.

2. The Subjective Prong as Applied to Taxpayers

We now turn to whether Taxpayers had a subjective non-tax purpose for entering into the Transaction. Some courts have required taxpayers to satisfy only one of the two prongs to avoid application of the economic substance doctrine, while others require that taxpayers satisfy both prongs, or apply both prongs as part of a unitary analysis. Compare Rice's Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985) (requiring that the court must find taxpayer failed both prongs before treating transaction as a sham) with Coltec, 454 F.3d at 1355 (explaining that economic substance doctrine may apply if taxpayer fails to meet one prong) and ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998) (noting that the two prongs are not part of a "rigid two-step analysis").

Though the Transaction was originally created in Year 1 for HoldingCo, a real estate developer, for the ostensible purpose of protecting it from interest rate increases, Promoter thereafter acquired and marketed the Transaction to individual professionals working in diverse fields. Promoter targeted a group of investors, including Taxpayers, who could not possibly have shared HoldingCo's or the other investors' interest rate exposure. The legal opinions attempt to connect the investors' motivation for entering into the transaction with vague concerns regarding increased interest rates.

The parties who created the Transaction were familiar with the applicable tax law, and attempted to insert a peppercorn of profitability (i.e., the swaption) into a much larger transaction that involved a circular flow of cash. Although one can have a legitimate business purpose for purchasing a transaction that protects against future increases in interest rates, Taxpayers' transaction costs are far greater than the value of potential Additional Payments from the Contracts. Moreover, Table IV of the CCA dated July 25, 2014, sets forth Taxpayers' true motivation for entering into the Transaction, i.e., the expected benefits from the tax savings after only four years are more than three times Taxpayers' cost of entering into the Transaction, regardless of whether interest rates increase (making Additional Payments due). We therefore conclude that Taxpayers were motivated by the Transaction's tax benefits, and not by the desire for protection against interest rate increases.

Taxpayer's investment in the Transaction fails to satisfy either prong of the economic substance doctrine, as set forth both in case law. Accordingly, the Service may disregard the Transaction for tax purposes, and Taxpayers may not claim deductions with respect to items attributable to the Transaction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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Please call (202) 317-6842 if you have any further questions.

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