No. 13-1037

In the Supreme Court of the United States

WFC HOLDINGS CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

AMICI CURIAE BRIEF OF THE CATO INSTITUTE, THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, AND THE FINANCIAL SERVICES ROUNDTABLE IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE*[1]

Established in 1977, the Cato Institute is a nonpartisan public policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the principles of constitutional government that are the foundation of liberty. Toward those ends, Cato holds conferences and publishes books, studies, and the annual *Cato Supreme Court Review*. This case concerns Cato because it implicates the right of taxpayers to structure their own affairs as they see fit.

The Chamber of Commerce of the United States of America is the world's largest business federation. It represents 300,000 direct members and indirectly represents the interests of more than 3 million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files amicus curiae briefs in cases that raise issues of concern to the nation's business community.

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[1] No counsel for any party has authored this brief in whole or in part, and no entity or person, aside from *amici curiae*, their members, and their counsel, made any monetary contribution intended to fund the preparation or submission of this brief. All parties have been timely notified of the undersigned's intent to file this brief; both Petitioner and Respondent have consented to the filing of this brief. Petitioner's blanket written consent is on file with the Clerk of the Court. A letter of consent from Respondent accompanies this brief.

The Financial Services Roundtable ("FSR") represents 100 of the largest integrated financial services companies providing banking, insurance investment products, and services to the American consumer. Member companies participate through the Chief Executive Office ("CEO") and other senior executives nominated by the CEO. FSR member companies account directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

INTRODUCTION AND SUMMARY OF ARGUMENT

As originally conceived by this Court, the economic substance doctrine imposed a narrow restriction on what the government otherwise concedes is lawful activity: a taxpayer may not claim tax benefits from a transaction that generates "nothing of substance" other than those tax benefits. *Knetsch v. United States*, 364 U.S. 361, 366 (1960). But in the thirty-five years since this Court last addressed the doctrine, it has ballooned into something amorphous and unworkable. Dubious even in its narrowest form, this unpredictable doctrine now frequently ensnares even those taxpayers who have the benefit of expert tax counsel and who undertake transactions that indisputably yield benefits beyond tax savings.

The time has come for this Court to revisit the economic substance doctrine. As Petitioner ably explains, the lower courts are intractably split about when a transaction lacks sufficient economic substance to allow a taxpayer to claim tax benefits. *Amici* write to emphasize the real costs to the taxpayer and to the economy that uncertainty creates. When taxpayers cannot

assess their tax liability in advance, they may overreport their tax burden or simply shy away from uncertain transactions altogether. Those costs are passed on to nearly every actor in the economy: to workers through lower wages and fewer jobs, to investors through lower rates of return on capital, and to consumers through higher prices. The uncertainty surrounding the economic substance doctrine also stunts economic growth, discouraging business expansion and encouraging investors to take their money overseas, where tax laws are more predictable.

This Court should grant review to narrow and restore predictability to the economic substance doctrine. And this case presents an excellent vehicle to do so because the decision below adopted an especially misguided variant of the doctrine. WFC unquestionably had a legitimate business purpose: it needed to dispose of excess real estate after a merger. Consulting with tax planners, WFC found a way to achieve that goal through a transaction that had tax benefits. But the Eighth Circuit disallowed those benefits because, in part, it found that WFC could have chosen a different transaction that had higher tax liability.

That test effectively adopted a tax-maximization rule, in which taxpayers are entitled to tax benefits only if they have chosen among available transactions the one that requires them to pay the most tax. It also penalized WFC's legitimate tax planning. Tax planning necessarily involves selecting transactions that fulfill a legitimate business purpose in the most tax-advantageous way – and there is nothing wrong with that. "[A taxpayer's] legal right . . . to decrease the

amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). The Eighth Circuit's approach to economic substance cannot be reconciled with that basic principle. This Court should grant certiorari to resolve the lower-court confusion regarding the economic substance doctrine.

ARGUMENT

I. This Court Should Revisit the Economic Substance Doctrine

A. Confusion About the Doctrine Has Grown Since the Court Last Addressed It Thirty-Five Years Ago

This Court's last word on the economic substance doctrine came thirty-five years ago in *Frank Lyon Co. v. United States*, where this Court held that a transaction does *not* violate the economic substance doctrine where, at a minimum, "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." 435 U.S. 561, 583-84 (1978).

Since *Frank Lyon*, the lower courts – and the taxpayers who must abide by their rulings – have been confused about how the doctrine works. *See generally* Pet. 23-26. Whereas this Court originally framed the question as whether "there was [some]thing of substance to be realized" from a transaction, *Knetsch*, 364

U.S. at 366, several courts have expanded the doctrine to ask whether the taxpayer had a subjective intent to minimize his tax liability. *See, e.g.*, *Sala v. United States*, 613 F.3d 1249, 1253 (10th Cir. 2010); *ACM P'ship v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998); *Illes v. Comm'r*, 982 F.2d 163, 165-66 (6th Cir. 1992). That subjective standard has been applied so inconsistently that one dissenting judge likened it to a "smell test" – "[i]f the scheme in question smells bad, the intent to avoid taxes defines the result" and the tax benefits are disallowed. *ACM*, 157 F.3d at 265 (McKee, J., dissenting). In the decision below, moreover, the Eighth Circuit looked to additional factors, asking whether the transaction could have been structured differently and whether any single element of the transaction was designed for tax benefits. *See* Pet. App. 17a-18a.

In the face of this uncertainty, the need for this Court to revisit the economic substance doctrine is manifest. As this Court has repeatedly observed, "in tax law[,] . . . certainty is desirable." *United States v. Generes*, 405 U.S. 93, 105 (1972). But where, as here, the circuits apply conflicting, unpredictable standards, even sophisticated taxpayers can no longer predict when courts will disallow tax benefits. The result is that investment will be chilled and the United States will be at a disadvantage to countries with predictable tax laws. Nor will this uncertainty be eliminated by the recent codification of the economic substance doctrine. *See* 26 U.S.C. § 7701(o). The codified principles cannot reach the many pre-codification transactions that remain under administrative and judicial review, and co-

dification hardly resolved all the questions of the doctrine's scope in any case.

B. The Uncertainty Surrounding the Doctrine Burdens the Economy

1. Uncertainty in tax law imposes substantial costs on businesses and consumers with no resulting benefits to the economy. *See, e.g.*, Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 Tax L. Rev. 489, 499-501 (2011); *see also* Seth H. Giertz & Jacob Feldman, Mercatus Ctr., *The Economic Costs of Tax Policy Uncertainty: Implications for Fundamental Tax Reform* 15 (2012) ("[T]he fact that policy uncertainty adversely affects the economy is well-established.").[2] The harms caused by uncertainty are especially acute for large companies such as WFC, which regularly engage in transactions raising complex tax issues. Osofsky, *supra*, at 494; *see also* Joel Slemrod, *Is Tax Reform Good for Business? Is a Pro-Business Tax Policy Good for America?*, *in Fundamental Tax Reform: Issues, Choices, and Implications* 143, 164-65 (John W. Diamond & George R. Zodrow eds., 2008).

This uncertainty is at the root of several types of harm. It forces companies to over-report tax liability and to spend millions of dollars on tax planning and litigation – costs that are passed on to investors, workers, and consumers. It also stunts economic growth by chilling legitimate business transactions and reducing

[2] *Available at* http://tinyurl.com/ou8ny9t

capital mobility. This Court's intervention is necessary to remedy those economic harms.

Overpayment. When tax law is uncertain, taxpayers tend to over-report their tax burden to avoid an audit or the expense of suing for a refund. *See, e.g.*, Marsha Blumenthal & Charles Christian, *Tax Preparers*, *in The Crisis in Tax Administration* 201, 205 (Henry J. Aaron & Joel Slemrod eds., 2004). Some scholars have even suggested that the IRS intentionally creates uncertainty in the hopes of increasing tax revenues. *See* David A. Weisbach, *Ten Truths About Tax Shelters*, 55 Tax L. Rev. 215, 250 (2002); James Alm et al., *Institutional Uncertainty and Taxpayer Compliance*, 82 Am. Econ. Rev. 1018, 1018 (1992); Suzanne Scotchmer & Joel Slemrod, *Randomness in Tax Enforcement*, 38 J. Pub. Econ. 17, 17 (1989). This uncertainty likely causes many taxpayers to decline to report legitimate losses or deductions in fear of costly audits and litigation.

Forgoing Business Expansion. "When businesses are uncertain about taxes," they "adopt a cautious stance" because "it is costly to make a . . . mistake." Steven J. Davis et al., Am. Enter. Inst., *Business Class: Policy Uncertainty Is Choking Recovery* (Oct. 6, 2011).[3] Because "investors usually look at the longer-term tax structure in making major investment decisions," increasing uncertainty in the tax laws causes businesses to keep capital on the sidelines. Duanjie Chen & Jack Mintz, *New Estimates of Effective Corporate Tax Rates on Business Investment*, Tax & Budget Bulletin (Cato Institute), Feb. 2011. Thus, the lack of

[3] *Available at* http://tinyurl.com/n7hucjg

predictability in the economic substance doctrine will cause some businesses to forgo legitimate transactions out of fear that any tax benefits would be disallowed. As the American Bar Association and the American Institute of CPAs warned in 2011, "broad assertions of the [economic substance] doctrine could have a significant chilling effect on a wide range of business transactions." Am. Bar. Ass'n Tax Section & Am. Institute of Certified Public Accountants, *Request for Guidance on Implementation of Economic Substance Doctrine* 11 (Jan. 18, 2011).[4]

Compliance Costs. The economic substance doctrine also increases the costs of tax planning and compliance. Faced with unpredictable standards for determining economic substance, taxpayers must pay considerable sums for advice from accountants and attorneys, as WFC did here, or bear the economic cost of shying away from *bona fide* opportunities that are both potentially profitable and tax efficient. Such "compliance and administrative costs" are "deadweight losses to the economy." Slemrod, *supra*, at 163. As the Treasury Department itself has recognized: "The cost of those lawyers and accountants adds to the price of every product, but they do nothing to make our factories more efficient, our computers faster or our cars more durable." Press Release, Dep't of the Treasury, *Treasury Secretary Paul O'Neill Statement on Treasury's Plan to Combat Abusive Tax Avoidance Transactions* (Mar. 20, 2002).[5]

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[4] *Available at* http://tinyurl.com/8ysu52o

[5] *Available at* http://tinyurl.com/l9aojlk

2. The costs of uncertainty in the economic substance doctrine – overpayment, compliance expenses, and forgoing business expansion – are not borne by businesses alone. The uncertainty surrounding the economic substance doctrine harms every actor in the economy: workers, investors, and consumers.

Labor. The burden of the corporate income tax lands on some combination of shareholders, workers, or consumers. Economic studies provide no clear-cut answer to the question, and the result will vary depending on particular marketplace factors. However, there is a broad consensus that more of the burden is now landing on workers because of globalization. *See* Li Liu & Rosanne Altshuler, *Measuring the Burden of the Corporate Income Tax Under Imperfect Competition*, 66 Nat'l Tax J. 215, 233 (2013). Over the long run, the economic substance doctrine's lack of predictability thus results in depressed wages. *See, e.g.*, David F. Bradford, *Untangling the Income Tax* 133-39 (1986); Robert Carroll, Special Report No. 169: *The Corporate Income Tax and Workers' Wages: New Evidence from the 50 States*, Tax Foundation Special Report 1-5 (Aug. 2009) (showing that states with higher corporate tax rates had lower worker wages).[6]

Investors. When businesses over-report their tax burden, those additional tax costs are also borne in part by investors in the form of diminished return on capital. *See* Julie Anne Cronin et al., *Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology*, 66 Nat'l Tax J. 239, 260 (2013); Jennifer Gravelle, *Corpo-*

[6] *Available at* http://tinyurl.com/l5abrwz

rate Tax Incidence: Review of General Equilibrium Estimates and Analysis, 66 Nat'l Tax J. 185, 211 (2013). A lower return on capital means less investment and a drag on economic growth. It also encourages investors to take their capital overseas. *See, e.g.*, Kenneth Klassen et al., *Geographic Income Shifting by Multinational Corporations in Response to Tax Rate Changes*, 31 J. Acct. Res. 141, 141-43 (1993 supp.); Gravelle, *supra*, at 211. Large multinational companies in particular are likely to shift investment away from the United States when U.S. tax burdens increase or become less predictable. *See* Osofsky, *supra*, at 494. Uncertainty in how the economic substance doctrine is applied thus inhibits capital investment in the United States. *See* R. Glenn Hubbard et al., *Have Tax Reforms Affected Investment?*, *in Tax Policy and the Economy* 131, 145-46 (J.M. Poterba ed., 1995) (concluding that "prior knowledge of changes in tax parameters can improve forecasts of asset investment").

Consumers. In some instances, "corporate tax rate changes have been passed on . . . to consumers in the form of higher prices." *See, e.g.*, J. Richard Aronson et al., *The Potential for Short-Run Shifting of a Corporate Profits Tax*, 66 Bull. of Econ. Research 1, 2 (2014). As a result, the economic substance doctrine likely causes consumers to pay higher prices for products with no resulting increase in quality.

In sum, the uncertainty surrounding the economic substance doctrine – exemplified by the test adopted by the Eighth Circuit here – imposes significant economic costs: tax overpayments, onerous compliance expenses, decreased investment, capital flight, lower wages,

higher prices, and, overall, lower economic growth. This Court should review this case to clear up the uncertainty surrounding the doctrine and remedy the substantial harm caused by the lower courts' myriad and confused standards.

C. The Codification of the Doctrine in 2010 Did Not Clear Up Lower-Court Confusion

Congress codified the economic substance doctrine in the Health Care and Education Reconciliation Reform Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067-68 (codified at 26 U.S.C. § 7701(o)). But that statute did little to alleviate the confusion in the courts below because it framed the doctrine in broad terms that leave key questions to the courts.

For instance, Congress provided that a "transaction shall be treated as having economic substance only if . . . the transaction changes *in a meaningful way* (apart from Federal income tax effects) the taxpayer's economic position." 26 U.S.C. § 7701(o)(1), (o)(1)(A) (emphasis added). The crux of that standard – what constitutes "a meaningful way" – was left to the courts to determine. Moreover, Congress provided that § 7701(o) applies only "[i]n the case of any transaction to which the economic substance doctrine *is relevant*," and Congress clarified that "[t]he determination of whether the economic substance doctrine is relevant to a transaction *shall be made in the same manner as if this subsection had never been enacted*." *Id.* § 7701(o)(1), (o)(5)(C) (emphasis added). It is entirely up to the courts to devise tests for when the doctrine is "relevant" and the statutory standards are triggered.

Accordingly, there remains a strong need for this Court to clarify the economic substance doctrine notwithstanding the enactment of 26 U.S.C. § 7701(o). This case provides an ideal vehicle to do so. Although the transaction at issue here – like all transactions that occurred on or before March 30, 2010 – is not governed by § 7701(o), *see, e.g.*, *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425, 431 n.7 (3d Cir. 2012), the fact that Congress incorporated so much of the common law standard into § 7701(o) means that the rule announced in this case will likely apply to pre- and post-codification cases alike.

Moreover, as Petitioner notes, there are potentially thousands of pre-2010 transactions still working their way through the administrative process and the courts. Pet. 32. Those cases involve as much as $1 billion in disputed taxes. *Id.* Thus, even if the rule in this case were limited to pre-2010 transactions, it would still provide critical guidance to the lower courts in adjudicating a large number of important cases.

II. This Court Should Reject the Eighth Circuit's Version of the Economic Substance Doctrine

This case exemplifies how unpredictable the economic substance doctrine has become. As originally envisioned by this Court, the test for economic substance was narrow and predictable: tax benefits were disallowed only where "there was nothing of substance to be realized" from the transaction in question. *Knetsch*, 364 U.S. at 366. Yet the Eighth Circuit – like many lower courts – has expanded the doctrine to encompass vague factors that are difficult to understand and apply. This Court should reject the Eighth Cir-

cuit's approach and return the doctrine to a narrow, predictable test.

WFC unquestionably had a legitimate business purpose for the transaction at issue: it is undisputed that WFC needed to dispose of excess real estate following a merger. In choosing among the available transactions to achieve that purpose, WFC was keenly aware that its choice would have tax consequences. Pet. App. 5a-8a. It thus sought advice from a national accounting firm that worked with its in-house tax advisors to ensure that it chose a transaction form that would meet every requirement in the Tax Code. *Id.* WFC even specifically addressed the economic substance doctrine, ensuring that there would be "[some]thing of substance to be realized" from the transaction "beyond a tax deduction," *Knetsch*, 364 U.S. at 366, and indeed, the transaction WFC entered generated millions of dollars in profit totally apart from any tax benefits, Pet. App. 8a-9a.

Yet despite WFC's careful planning, the Eighth Circuit applied a novel test for economic substance and disallowed WFC's claimed losses. The court did *not* hold that WFC had violated any particular provision of the Tax Code, and there is no allegation that WFC did so. Nor did the court hold that disposing of real estate is an invalid business purpose; it unquestionably is. Instead, the court adopted an unprecedented rule disallowing claimed losses where the taxpayer "could have obtained that [same] profit potential" through a simpler transaction that would not have resulted in tax benefits. Pet. App. 17a (quotation marks omitted). Moreover, the court discounted the millions of dollars of profit

the transaction generated on the ground that this gain was not sufficiently sizeable compared to the project's tax benefits.

Certiorari is warranted to reverse that sweeping rule. This Court has repeatedly explained that the benefits of the Tax Code do not depend on "whether alternative routes may have offered better or worse tax consequences." *Boulware v. United States*, 552 U.S. 421, 429 n.7 (2008). As this Court has recognized, "[t]o make the taxability of [a] transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." *Founders Gen. Corp. v. Hoey*, 300 U.S. 268, 275 (1937). Likewise, the rule as originally pronounced by this Court was that the economic substance doctrine applies only, if ever, to transactions that have "nothing of substance" to them, *Knetsch*, 364 U.S. at 366, which is a wholly inapposite description of the millions of dollars that this transaction generated.

Here, however, the Eighth Circuit faulted WFC for selecting from among the available transactions one that would achieve WFC's business purpose with the greatest tax benefits. But there is nothing nefarious about that; choosing a transaction that will achieve a valid business purpose through the most tax-advantageous means is the very purpose of tax planning. *See, e.g.*, John F. Prusiecki, Coltec*: A Case of Misdirected Analysis of Economic Substance*, 112 Tax Notes 524, 527 (2006) ("[A]ny transaction that involves any tax planning at all has one or more aspects or elements that are tax motivated and serve no nontax purposes."). Yet the Eighth Circuit effectively prohibited

WFC from engaging in tax planning by disallowing the tax benefits from a transaction that unquestionably achieved WFC's valid purpose of disposing of excess real estate.

The Eighth Circuit's decision went even further: In disallowing WFC's tax benefits because there were different transactions that could have achieved the same purpose, the Eighth Circuit effectively enacted a tax-*maximization* regime. Taken to its logical extreme, the Eighth Circuit's rule requires taxpayers with a valid business purpose to select the transaction that fulfills that purpose with the highest possible tax liability. That rule is profoundly unwise and contrary to this Court's precedent: "[A taxpayer's] legal right . . . to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

CONCLUSION

For the foregoing reasons, *amici* urge the Court to grant the petition for certiorari.

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