Holding a Bad Hand: The Third Circuit Addresses Economic Substance, Part I.

While tax law is driven in large measure by statutes and regulations, case law remains significant, particularly in the context of litigation involving tax shelters.

Historically, courts developed a variety of common law doctrines such as “substance over form,” “step transaction,” or “business purpose” that come into play in the context of transactions that are perceived to be abusive. Among the more prominent of these doctrines is the economic substance doctrine. While Congress took steps to codify the economic substance doctrine in 2010, it did so on a prospective basis, leaving a large number of pending tax cases to be governed by existing common law principles.

Recently, the Third Circuit applied the common law economic substance doctrine to a so-called CARDS shelter, addressing both substantive liability and liability for an accuracy related penalty. *Neal Crispin v. Comm'r,* No. 12-2275 (3d Cir. Feb. 25, 2013).

In describing a CARDS (Custom Adjustable Rate Structure) transaction, the Court identified a series of steps that were characteristic of the transaction:

- An entity that is not subject to U.S. tax borrows foreign currency from a foreign bank, creating a CARDS loan.
- A U.S. taxpayer buys a portion of the foreign currency by assuming liability for an equal amount of the loan.
- The taxpayer also agrees to assume joint and several liability for the loan, which is claimed to give the taxpayer a basis equal to the entire amount of the loan. The government, however, takes the position that there is an understanding that this won't be enforced and that the taxpayer's basis is improperly inflated.
- The taxpayer exchanges the foreign currency he purchases for U.S. dollars.
- This exchange is a realization event, and the taxpayer claims a loss based upon the difference between the small amount realized on the currency purchased and the basis claimed, which is the entire amount of the CARDS loan.

Neal Crispin v. Comm'r, No. 12-2275, slip op. at 4-5 and n. 3.

The taxpayer, Mr. Crispin, was the owner of an S-corporation known as Murus Equities, Inc., which engaged in leasing, structured finance transactions and also invested in mortgage backed securities. After being contacted by a promoter, Chenery Associates, Inc., Crispin entered into his CARDS transaction in 2001, and he ultimately sought to offset several million dollars in income with the losses that it generated. *Id.* at 6. Crispin was approached about this transaction when he was in the process of seeking financing for an aircraft acquisition for Murus. *Id.* The transaction followed the same basic steps outlined above: a foreign borrower entered into a 30-year CARDS loan denominated in Swiss francs, with the loan proceeds retained by the lender; Crispin purchased 15% of the currency and agreed to be jointly and severally liable on the entire loan. *Id.*

As the transaction proceeded in early December 2001, a foreign entity borrowed 74 million Swiss francs for a 30-year term, but the loan was callable at any time after the first year. *Id.* at 8. In late December, Murus acquired 4.8 million Swiss francs. *Id.* at 9. The same day, Murus exchanged 3.1 million Swiss francs for 1.8 million U.S. dollars, which was used to acquire a promissory note maturing at the end of one year that secured the obligation of Murus to the lender. *Id.* The bank thereafter terminated the loan and the counterparty used the remaining collateral and the note acquired by Murus to pay off the loan. *Id.* at 10.

Murus filed a 2001 federal tax return indicating that it had lost $7.6 million on the transaction; since Murus was an S-corporation, losses flowed through to Crispin, who reported net income of $3,244 from Murus. *Id.* at 11. The returns were supported by a tax opinion issued in April 2002; the opinion noted that the IRS had questioned the economic substance of CARDS transactions, but indicated that the transaction should have sufficient business purpose to be respected by the IRS. *Id.* at 10-11. The law firm providing the opinion had also done so for other clients of the promoter, Chenery Associates. *Id.* at 10.

The case reached the Third Circuit following Crispin's unsuccessful petition to the Tax Court. The Court of Appeals began its analysis by reiterating its historical approach to economic substance cases, which entails an examination of both the objective substance of the transaction and the taxpayer's subjective purpose in entering into the transaction. *Id.* at 15 (citing *ACM P'ship v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998)).

The Tax Court had found Crispin's evidence on both prongs of the economic substance test to be wanting. On the objective prong, the Tax Court had found that Crispin had experienced "no consequences other than receiving a tax deduction." *Id.* at 16. Similarly, the Tax Court had questioned the validity of Crispin's stated business purpose, which was to obtain long-term financing. Among the problems here were the fact that the loan was callable, and the fact that bank retained control of the proceeds as collateral; any effort to use the proceeds would require the substitution of cash collateral. *Id.* While Crispin had asserted that he intended to substitute aircraft for his cash collateral, he never made any effort to do so. Finally, there was no prospect of profit in the transaction, since the rate paid on the CARDS loan exceeded the interest paid on the collateral. *Id.*

Given the state of the record, the Court of Appeals had little difficulty sustaining the Tax Court's conclusion that the CARDS transaction lacked economic substance. *Id.* at 16-17.

I will comment on this opinion in greater detail in a future post.

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