No. 02-1859

In the Supreme Court of the United States

BOCA INVESTERINGS PARTNERSHIP, A PARTNERSHIP, AND AMERICAN HOME PRODUCTS CORPORATION, TAX MATTERS PARTNER, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner Boca Investerings is to be recognized as a valid partnership for federal tax purposes.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a) is reported at 314 F.3d 625. The opinion of the district court (Pet. App. 17a-238a) is reported at 167 F. Supp. 2d 298.

JURISDICTION

The judgment of the court of appeals was entered on January 10, 2003. The petition for rehearing was denied on March 26, 2003. Pet. App. 239a. The petition for a writ of certiorari was filed on June 24, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1990, American Home Products Corporation (AHP) decided to sell a subsidiary named Boyle-Midway Household Products, Inc. In an effort to eliminate the tax liability arising from the anticipated $ 605 million capital gain from that sale, AHP officials met with representatives from the Merrill Lynch Company to discuss a tax shelter scheme that Merrill Lynch was then marketing to several large companies. Pet. App. 1a-2a.

Merrill Lynch had developed a tax avoidance scheme that was designed to generate large paper capital losses for a corporation to use to shelter from tax an equal amount of capital gains realized by that corporation. Pet. App. 1a. The plan involved (i) creating a purported "partnership" that would have a foreign entity not subject to United States taxation as one of its partners and (ii) having that entity enter into a contingent installment sale to invoke the ratable basis recovery rule in Temporary Income Tax Regulations Under the Installment Sales Revision Act § 15A.453-1(c)(3)(i) (1981) (Temp. Treas. Reg.). The ratable basis recovery rule is a rule of tax accounting that applies to "contingent installment sales" of property reportable under the installment method of accounting provided by Section 453 of the Internal Revenue Code. A contingent installment sale is a transaction that extends over a period of more than one year and that has an indeterminate sales price on the date of sale. The ratable basis recovery rule allows the seller in a contingent installment sale to recover its basis in the asset over the period of the transaction. Pet. App. 3a.[1]

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[1] Merrill Lynch marketed the scheme to eight large United States corporations, including AHP (the real party in interest in

The tax shelter scheme being promoted by Merrill Lynch involved the following steps (Pet. App. 4a-6a):

(1) AHP was to enter into a partnership with a foreign entity that was not subject to United States taxation.

(2) Upon the formation of the partnership, the foreign entity was to have the overwhelming majority partnership interest while AHP would own a distinct minority interest.

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this case), Colgate-Palmolive Company (the real party in interest in *ACM Partnership* v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999)), AlliedSignal (the real party in interest in *ASA Investerings Partnership* v. *Commissioner*, 201 F.3d 505 (D.C. Cir.), cert. denied, 531 U.S. 871 (2000)), and Brunswick Corporation (the real party in interest in *Saba Partnership* v. *Commissioner*, 78 T.C.M. (CCH) 684 (1999), remanded, 273 F.3d 1135 (D.C. Cir. 2001), on remand, 85 T.C.M. (CCH) 817 (2003)). In *ACM Partnership*, the court of appeals determined that, by creating phantom paper gains and phantom paper losses, the Merrill Lynch transaction lacked economic substance. The court therefore held that neither the phantom gains nor phantom losses reported on the partnership returns were to be recognized for federal tax purposes. 157 F.3d at 260. In *ASA Investerings*, the court of appeals held that the partnership (between AlliedSignal, an AlliedSignal subsidiary, and foreign entities) that was created to implement the Merrill Lynch scheme was a sham. 201 F.3d at 512-516. The income and losses reported by the partnership were therefore allocated to AlliedSignal and its subsidiary. *Ibid.* In *Saba Partnership*, the Tax Court initially ruled in favor of the Commissioner on the economic substance theory adopted by the Third Circuit in *ACM Partnership*. 78 T.C.M. (CCH) at 722-723. The D.C. Circuit, however, remanded the case to the Tax Court for reconsideration in light of the intervening decision of that circuit in *ASA Investerings*, 273 F.3d at 1141. On remand, the Tax Court applied the decision in *ASA Investerings* and ruled that the putative partnerships created to implement the Merrill Lynch scheme were shams. 85 T.C.M. (CCH) at 823-825.

(3) To come under the ratable basis recovery regulation, the partnership was to purchase short-term private placement securities that were eligible for the installment method of accounting provided under Section 453 of the Code and was then promptly to sell those instruments for a large amount of cash and a comparatively small amount of debt instruments whose yield over a fixed period of time was not ascertainable. The gain from the sale of the private placement securities was to be allocated among the partners for federal tax purposes in accordance with their percentage partnership interests.

(4) Under Temp. Treas. Reg. § 15A.453-1(c)(3)(i), the partnership would claim a large "basis" in the debt instruments acquired in exchange for the private placement securities.

(5) AHP would then acquire a majority interest in the partnership during its following taxable year by purchasing a portion of the interest owned by the foreign entity.

(6) The partnership would thereafter distribute the debt instruments with the large basis to AHP and distribute cash to the foreign entity in a partial redemption of its interest.

(7) AHP would then sell the debt instruments to a third party. Because the basis of the instruments would then greatly exceed their value, this disposition would result in a large paper loss. AHP would then use the paper "loss" from the transaction to shelter from tax the capital gain it had realized from the sale of Boyle-Midway.

The foreign partner in the proposed partnership was to be Algemene Bank Nederland, N.V. (ABN). Pet. App. 7a. ABN was a Netherlands financial institution that also played the role of the foreign partner in similar transactions that Merrill Lynch marketed to other United States corporations. *Ibid.* See *Saba Partnership* v. *Commissioner*, 273 F.3d 1135, 1138 (D.C. Cir. 2001), on remand, 85 T.C.M. (CCH) 817 (2003); *ASA Investerings Partnership* v. *Commissioner* 201 F.3d 505, 508 (D.C. Cir.), cert. denied, 531 U.S. 871 (2000); *ACM Partnership* v. *Commissioner*, 157 F.3d 231, 235.

The Merrill Lynch scheme was implemented in the spring of 1990. AHP and a wholly-owned subsidiary entered into a purported "partnership" with two Netherlands Antilles "special purpose corporations." Pet. App. 6a.[2] The special purpose corporations were controlled by foundations that were, in turn, controlled by ABN. *Id.* at 64a-65a. The AHP subsidiary was known as AHP 10; the Netherlands Antilles corporations were known as Syringa and Addiscombe. *Id.* at 64a; 71a. The partnership that they formed is petitioner Boca Investerings Partnership.[3]

AHP contributed $135 million in exchange for a 9% partnership interest. Pet. App. 86a. AHP 10 contributed $15 million in exchange for a 1% partnership interest. *Ibid.* Syringa contributed $1.245 billion in exchange for an 83% partnership interest. *Ibid.* Addiscombe contributed $105 million in exchange for a 7%

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[2] AHP did not learn the identities of its purported foreign partners until the day the partnership was formed. Pet App. 69a.

[3] AHP, acting as the tax matters partner, brought this action in the name of petitioner Boca Investerings. See note 6, *infra*. References in this brief to "petitioner" are to Boca Investerings.

partnership interest. *Ibid.* The stated purpose for the partnership was to allow the parties to profit from investments. *Id.* at 78a.

On May 1 and 2, 1990, petitioner purchased $1.1 billion of private placement floating-rate notes from two Japanese banks and PepsiCo. Pet. App. 6a. In late May 1990, petitioner sold the private placement notes for $880 million in cash and several London Interbank Offering Rate (LIBOR) Notes. *Id.* at 6a-7a. The LIBOR is the primary fixed income rate used in Euro markets. LIBOR Notes are instruments that pay variable amounts at three-month periods (reflecting adjustments in the LIBOR during the period) on a fixed sum (a notional principal amount).[4] The LIBOR Notes received by Boca provided for quarterly payments for 20 quarters commencing September 1, 1990, on a specified notional principal amount. *Id.* at 99a.

2. On its partnership tax return for the 1990 taxable year (ending May 31, 1990), petitioner treated the sale of the private placement notes as an "installment sale" under Section 453(b) of the Internal Revenue Code and as a "contingent payment installment sale" under Temp. Treas. Reg. § 15A.453-1(c). Pet. App. 172a. Petitioner therefore reported a gain of $721,873,843 from these transactions for 1990, which reflected the excess of the cash received from the sale of the private placement notes ($880,000,000) over the portion of the basis in the LIBOR Notes recovered during that year ($58,126,157). *Id.* at 173a. The gain was allocated to the

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[4] The owner of a LIBOR Note effectively purchases a stream of payments for a certain period that includes a recovery of principal as well as an interest component. The purchaser of a LIBOR Note makes a profit if the interest rate rises, and incurs a loss if the rate declines.

partners based upon their ownership interests: $64,968,646 was allocated to AHP; $7,218,738 was allocated to AHP 10; $599,155,290 was allocated to Syringa; and $50,531,169 was allocated to Addiscombe. *Ibid.* Syringa and Addiscombe did not pay any United States tax or foreign tax on the gain allocated to them from the sale of the private placement notes.

On August 3, 1990, petitioner distributed LIBOR Notes to AHP and LIBOR Notes plus $2,264,432 in cash to AHP 10, and distributed cash to Syringa and Addiscombe in partial redemption of their interests in petitioner. Pet. App. 119a. The LIBOR Notes distributed to AHP were valued at $197,485,353; the notes distributed to AHP 10 were valued at $19,596,647; the cash distributed to Syringa totaled $147,282,023; the cash distributed to Addiscombe totaled $27,596,125. *Ibid.*

In November 1990, AHP and AHP 10 sold the LIBOR Notes that had been distributed to them. Pet. App. 8a. On its 1990 consolidated federal income tax return, AHP reported a short term capital loss of $710,669,136 from those transactions. *Id.* at 130a. Setting those losses off against the capital gain reported by AHP and AHP 10 from petitioner's sale of the private placement notes ($72,187,584), AHP reported a tax loss of $638,481,552 from the Merrill Lynch transaction. AHP used this loss to offset its capital gain from the sale of Boyle-Midway ($605,104,583) in addition to other gains that it reported from 1990 to 1993. *Id.* at 8a.

On December 17, 1990, petitioner distributed $3,524,207 to Syringa in redemption of its remaining interest in petitioner. Pet. App. 131a. In September 1991, AHP and AHP 10 purchased Addiscombe's remaining interest in petitioner. *Id.* at 134a.

The costs incurred by AHP in connection with these transactions were approximately $13 million. Pet. App. 109a. AHP also paid a $7 million fee to Merrill Lynch for structuring the transaction. *Id.* at 6a. These outlays were partially offset by cash returns from various steps of the transactions. As a result, although AHP claimed a tax loss exceeding $638 million from the Merrill Lynch transactions, its "actual losses" were only "about $8 million." *Id.* at 1a.

3. The Internal Revenue Service audited petitioner's partnership returns for 1990 through 1993 and determined that the ABN affiliates had not entered into a valid partnership with AHP (and AHP 10). The Commissioner therefore adjusted petitioner's returns to allocate all the gains and losses reported by petitioner to AHP and AHP10.[5] AHP then filed this suit in district court to contest the proposed adjustments.[6]

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[5] The Commissioner also proposed alternative adjustments that reflected other theories. In particular, the government claimed that the Merrill Lynch transaction lacked sufficient economic substance to be recognized for federal tax purposes. See note 1, *supra*. The court of appeals did not reach that issue, for it ruled in the government's favor on other grounds. See pages 9-11, *infra*.

[6] As a result of amendments to the Internal Revenue Code made by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, tax litigation involving partnership items now is conducted in a single proceeding in the name of the partnership. Following the completion of such litigation, appropriate computational adjustments are made to the tax returns of each of the partners to reflect the results of the partnership level litigation. See 26 U.S.C. 6221-6233.

A partnership may file a petition contesting proposed adjustments to its returns in a district court only if the partner filing the petition deposits with the Secretary of the Treasury the additional amounts that would be due from that partner in the event the

4. The district court held that the Commissioner erred in concluding that petitioner was not a genuine partnership for federal tax purposes. Pet. App. 17a-238a. The court concluded that the evidence established that the parties intended to, and in fact did, organize petitioner as a partnership. *Id.* at 188a. The court stated that "it is irrelevant if AHP was motivated in part to organize [petitioner] as a partnership by a desire to reduce taxes." *Id.* at 198a.

5. The court of appeals reversed. Pet. App. 1a-16a. The court noted that "this is the third case before us involving this particular type of scheme. *See Saba P'Ship* v. *Comm'r*, 273 F.3d 1135 (D.C. Cir. 2001); *ASA Investerings P'ship* v. *Comm'r*, 201 F.3d 505 [(D.C. Cir.), cert denied, 531 U.S. 871 (2000)]." *Id.* at 2a. The court pointed out that in this case, as in the two prior cases, "although the transaction is basically a wash, generating hardly any economic gain or loss, Merrill Lynch's lawyers' interpretation of the relevant provisions allows the partnership to claim a massive tax gain, which is allocated to the foreign partner, and a massive tax loss, which the U.S. corporation keeps for itself." *Id.* at 3a-4a (quoting *Saba Partnership*, 273 F.3d at 1136). The court concluded that this case is controlled by its prior decision involving the same Merrill Lynch scheme in *ASA Investerings*. Pet. App. 2a.[7]

adjustments are upheld. 26 U.S.C. 6226(e)(1). In this case, AHP deposited with the Secretary of the Treasury the maximum additional amount that it determined would be due as a result of the proposed adjustments. (Compl. at 2, ¶ 2.)

[7] Petitioner errs in suggesting (Pet. 7) that the government did not challenge the legal standards applied by the district court in this case. See Gov't C.A. Br. at 25 ("The district court's judgment cannot be reconciled with *ASA*, and should be reversed by this Court."); *id.* at 25-42 ("The district court erred in concluding that

In *ASA Investerings*, the court held that the Merrill Lynch tax avoidance scheme employs sham partnerships that are not to be recognized for federal tax purposes. The court explained that, "where taxpayers use an 'elaborate partnership' with entities created solely for the purpose of the questioned transaction, 'the absence of a non-tax business purpose' is fatal to the recognition of the entity for the tax purposes." Pet. App. 15a-16a (citing *ASA Investerings*, 201 F.3d at 512). Applying the holding of *ASA Investerings* to this case, the court of appeals reversed the decision of the district court because that "court did not find that a legitimate, non-tax necessity existed for the formation of the Boca partnership, and because the evidence of record would not have supported such a finding if made." *Id.* at 16a. The court of appeals explained that (*id.* at 13a-14a):

> In the current case, the district court never made a finding of fact in regard to the necessity of AHP's acquisition of foreign partners in order to engage in the transactions. No official testified that AHP needed a partnership with a foreign corporation to invest in LIBOR notes or [private placement notes]. AHP's participation in the partnership defies common sense from an economic standpoint, since it could have purchased the [private placement notes] and the LIBOR notes directly, and avoided millions in transaction costs, including the $7 million fee it

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this case is materially different from *ASA*."); *id.* at 26-27 (arguing that the factors identified in *ASA* that showed a lack of intent to enter into a genuine partnership were also present in this case); *id.* at 40-41 ("there was no legitimate nontax business reason for AHP to enter into a 'partnership' with ABN, a foreign entity whose identity it did not even learn until the date the 'partnership' was formed").

> paid to Merrill Lynch and the "premiums" paid to the foreign partners for the purchase of their ownership interests.
>
> Without a finding on the business need for the partnership from AHP's standpoint in this transaction, the judgment under review cannot stand. In addition, the foreign partners Syringa and Addiscombe were, like the foreign entities in *ASA*, "concocted" for the occasion—neither having existed prior to the transaction's commencement, nor serving any other purpose. * * * In fact, the parties stipulated in the court below that both entities came into being only on April 19, 1990, the same day that Boca was created. Stip. Of Facts at ¶ 29. Nothing in the record indicates that AHP ever considered or weighed the benefits of using a different type of transaction in order to make these investments, including the option of purchasing them directly.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Indeed, this Court has twice previously declined to review decisions that invalidated this same Merrill Lynch tax avoidance scheme in other cases. See note 1, *supra*. Further review is therefore not warranted.

1. This Court has emphasized that partnerships are sometimes employed improperly as devices to circumvent the tax laws. *Commissioner* v. *Tower*, 327 U.S. 280, 289 (1946). In light of "the realities of tax avoidance schemes," the Court has held that a partnership is not to be recognized for tax purposes when "no

genuine union for partnership business purposes was ever intended." *Id.* at 289, 292. To prevent tax abuses, the Court has directed lower courts to examine putative partnership arrangements to determine whether "*the parties in good faith and acting with a business purpose* intended to join together in the present conduct of the enterprise." *Commissioner* v. *Culbertson*, 337 U.S. 733, 742 (1949) (emphasis added).

The court of appeals properly applied the standards established in *Tower* and *Culbertson* in concluding that petitioner was not to be recognized as a valid partnership for federal tax purposes.[8] The Merrill Lynch scheme involved an obvious tax avoidance plan that culminated in a claimed $638 million capital loss for a U.S. taxpayer from a transaction that had no valid business purpose. The scheme required the creation of a putative partnership between the U.S. taxpayer (AHP) and foreign entities that were created solely for the purpose of implementing the scheme. The scheme required AHP to act in an economically irrational manner by incurring millions of dollars in unnecessary transaction costs—costs that would have been avoided if AHP had simply directly purchased the financial instruments that formed the transaction. Pet. App. 13a. In these circumstances, the court of appeals properly refused "to shut its eyes to the realities of tax avoidance schemes" (*Commissioner* v. *Tower*, 327 U.S. at 289) and correctly concluded that the absence of any valid business purpose for the arrangement deprived

[8] Petitioner errs in asserting (Pet. 9) that the court of appeals approved the district court's finding that the parties in good faith and with a nontax business purpose intended to form and did form a partnership. The court of appeals reversed the district court's judgment on this very point. Pet. App. 15a-16a.

the partnership of any substance for tax purposes. Pet. App. 13a-16a.

2. The decision in this case is consistent with each of the other appellate decisions that have addressed the Merrill Lynch tax avoidance scheme. In four separate cases, the courts of appeals have uniformly rejected the asserted tax consequences of the abusive Merrill Lynch transactions. This Court has now twice rejected petitions for certiorari from these decisions. See note 1, *supra*.

Petitioner nonetheless asserts that the court erred in this case in holding that "federal income tax law recognizes a partnership *only* if there was a non-tax business necessity for its formation." Pet. 9. That assertion mischaracterizes both the text and the reasoning of the court's opinion. The court of appeals specifically limited its decision to the unique circumstances of the Merrill Lynch tax avoidance scheme, and it stressed that it was not requiring taxpayers in ordinary transactions to justify the use of the partnership form of conducting business (Pet. App. 15a-16a; citations omitted):

> We do not of course suggest that in every transaction using a partnership a taxpayer must justify to that form, but as we made clear in both *ASA Investerings* and *Saba Partnership*, where taxpayers use an "elaborate partnership" with entities created solely for the purpose of the questioned transaction, "the absence of a non-tax business purpose" is fatal to the recognition of the entity for the tax purposes.

See *id.* at 14a ("In order to satisfy the legal test *for this type of partnership*, the district court must have found a non-tax business purpose need for the partnership in order to accomplish the goals of the partners") (emphasis added). By its own terms, the decision in this case thus applies specifically to the use of partnerships in the context of elaborate and abusive tax avoidance schemes.

The requirement that a non-tax business purpose must exist for the partnership to be respected for tax purposes is, in any event, a proper application of this Court's decisions. In *Culbertson*, this Court held that the controlling inquiry is whether "the parties in good faith and *acting with a business purpose* intended to join together in the present conduct of [an] enterprise." 337 U.S. at 742 (emphasis added). The court of appeals properly concluded in this case that the Merrill Lynch transactions were not conducted for a business purpose and were instead designed to create "phantom" losses in an effort to avoid taxes.[9] See *ACM Partnership* v. *Commissioner*, 157 F.3d at 245 (holding that the Merrill Lynch scheme creates "phantom" losses that are not to be recognized for tax purposes). As the court emphasized, the asserted "partnership" with foreign entities had no plausible business justification and also "defie[d] common sense from an economic standpoint" because it forced AHP to incur millions of dollars in unnecessary transaction costs. Pet. App. 13a. The court's application of established legal principles to the particular facts of this case does not warrant further review.

3. Petitioner errs in suggesting (Pet. 9) that the fact-intensive decision in this case conflicts with the decision of the Sixth Circuit in *Miller* v. *Commissioner*, 183

[9] The foreign entities were created on the day before the formation of the partnership. Their only function was to receive the "phantom" income produced by the Merrill Lynch transaction, and thereby allow AHP to claim the corresponding phantom losses. Pet. App. 2a-4a, 13a.

F.2d 246 (1950). The *Miller* case is not even remotely similar to the present case. The issue in *Miller* was whether a family partnership (between a husband and wife) was to be recognized for federal tax purposes. In holding that the family partnership was to be given effect for tax purposes, the court in *Miller* simply applied the statement in *Culbertson* that a partnership formed "in good faith and acting with a business purpose" will be respected for tax purposes. *Id.* at 249 (quoting 337 U.S. at 742). Nothing in *Miller* addresses whether a partnership satisfies that standard when, as in this case, it is formed solely to implement a complex tax avoidance scheme that seeks to create hundreds of millions of dollars of phantom losses for a U.S. corporate taxpayer. Moreover, nothing in *Miller* supports petitioner's assertion (Pet. 16) that the Sixth Circuit would validate such a scheme.

Petitioner similarly errs in relying (Pet. 12) on the decision of the Tax Court in *Nichols* v. *Commissioner*, 32 T.C. 1322 (1959). The issue in *Nichols*, as in *Miller*, was whether a family partnership (between a husband and wife) should be recognized for federal tax purposes. As in *Miller*, nothing in the Tax Court's opinion in *Nichols* addresses the appropriate method for determining the validity of a partnership created to implement a complex tax avoidance scheme. And, nothing in *Nichols* suggests that the Tax Court would validate such a scheme. To the contrary, in the three Tax Court decisions that involve the Merrill Lynch tax avoidance scheme, the Tax Court has refused to recognize the phantom losses generated by these transactions. See note 1, *supra*.[10]

4. There is a notable irony to petitioner's contention that the decision of the court of appeals "discourages economically beneficial activity" (Pet. 19). As the court in fact recognized, the tax scheme involved in this case is a paradigm example of the sort of disingenuous and wasteful behavior that the business purpose doctrine seeks to discourage. The decision of the court of appeals precludes AHP from claiming hundreds of millions of dollars in phantom losses from a transparently artificial tax avoidance scheme that was implemented through perversely irrational economic behavior. Pet. App. 13a. The decision in this case has no adverse impact on legitimate business activity. It simply prevents corporations from using abusive tax shelters to raid the Treasury.

Petitioner's contention (Pet. 20-23) that the decision of the court of appeals casts doubt on the tax treatment of millions of partnerships is frivolous. The decision of the court of appeals merely applies the well-established business purpose requirement of *Culbertson* to the unique facts of this case. Partnerships that have a legitimate business purpose are not threatened either by the decision in this case or by this Court's decision in *Culbertson*.

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[10] In any event, a conflict between a decision of a court of appeals and a decision of the Tax Court would not provide grounds for certiorari. See Sup. Ct. R. 10(a).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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