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Colgate Gets the Brush-Off from the Third Circuit: Lack of Economic Substance Found in Tax-Motivated Installment

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During the late 1980's, Merrill Lynch & Co., Inc. ("ML") developed a strategy intended to generate substantial capital losses for ML's corporate clients.[1] Several of the nation's largest corporations invested in partnerships formed to implement this strategy. Transactions such as those promoted by ML ultimately led the Internal Revenue Service (the "Service") to promulgate Treasury Regulation ("Regulations") section 1.701-2, captioned "Anti-abuse rule," under which the Service claims broad authority, effective for transactions occurring on or after May 12, 1994, to adjust or modify the tax treatment that would otherwise apply to a partnership transaction in order to "achieve tax results that are consistent with the intent" of the partnership provisions of the Internal Revenue Code (the "Code").[2]

Two recent decisions, one by the Tax Court and the other by the Court of Appeals for the Third Circuit, have now held that the ML strategy was unavailing even prior to the effective date of the "anti-abuse rule" and that claimed capital losses generated by use of the strategy in transactions promoted by ML (almost $100,000,000 claimed by Colgate-Palmolive Company ("Colgate") and almost $200,000,000 claimed by AlliedSignal Inc.) were not allowable. *ACM Partnership v. Commissioner*, Daily Tax Report, Oct. 15, 1998, at K-15 (3d Cir. Oct. 13, 1998), *aff'g and rev'g* 73 T.C.M. (CCH) 2189 (1997), and *ASA Investerings Partnership v. Commissioner*, 1998 RIA TC Memo paragraph 98,305 (Aug. 20, 1998).

While practitioners may be inclined to give less weight to the Tax Court's decisions in these two cases, each of which was issued as a mere "memorandum opinion,"[3] the decision of the Court of Appeals, on which this article focuses, appears certain to be a major landmark in the development of the law governing when tax-motivated transactions will and will not be respected. (The *ASA* decision, in which the Tax Court held that no valid partnership had been formed for Federal tax purposes—and that it therefore did not need to analyze the tax consequences of the purported partnership transactions—is worthy of an article all its own.)

In 1988, Colgate realized a capital gain of over $100,000,000, attributable largely to the sale of the stock of a subsidiary. Accordingly, Colgate was interested when it was approached by ML in May 1989 with a proposal that Colgate form an investment partnership with a foreign, nontaxable investor, in the anticipation that the investment partnership would generate capital losses that Colgate could carry back to 1988 to reduce the tax imposed on its large capital gain. The proposal involved the purchase by the investment partnership of short-term obligations, the sale of those obligations in exchange for a combination of cash and contingent-payment notes, and, through application of the installment sale and partnership allocation provisions of the Code and Regulations, the allocation of a large capital gain to the nontaxable partner and of a large capital loss to Colgate.

At the time that ML made this proposal, Colgate had concluded that an anticipated decline in interest rates made it advantageous for it to repurchase certain long-term debt that it had outstanding. Use of the proposed partnership as a vehicle for such a repurchase was attractive to Colgate, because of certain favorable financial accounting rules that would apply. Accordingly, commencing in July 1998, ML presented a series of summaries to Colgate which described the transactions from beginning to end and included both the tax benefits that were supposed to be inherent in the basic ML proposal and Colgate's debt management objectives. In late October 1989 the three entities that were to participate in the transactions as partners in the investment partnership were formed and, shortly thereafter, the strategy began to unfold:[4]

> **(1)** Colgate and ML created subsidiaries to participate in the transaction. (Throughout this article, these subsidiaries are referred to by their respective parents' names.) At the same time, Algemene Bank Nederland N.V. ("ABN"), a foreign bank, created a subsidiary, Kannex Corporation N.V. ("Kannex"). Kannex was a Netherlands Antilles corporation that was not subject to tax in the United States (or apparently anywhere else) on its share of the income of the investment partnership.
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> **(2)** The investment partnership ("ACM") was formed and, on November 2, 1989, Kannex contributed $169,400,000 to ACM for an 82.6% interest, Colgate contributed $35,000,000 for a 17.1% interest, and ML contributed $600,000 for a 0.3% interest.
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> **(3)** ACM deposited its funds overnight in ABN's New York branch. The next day, November 3, 1989, ACM used its funds to purchase $205,000,000 in floating rate Citicorp notes. The initial interest rate on the notes was 8.78%, 3 basis points higher than the rate on the overnight deposit in ABN's branch, and reset on the 15th of each month. On November 15, 1989, the rate reset to 8.65%. There were restrictions on the liquidity of the Citicorp notes.[5]
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> **(4)** On November 27, 1989, ACM sold $175,000,000 of the Citicorp notes to a Japanese and a French bank. The consideration received by ACM was equal in value to the amount it had paid for those notes, reduced by over $1,000,000 in transaction costs. However, although $140,000,000 of the consideration was paid in cash, the remainder took the form of "LIBOR notes," contingent payment instruments which had no theoretical maximum principal amount and which became more valuable as interest rates increased. The LIBOR notes called for quarterly payments commencing in 1990 and ending in 1994. At the time of their acquisition by ACM, the LIBOR notes had an approximate fair market value of $34,400,000. The stated reason for acquiring the LIBOR notes was to provide a hedge for ACM against the possibility that interest rates would increase, thereby making the long-term Colgate debt that ACM planned to buy less valuable. Bear in mind that Colgate's stated reason for entering into the transactions, including the formation of ACM and the acquisition by ACM of Colgate debt, had been to reduce Colgate's exposure, as a debtor, to the risk of interest rate *decreases*; in contrast, the stated reason for ACM's acquisition of the LIBOR notes was to reduce its exposure, as Colgate's creditor, to the risk of interest rate *increases*. As discussed below, the Court was very troubled by this inconsistency and emphasized it strongly in deciding that the transactions lacked economic substance. ML also arranged a series of "swaps" by means of which it hedged the purchasing banks against interest rate risks on the Citicorp notes.
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> **(5)** In transactions occurring from December 1989 through October 1990, ACM used the cash proceeds of the sale of the Citicorp notes to purchase long-term Colgate debt from various creditors of Colgate.

(6) Over the period from December 1989 through June 1991, Kannex's entire interest in ACM was acquired, in part by purchase by Colgate and in part by redemption by ACM. On December 17, 1991,[6] ACM sold the LIBOR notes for a price equal to about 40% of their fair market value at the time they had been acquired; this discount was caused primarily by a true reduction in fair market value, reflecting a substantial *decline*[7] in interest rates over the period that the LIBOR notes were held by ACM, but was also caused in part by transaction costs that were paid to ML. The stated reason for this sale was that, since ACM was now owned more than 99% by Colgate, it was no longer appropriate for it to hedge the interest rate risk inherent in its positions as Colgate's creditor.

The records maintained by ACM showed that the decision to take each step was supported by an economic analysis contemporaneous with that step.

The sale of the Citicorp notes was reported by ACM as an installment sale. Under the rules governing installment sales having no "stated maximum selling price," the seller's basis in the property sold is generally recovered ratably over the period during which payments (including any cash downpayment) may be received.[8] In this case, payments were due during each of the 6 years from 1989 through 1994 and ACM thus applied only 1/6 of its basis in the Citicorp notes against the $140,000,000 cash payment in computing its gain recognized during 1989. This resulted in ACM's reporting a large capital gain, 82.6% of which was allocated to Kannex, a nontaxpayer. The remaining 5/6 of ACM's basis in the Citicorp notes was treated as its basis in the LIBOR notes. That amount of basis far exceeded the value of the LIBOR notes, even before giving effect to the decline in value of the LIBOR notes caused by the decline in interest rates. Thus, when the LIBOR notes were sold, at a time that Colgate owned more than 99% of ACM, ACM reported a very large loss. Colgate claimed its 99% share of that loss and attempted to carry it back to offset its 1988 capital gains.

The Tax Court held that ACM realized neither a gain during 1989 nor any loss during 1991. The Court of Appeals affirmed the Tax Court's conclusion that the purported installment sale lacked economic substance and did not give rise to a loss that could be allocated to Colgate. However, contrary to the Tax Court's conclusion, the Court of Appeals held that the actual economic loss caused by the decline in value of the LIBOR notes below the value at which they had been acquired by ACM did give rise to an allowable capital loss.

The Court of Appeals began by noting that two key factors "inform the analysis of whether [a] transaction has sufficient substance, apart from its tax consequences, to be respected for tax purposes"—the "objective economic substance of the transactions" and the "'subjective business motivation' behind them." The Court found that neither of these factors would support respecting ACM's transactions.

With regard to "objective economic consequences," the Court viewed ACM's investment in and sale of Citicorp notes as "fleeting and economically inconsequential." Those transactions were pejoratively described as "ACM's relinquishment of assets that it had acquired 24 days earlier under circumstances which assured that their principal value would remain constant and that their interest payments would not vary materially from those generated by ACM's cash deposits." Thus, while ACM did, in substance, acquire the LIBOR notes, it did not do so in an installment sale of the Citicorp notes governed by the rules for sales lacking "stated maximum selling prices." Rather, the Court seemed to be saying, ACM, in substance, purchased the LIBOR notes for a cash consideration approximately equal to their initial fair market value. Thus, to the extent that the claimed basis in the LIBOR notes was in excess of that amount, the claimed loss was not "bona fide," as required by Treasury Regulation section 1.165-1(b).

The Court of Appeals agreed with the Tax Court that the subjective aspects of the inquiry into economic substance were relevant as well (although it seemed to take issue with the Tax Court's focus on those aspects to the exclusion of an analysis of the "objective substance"). On the record before it, the Court of Appeals concluded that the transactions were, in fact, not designed either to serve their asserted non-tax goals or to generate a pre-tax profit. For example, if the purpose of holding the Citicorp notes was to provide an interim investment for ACM's funds prior to their use in acquiring Colgate debt, the Citicorp notes—which were illiquid and involved significant transaction costs not applicable to an ordinary bank account—ill served that purpose. Similarly, as discussed above, the various rationales asserted regarding the hedging of interest rate risks seemed to contradict each other, sometimes looking from the perspective of Colgate as debtor and sometime from the perspective of ACM as creditor, just to come up with some theory which could be articulated for each of the steps.

In sum, the Court of Appeals disregarded the investment of ACM in the Citicorp notes and held that the purported sale of those notes did not give rise to a loss. However, the Court of Appeals parted company with the Tax Court over the question of whether the economic loss that ACM sustained, resulting from a decline in value of the LIBOR notes, was deductible. The Tax Court had not allowed ACM to deduct any portion of its loss on the disposition of the LIBOR notes. The Court of Appeals felt, however, that "the LIBOR notes, although not *intended* to serve non-tax purposes, had significant economic effects, consisting of several million dollars in actual economic losses [emphasis added]" and that those actual economic losses should be allowed as deductions.

While the decision of the Court of Appeals may not formulate a specific "test" that can be readily applied to predict the outcome of future cases,[9] its dual focus on the objective and subjective elements of the transaction is certain to be influential in the analysis of tax-motivated transactions. The Court's unwillingness to be influenced by documentation of alleged business purposes when the tax motivation of a transaction is evident will also pose some practical and ethical problems for tax advisors. Meanwhile, we can only wait for the Service and the courts to drop the next shoe—whatever that may be!

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1 In the case of a corporation, capital losses are deductible only to the extent of the taxpayer's capital gains. Internal Revenue Code ("Code") section 1211(a). However, excess capital losses of a corporation may generally be carried back 3 years and forward 5 years. Code section 1212(a). Since corporate capital gains are not now taxed at a preferential rate, *see* Code sections 11 and 1201(a), but rather at the full 35% rate applicable to ordinary income, there is a strong incentive for a corporation with capital gains to seek to generate capital loss deductions.

2 *Example 7* contained in section 1.701-2(d) specifically targets transactions that use partnerships in a way very similar to the ML strategy and holds that the Internal Revenue Service can "recast the transaction as appropriate" under the anti-abuse rule *or* challenge it under "applicable nonstatutory principles and other statutory and regulatory authorities."

3 *See* M. Sommer & A. Waters, *Tax Court Memorandum Opinions—What Are They Worth?*, Tax Notes, July 20, 1998, at 384.

4 Space permits setting out only some of the facts that the Court of Appeals found relevant in deciding that the transactions would not be respected for tax purposes.

5 These restrictions were imposed in order to meet the Code's requirements for installment sales.

6 In December 1989, a small portion of the LIBOR notes was distributed by ACM to Colgate and sold by Colgate to a third-party purchaser procured by ML. The tax analysis of the loss incurred by Colgate on this sale did not differ from that discussed in text of the loss incurred by ACM on the sale of the bulk of the LIBOR notes in December 1991.

[7] As noted above, the stated purpose of the LIBOR notes was to hedge ACM's position as a holder of Colgate's long-term indebtedness against an *increase* in interest rates. When interest rates in fact declined, the value of the LIBOR notes declined along with them.

[8] Treasury Regulation section 15a.453-1(c)(3)(i).

[9] A dissenting opinion by Circuit Judge McKee expresses concern that the majority opinion does set out a test, but that it is only the old "smell test"—"If the scheme in question smells bad, the intent to avoid taxes defines the result[,] as we do not want the taxpayer to 'put one over.'" Judge McKee would have found, first, that ACM's sale of the Citicorp notes for cash and LIBOR notes was a taxable exchange and, second, that no further analysis was necessary to decide the case in favor of ACM.