No. 10-2775

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

MERCK & CO., INC.,

Appellant,

v.

UNITED STATES OF AMERICA,

Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY
Case No. 05-2575, HON. KATHERINE S. HAYDEN

BRIEF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT URGING REVERSAL

NATIONAL CHAMBER
LITIGATION CENTER, INC.
Robin S. Conrad
Amar D. Sarwal
1615 H Street, NW
Washington, DC 20062
202-463-5337

ROBBINS, RUSSELL, ENGLERT,
ORSECK, UNTEREINER & SAUBER LLP
Roy T. Englert, Jr.
Mark T. Stancil
William P. Baude
1801 K Street, NW
Suite 411
Washington, DC 20006
202-775-4500

Counsel for *Amicus Curiae*

CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and Local Rule 26.1, The Chamber of Commerce of the United States of America certifies as follows:

1. The Chamber has no parent corporation.

2. The Chamber does not issue stock, and no publicly held company owns a 10 percent or greater interest in the Chamber.

3. There are no publicly held corporations which are not a party to the proceedings before this Court but have a financial interest in the outcome of the proceeding.

4. This is not a bankruptcy appeal.

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page(s)

Cases

TABLE OF AUTHORITIES—continued

Page(s)

TABLE OF AUTHORITIES—continued

Page(s)

TABLE OF AUTHORITIES—continued

Page(s)

Statutes and Regulations

TABLE OF AUTHORITIES—continued

Page(s)

Miscellaneous

TABLE OF AUTHORITIES—continued

Page(s)

INTEREST OF *AMICUS CURIAE*

The Chamber of Commerce of the United States of America is the world's largest business federation. The Chamber represents 300,000 direct members and indirectly represents the interests of more than three million businesses and organizations of every size and in every sector and geographic region of the country. The Chamber serves as the principal voice of the business community. An important function of the Chamber is to represent the interests of its members by filing *amicus* briefs in this Court and others on issues of national concern to American businesses. The Chamber has a particularly strong interest in this case because it involves issues of universal significance to the Chamber's members. This case turns on the extent to which businesses may rely on authoritative government pronouncements in calculating their tax liability. The case also turns on the extent to which the IRS or the courts may retroactively invalidate, or recharacterize for tax purposes, legitimate business transactions with economic substance.

SUMMARY OF ARGUMENT

This should have been a simple case. The tax code required Schering-Plough to compute its income according to the IRS's instructions in Notice 89-21. That notice required Schering-Plough to report the lump-sum payments over time,

as it did. When the IRS later chose to change this tax treatment in new regulations it expressly made those regulations non-retroactive.

Nonetheless, the district court invalidated the transactions and disregarded Schering-Plough's reliance on Notice 89-21. In doing so, the court committed three important errors. It incorrectly recharacterized the swap-and-assign transactions as a loan from the subsidiaries to Schering-Plough—but it could do so only by ignoring longstanding precedent. It incorrectly held that Notice 89-21 was invalid because it "clash[ed]" with the purposes of "Subpart F" of the tax code—but there is no clash between the two provisions. And the district court incorrectly upended Notice 89-21 in the name of the economic substance doctrine. That doctrine has no place where, as here, a transaction complies with the plain intent of the law. Even if the doctrine were applicable, the court misapplied it by repeatedly ignoring the undisputed fact that Schering-Plough needed cash and was able to raise it through these transactions without inflating its balance sheet with debt.

Affirming the district court's ruling would have harsh consequences for American business. Businesses depend on clear, predictable rules to plan their affairs. If the tax consequences of its decisions are unpredictable, a company does not know how to deploy its resources or to price its products. And while companies wait—sometimes decades—for the IRS's final word on their tax bill,

they will be forced to park massive amounts of money on the sidelines rather than put it to productive use.

Under the district court's version of the economic substance doctrine, there are no meaningful rules. Examined closely enough, almost any complicated business transaction can be argued to resemble something else, or to have elements that were included for tax reasons. And taxpayers can take no comfort in the knowledge that they have done what the IRS *commanded.* Faced with such a regime, companies will either abandon legitimate tax savings for fear of crippling litigation, or divert otherwise productive resources to accountants and lawyers and hope for the best. That is not how the tax system should work.

ARGUMENT

I. Notice 89-21 *Required* The Tax Treatment At Issue Here, And Schering-Plough Had A Right To Rely On That Pronouncement.

There may be cases in which the tax laws and regulations are unclear in prescribing one specific tax treatment. This is not one of them. We first briefly examine the overwhelming authority supporting Schering-Plough's tax treatment. We do so not because the Chamber has a systemic interest in the tax consequences of notional principal contracts, but because appreciating the specificity and clarity of the rules upon which Schering-Plough relied is necessary to apprehend fully the stunning departure authorized in the name of "recharacterizing" the transactions and invalidating them under the increasingly amorphous economic substance

doctrine. Upholding the IRS's bait-and-switch was an error of the highest order, creating profound uncertainty for any business hoping to rely on guidance issued by the IRS.

A. Notice 89-21 Squarely Addressed Notional Principal Contracts And Directed Schering-Plough's Tax Treatment.

1. The tax rules governing notional principal contracts were straightforward when Schering-Plough entered into the transactions at issue here. Section 446(b) of the tax code instructed Schering-Plough that "the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." 26 U.S.C. § 446(b). An IRS pronouncement, Notice 89-21, exercised the Secretary's discretion "with respect to the federal income tax treatment of lump-sum payments received in connection with . . . [n]otional principal contract[s]." 1989-1 C.B. 651. Notice 89-21 commanded that "lump-sum payments" *must* be "taken into account over the life of the contract." *Ibid.* In contrast, "including the entire amount of such payment in income when it is received," the notice declared, "is an *impermissible* method of accounting." *Ibid.*

The tax treatment prescribed in Notice 89-21 was not accidental. Rather, it was a carefully considered response to the IRS's concern that notional principal contracts not be used to *accelerate* a taxpayer's recognition of the lump-sum payment. Businesses with large net operating losses hoped to offset other income, but could not carry those losses forward indefinitely. For example, operating

losses expire after twenty years, see 26 U.S.C. § 172(b)(1)(A)(ii), and cannot be retained following certain corporate acquisitions, see 26 U.S.C. § 382. So businesses were driven to use notional principal contracts "to refresh loss carryovers that otherwise might have gone unused." David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 Tax L. Rev. 491, 514 (1995). By reporting a lump-sum payment as immediate income, the company could use its expiring losses and replace them with new losses in the future as the company made its swap payments. Albert J. Vernacchio, *The Taxation of Notional Principal Contracts After Notice 89-21*, 28 Duquesne L. Rev. 515, 529 (1990). "The government viewed this as a significant tax problem." Weisbach, 50 Tax L. Rev. at 514. Notice 89-21 was thus a carefully considered decision to require taxation of the lump-sum payment over time.

The IRS could have decided to tax notional principal contracts another way. Indeed, in 1993, the IRS adopted a new position, superseding Notice 89-21 and creating new regulations on the reporting of income from assignments of receive legs. 26 C.F.R. §§ 1.446-3(g)(4), (h)(4)(i). In recognition that it was reversing its previously published guidelines, however, the IRS expressly made the new regulations non-retroactive. See 26 C.F.R. § 1.446-3(j). That decision was likewise a deliberate one; at the time, 26 U.S.C. § 7805(b) expressly authorized the IRS to make such regulations retroactive. See also *Tate & Lyle, Inc.* v. *Comm'r*,

87 F.3d 99, 106-108 (3d Cir. 1996) (upholding retroactive regulation against constitutional and statutory challenges).

Accordingly, the tax treatment of Schering-Plough's swap-and-assign transactions (all of which predated the 1993 regulations) was clear, and Schering-Plough reported the transactions as Notice 89-21 expressly commanded. If even such clear legal commands can later be disregarded by the IRS, no company is safe from tax uncertainty.

2. It is no answer, as the district court suggested, that one sentence of Notice 89-21 states that it does not apply "to the extent that such transactions are in substance properly characterized as loans." 1989-1 C.B. 651. Extensive case law makes plain that Schering-Plough's sale of the stream of income from ABN was a sale, not a loan. Most notably, a loan requires "an unconditional obligation on the part of the transferee to repay the money" to the transferor. *Geftman* v. *Comm'r*, 154 F.3d 61, 68 (3d Cir. 1998) (internal quotation marks omitted). But Schering-Plough had *no obligation to pay its subsidiaries*; ABN did. As the Supreme Court's seminal decision in *Frank Lyon Co.* v. *United States* further shows, ABN was a disinterested third party whose involvement demonstrates that the transaction was not a sham. 435 U.S. 561, 573-576 (1978).

Indeed, Schering-Plough listed, and the district court acknowledged, numerous aspects of the transactions that rendered them sales, not loans, under

settled doctrine. See Op. 43-44; Pl. Pre-trial Br. 14-21; see also Schering-Plough Br. 23-32. The court did not dispute these facts. Rather it "declined to follow the line of reasoning represented by the non-binding case law," New Trial Op. 3, and instead invented its own reasons for distinguishing the prior cases. Businesses trying to plan their affairs do not have that same luxury.

3. The district court's assertion that Schering-Plough should have known to ignore Notice 89-21 because it "clash[ed]" with "the enveloping Subpart F regime," Op. 90, is likewise misguided. The court did not quote any part of the statutory text or point to any actual conflict between the statute's requirements and the Notice's timing rules. It simply asserted, without explanation, that Subpart F requires taxation to be "immediate," Op. 89, 90, and therefore ignored the IRS's published conclusion to the contrary.

The district court was confused. Subpart F provides that certain untaxed foreign earnings must be taxed when they are invested in "United States property." 26 U.S.C. § 956; see also § 951(a)(1)(B). It does not apply to all domestic investments. See, *e.g.*, 26 U.S.C. § 956(c)(2) (enumerating twelve subparagraphs of exceptions, several with multiple subparts, from the definition of "United States property"). Notice 89-21, in turn, requires that lump-sum payments "be taken into account over the life of the contract." 1989-1 C.B. 651. For this reason commentators have long recognized that Notice 89-21 "impacts the use of notional

principal contracts . . . in characterizing income for purposes of Subpart F of the Code." Vernacchio, 28 Duquesne L. Rev. at 516 n.5. And other IRS notices describing income taxable under Subpart F specifically instructed taxpayers to see "Notice 89-21 for guidance about the proper method of accounting for payments made or received with respect to notional principal contracts." Notice 89-90, 1989-2 C.B. 407 (citation omitted). There is no "clash."

Moreover, the district court deviated from the many cases rejecting the IRS's expansive readings of Subpart F's "purposes." For example, in *The Limited, Inc.* v. *Comm'r*, the IRS invoked the purportedly expansive purposes of Subpart F and convinced the Tax Court to disregard a statutory exemption for "'deposits with persons carrying on the banking business.'" 113 T.C. 169, 182, 189-190 (1999) (quoting then-current version of 26 U.S.C. § 956(b)(2)(A)). The Sixth Circuit reversed, criticizing the Tax Court for "rac[ing] to the legislative history," and acting as an "uber-legislature" in rewriting the statute. 286 F.3d 324, 335-336 (6th Cir. 2002). As the Tax Court has elsewhere acknowledged, the statute is riddled with so many exceptions that "the search for a unified legislative purpose in subpart F proves to be elusive." *Dougherty* v. *Comm'r*, 60 T.C. 917, 927 (1973). Numerous other decisions have likewise rejected the government's attempts to invoke the purported purposes of Subpart F in lieu of its text. See *Lovett* v. *United States*, 621 F.2d 1130, 1140 (Ct. Cl. 1980); *MCA, Inc.* v. *United States*, 685 F.2d

1099, 1105 (9th Cir. 1982); *Brown Group, Inc.* v. *Comm'r*, 77 F.3d 217, 222 (8th Cir. 1996); *Vetco, Inc.* v. *Comm'r*, 95 T.C. 579, 593-594 (1990); *Dover Corp.* v. *Comm'r*, 122 T.C. 324, 352 (2004). These Subpart F decisions repeat a universal truth about statutory interpretation: "no legislation pursues its purposes at all costs. Deciding what competing values will or will not be sacrificed to the achievement of a particular objective is the very essence of legislative choice—and it frustrates rather than effectuates legislative intent simplistically to assume that *whatever* furthers the statute's primary objective must be the law." *Rodriguez* v. *United States*, 480 U.S. 522, 525-526 (1987) (per curiam) (emphasis in original).

If affirmed, the district court's reasoning would also imperil *other* important IRS notices upon which businesses must rely. For example, in Notice 88-108, the IRS has provided an exception to Subpart F taxation for controlled foreign corporations that make short-term loans of 30 days or less. 1988-2 C.B. 446. A more recent series of notices has reaffirmed that exception and temporarily expanded it. See Notice 2008-91, 2008-43 I.R.B. 1001; Notice 2009-10, 2009-5 I.R.B. 419; 2010-12, 2010-4 I.R.B. 326. If the district court was right to strike down all IRS determinations that provide exceptions to "immediate" Subpart F taxation, then every business that has made short-term loans in reliance on these notices could soon face an unexpected tax bill.

B. The Economic Substance Doctrine Has No Place Upending Such Authoritative Pronouncements.

The district court overrode the plain language of Notice 89-21 and Section 446(b) in the name of the economic substance doctrine. Because Schering-Plough complied with the clear text and intent of the statute and its accompanying IRS determination, however, the economic substance doctrine should have no further bearing. The doctrine exists only as a tool to effectuate the intent of the statute and regulations, not to empower the IRS to second-guess transactions that are wholly consistent with that intent. *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935).

The decision below improperly elides the essential distinction between enforcing the result that Congress actually intended and examining whether, in hindsight, Congress *should have* permitted a particular tax treatment. The former is a legitimate aim of the economic substance doctrine; the latter is the most pernicious sort of judicial legislating. See *Horn* v. *Comm'r*, 968 F.2d 1229, 1231 (D.C. Cir. 1992) ("Although useful in determining congressional intent and in avoiding results unintended by tax code provisions, the doctrine cannot trump the plainly expressed intent of the legislature."). Congress plainly intended taxpayers to follow the IRS's determination, and that determination was plainly expressed by Notice 89-21. Even in tax cases, the courts "cannot rewrite statutes and regulations merely because [they] think they imperfectly express congressional intent or wise social policy." *Vainisi* v. *Comm'r*, 599 F.3d 567, 572 (7th Cir. 2010). The

economic substance doctrine thus had no legitimate role in the lower court's analysis.

Even if the doctrine were applicable here, the district court used it in an unprecedented—and deeply troubling—fashion. The court denied that Schering-Plough's sale of hundreds of millions of dollars in assets to its subsidiaries had any "'objective economic substance'"—*i.e.*, "'any practical economic effects.'" Op. 74, 75 (quoting *ACM P'ship* v. *Comm'r*, 157 F.3d 231, 247, 248 (3d Cir. 1998)). Schering-Plough rightly pointed out the obvious and undisputed fact to the contrary: Schering-Plough received huge amounts of cash that it did not have before the transaction, and therefore had the means to fund significant business operations without burdening its balance sheet with additional debt. Nevertheless, the district court insisted that "[t]he repatriated funds in themselves do not constitute an appreciable economic effect any more than shifting money from one pocket to another." Op. 76.

The district court was wrong. To dismiss a major financing transaction between two related companies as "shifting money from one pocket to another" is to misunderstand the nature of corporations. "[C]ourts respect entity separateness absent compelling circumstances calling equity . . . into play." *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005). Schering-Plough needed money that it did not have and did not want to imperil its credit rating. Obtaining that money by

selling a financial asset at market rates can no more be dismissed as "shifting money" than any other sale or transaction between related companies.

In effect, the government seeks an end run around the provision of the tax code that deals with transactions between commonly controlled companies. Section 482 authorizes the Secretary to redistribute income between "two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests" if "necessary in order to prevent evasion of taxes or clearly to reflect [the parties'] income." 26 U.S.C. § 482. Section 482 is *automatically satisfied* by an "arm's length" price. 26 C.F.R. § 1.482-1(b)(1). That is, a transaction satisfies Section 482 "if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." *Ibid.*; *Comm'r* v. *First Sec. Bank of Utah*, 405 U.S. 394, 407 (1972). But there is no dispute that Schering-Plough *did* sell the swap-and-assign transactions at an "arm's length" price. Op. 16-18.

The district court apparently believed that there is a related-party exception to Notice 89-21. Op. 42-43, 45. Not only is such an exception conspicuously absent from the notice itself, but it flies in the face of Section 482's specific

treatment of related-party transactions.[1] "A specific provision controls over one of more general application." *Gozlon-Peretz* v. *United States*, 498 U.S. 395, 407 (1991) (citing *Crawford Fitting Co.* v. *J.T. Gibbons, Inc*., 482 U.S. 437, 445 (1987)); *Bloate* v. *United States*, 130 S. Ct. 1345, 1354 (2010) (same). Thus, courts have recognized that

> Section 482 in the Internal Revenue Code is the specific provision that may be used to adjust the prices at which goods and services are transferred between entities owned or controlled by the same interests. It is a well-recognized rule of statutory construction that a specific provision controls when the same subject matter is addressed by a more general provision. . . . [S]ection 482 is the specific applicable provision that governs . . . even if the same subject matter is addressed by . . . more general [statutes.]

Pikeville Coal Co. v. *United States*, 37 Fed. Cl. 304, 312 (1997); see also *Rubin* v. *Comm'r*, 429 F.2d 650, 653 (2d Cir. 1970) (Friendly, J.) ("Resort to [S]ection 482 is clearly superior" and "[r]esort to 'common law' doctrines of taxation . . . ha[s] no place where, as here, there is a statutory provision adequate to deal with the problem presented."). Similarly, this Court has rejected the IRS's attempt to create a related-party exception to a dividend-taxation statute, explaining that "[S]ection 482"—not "rewriting [the statute]"—is the appropriate "weapon" to deal with related-party problems. *Atlas Tool Co.* v. *Comm'r*, 614 F.2d 860, 868 (3d Cir. 1980).

[1] Moreover, as Schering-Plough notes (at 36), ABN was "an unrelated, arms-length, independent party acting in its own economic self-interest."

Moreover, if (as the district court believed) these transactions had no "practical economic effects," *ACM*, 157 F.3d at 248 (internal quotation marks omitted), there would have been no conceivable reason for Schering-Plough to enter into them. These transactions did not *generate* losses or deductions, thereby allowing Schering-Plough to "shelter" income. So there is no possibility that its claimed need for cash is a pretext for any other tax benefits generated by the transaction.

The district court compounded its error by also denying that there was any "'subjective business motivation,'" Op. 74 (quoting *ACM*, 157 F.3d at 247), or "business purpos[e]," Op. 78, behind the swap-and-assign transactions. The district court again refused to look at the true non-tax purpose for the transaction: Schering-Plough's need for immediate cash without additional debt. Op. 78-79. It further criticized Schering-Plough for lacking a specific purpose for using this form of financing, concluding that "a reasonable taxpayer would not have undertaken such roundabout means to arrive at such straightforward ends." Op. 87.

Even if the tax considerations described in Notice 89-21 did shape—to some extent—how Schering-Plough decided to get that cash, that should not matter. "A 'business purpose' does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a 'business purpose,' when we are talking

about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business." *UPS* v. *Comm'r*, 254 F.3d 1014, 1019 (11th Cir. 2001) (citing *ACM*, 157 F.3d at 251). The swap-and-assign transactions plainly "figure[d] in a bona fide, profit-seeking business."

UPS squarely rejected the government's claim that there must be a separate business purpose for the *form* of a financing transaction, explaining that a transaction must be respected even when there is no "tax-independent reason for a taxpayer to choose between . . . different ways of financing the business." *UPS*, 254 F.3d at 1019; see also *ibid.* ("To conclude otherwise would prohibit tax-planning."). That rule has been the law of this Circuit for more than fifty years. See *Comm'r* v. *Gilmore's Estate*, 130 F.2d 791, 795 (3d Cir. 1942); Schering-Plough Br. 51-53. Schering-Plough sought cash to fund its operations. Its business activities cannot be thrown aside as a tax shelter.

A simple hypothetical illustration shows the absurdity of the district court's conclusion that Schering-Plough should have done the *opposite* of what Notice 89-21 commanded. Imagine that a different company at the same time was (unlike Schering-Plough) in a position to *benefit* from immediate lump-sum taxation for a swap-and-assign transaction—for example, because it had a large amount of net operating losses due to expire, 26 U.S.C. § 172, or to be lost in a corporate acquisition, 26 U.S.C. § 382. *Supra*, pp. 4-5. Imagine that the company entered

into the very same swap-and-assign transactions with a foreign subsidiary that are at issue here. Notice 89-21 makes it "impermissible" to claim the income up front and requires that the payments be "taken into account over the life of the contract." 1989-1 C.B. 651.

Could that taxpayer in good conscience (and without fear of sanction) have decided to ignore Notice 89-21 entirely? Could that taxpayer have decided—notwithstanding Notice 89-21's specific treatment of the transactions, the independent risk-bearing counterparty, and the lack of any repayment obligation—that this transaction was *really* a loan and therefore exempt from Notice 89-21? Could that taxpayer have decided that it was not following Notice 89-21, claiming that the "Big Picture" and Subpart F compelled that result? Surely not.

Likewise, had the company rejected the tax treatment directed in Notice 89-21 by insisting that the sale should really be treated as a loan, the recharacterization would have been dismissed with "no doubt." *East Coast Equip. Co.* v. *Comm'r*, 222 F.2d 676, 677 (3d Cir. 1955). Indeed, the district court here seized on a handful of instances in which a Schering-Plough document or employee referred to these transactions as "loans," as if that proved their true nature. But what of the countless more instances in which Schering-Plough referred to these as "sales" and treated them accordingly? Suppose our hypothetical taxpayer seeking not to follow Notice 89-21 had similar records. Could it have seriously thought that a

handful of mentions of the word "loan" would suffice to outweigh overwhelming evidence that under controlling precedent the transactions were "sales" in every other critical respect? Again, no reasonable taxpayer could have drawn such a conclusion.

Similarly, if the company had challenged Notice 89-21 as "clash[ing]" with the unwritten intent of Subpart F, it would never have prevailed. Rather, the taxpayer would have been reminded that "[t]he Commissioner has broad discretion . . . to choose an accounting method" under Section 446(b), *Prabel* v. *Comm'r*, 882 F.2d 820, 823 (3d Cir. 1989), and that the "taxpayer ordinarily has a heavy burden in overcoming any such determination by the Commissioner." *Ferrill* v. *Comm'r*, 684 F.2d 261, 263 (3d Cir. 1982) (per curiam); see also *Thor Power Tool Co.* v. *Comm'r*, 439 U.S. 522, 532-533 (1979). The very same legal principles that make it difficult for a company to *challenge* an IRS's determinations under Section 446(b) also entitle it to *rely* on those determinations.

The arguments made by the district court and the government for ignoring Notice 89-21 would have been dismissed as frivolous if made by the taxpayer in the first instance. Schering-Plough therefore cannot be punished after the fact for following rather than disobeying Notice 89-21.

Indeed, the impossibility of Schering-Plough's guessing that it should do the opposite of what Notice 89-21 said is vividly illustrated by the IRS's treatment of

Brunswick in 1997. According to the district court, Brunswick was a "'direct competitor to Schering-Plough'" and "'entered into a transaction that was identical in all material respects to the swap and assignment transactions entered into by Schering-Plough.'" Op. 27 (quoting Summary Judgment Op. at *5-7). After an audit, the Chief Counsel of the IRS "determined that IRS Notice 89-21 applied," and therefore the income from the notional principal contract could *not* be reported immediately. *Ibid*. According to the IRS *then*, the transaction could not be recharacterized as a loan because it predated the IRS's subsequent regulations, and "Notice 89-21 is the relevant authority controlling how the transaction in this case should be accounted for." Field Service Advisory, 1997 WL 33314844 (Aug. 29, 1997); see also Field Service Advisory, 1997 WL 33313967 (Dec. 12, 1997) (Because "the swaps were entered into prior to December 13, 1993, the effective date of Reg. § 1.446-3, Notice 89-21 . . . is dispositive."). Had Schering-Plough been the subject of the 1997 Field Advisories, it too would have been told to follow Notice 89-21 and report its income over time. Instead, it was told that it should have done the opposite. Schering-Plough had no way to know in advance which would happen.

II. Businesses Need Clear, Predictable Rules To Plan Their Affairs.

A. Sound And Reliable Tax Planning Is Essential To Businesses' Success And Growth.

Economic planning is a way of life in the business world. Companies must decide when and where to invest their resources, which course of action is the most profitable, and how to accomplish their goals at least cost. Such planning requires businesses to be subject to predictable, clear rules. See *Hertz Corp.* v. *Friend*, 130 S. Ct. 1181, 1193 (2010) ("Predictability is valuable to corporations making business and investment decisions.").

Tax planning is a critical part of a business's overall economic plan. Businesses must consider the costs and benefits of their actions, and tax burdens frequently form a substantial part of those costs and benefits. See *Comm'r* v. *Brown*, 380 U.S. 563, 579-580 (1965) (Harlan, J., concurring) ("[T]he tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source."). Indeed, Congress regularly enacts social policies into the tax code precisely because it understands that businesses will take those tax consequences into account—such as by providing tax-deductible retirement plans for their employees, see 26 U.S.C. §§ 219, 408, 408A, or pursuing tax incentives for investments in particular technologies, see 26 U.S.C. §§ 41(d), 46, 48C.

Similarly, businesses are entitled to structure their transactions in ways that lawfully minimize their tax burdens. Lawful tax planning is thus a part of daily business life. When businesses choose where to place their operation centers, where to sell their products, what products to sell, and what inputs to use to make them, tax consequences necessarily play an important role. See *Trinova Corp.* v. *Michigan Dep't of Treasury*, 498 U.S. 358, 385 (1991) ("It is a laudatory goal in the design of a tax system to promote investment that will provide jobs and prosperity to the citizens of the taxing State."). In some instances, tax advantages (or relative disadvantages) are the deciding factor in making significant business decisions.

The courts have long recognized the legitimacy of such tax planning.

> "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

Sullivan v. *United States*, 618 F.2d 1001, 1007 n.6 (3d Cir. 1980) (quoting *Comm'r* v. *Newman*, 159 F.2d 848, 850-851 (2d Cir. 1947) (L. Hand, J., dissenting)); see also *Frank Lyon*, 435 U.S. at 580 ("The fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences."). Indeed, corporations have a fiduciary duty to their shareholders to structure their transactions in the most efficient manner.

But rational tax planning is impossible unless the law is clear, predictable, and consistently applied. "The tax code is an intricate web and demands clear rules so that it may be administered with as little uncertainty as possible." *Sidell* v. *Comm'r*, 225 F.3d 103, 111 (1st Cir. 2000). If a company cannot figure out the tax consequences of its actions—or cannot determine whether the IRS and the courts will one day decide retroactively to alter those consequences without warning—it does not know what to do. The risk of suddenly being hit with massive additional tax liability will hang over all of its decisions.

Such uncertainty comes at a high price. If a company does not know the tax consequences of its actions, it does not know whether it has additional costs to pass on to consumers, or whether it is even employing its resources in the right field or industry. An uncertain tax bill is potentially *more* destabilizing than uncertain prices for raw materials—there are various financial strategies for dealing with, say, the uncertain price of oil; but there is no way to "hedge" against the IRS's changing its mind and refusing to live by its own mandate. Worse still, by the time the IRS passes judgment on a particular transaction, the deal is long since done. Just as businesses could not operate in a world where their suppliers name a price *after* the sale is completed, businesses cannot function effectively if they cannot rely on authoritative IRS pronouncements.

Moreover, because a company facing massive tax uncertainty never knows if or when it will be hit with millions of dollars in additional taxes, it cannot efficiently deploy its capital in case the IRS later decides to demand more taxes for a transaction that appeared to have been explicitly blessed. But corporations are under a duty to shareholders to put their proceeds to good use—*e.g.*, to return them to shareholders via dividend, invest in new products, or pursue countless other business objectives. In the absence of reasonable predictability, companies will be forced to park massive amounts of money on the unproductive sidelines while they await final word on their tax liability from the IRS or the courts.

That uncertainty has still further consequences, because there are limits to how much economic risk a company can responsibly take on before it must start spending money to avoid risk—either by buying insurance or hedges, or by employing its resources in safer, less profitable, investments. If the application of the tax code produces additional, artificial economic risks, businesses will have less room to take on risks related to *real* investments—the sorts of high-risk projects that form the backbone of economic growth and innovation. A drug company like Schering-Plough is a vivid reminder of this all-too-real possibility: $500 million reserved in case the IRS changes its mind is $500 million that cannot be deployed for research and development of new medicines. Even the largest

corporations face real opportunity costs, particularly because they also tend to have the largest tax bills.

Unpredictability may be tactically useful to the IRS's short-term litigation goals. By ensuring that it can constantly change the rules, the IRS makes it harder for any company even to know what the rules are—let alone to prove in court fifteen years later that it followed them. But, in addition to rendering the tax system fundamentally unfair, that uncertainty is bad for the rule of law, bad for business, and bad for the economy.

B. The District Court's Application Of The Economic Substance Doctrine Threatens The Predictability Of The Tax Code.

The greatest source of uncertainty in the application of the tax code has come from the government's disturbingly aggressive use of the economic substance doctrine. As discussed above, the district court's application of that doctrine was inconsistent with governing precedent. On a more fundamental level, the district court's mistakes showcase the potential indeterminacy of that doctrine and the critical importance of applying it very cautiously.

The economic substance doctrine in practice has become a "dizzyingly complex" gloss on top of an already-complicated tax system. Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 29 (2000). If not carefully confined, the doctrine is difficult for courts to apply consistently and nearly impossible for businesses to predict. It is therefore crucial that courts do not

allow the doctrine to metastasize beyond the limited contexts for which it was intended.

The economic substance doctrine originated as a means to police transactions that were essentially fictional—for example, a corporation that purported to "reorganiz[e]" but in fact did nothing but engage in "a pure paper shuffle." *Yosha* v. *Comm'r*, 861 F.2d 494, 497 (7th Cir. 1988) (describing *Gregory* v. *Helvering*, 293 U.S. 465 (1935)). The doctrine is also regularly applied to forbid overly clever interpretations of tax code loopholes that are obviously at odds with congressional intent. *Gregory*, 293 U.S. at 469; *Horn*, 968 F.2d at 1231; *Yosha*, 861 F.2d at 499; *supra* p. 10.

But in more recent years the government has attempted to expand the economic substance doctrine far beyond those bounds. As its position in this case demonstrates, the government believes that it can launch—with the benefit of perfect hindsight—a freestanding inquiry into a business's means for raising money and the viability of possible alternatives. If a court later agrees with the IRS that the transactions were insufficiently "straightforward," Op. 87, then it will recharacterize or disregard the transactions and impose massive, unexpected tax liability on the company.

Taxpayers can take no comfort in the knowledge that they have complied with the expressed intent of the law, or from the knowledge that their conduct was

actually *mandated* under one of the IRS's own pronouncements. Rather, the IRS claims the prerogative to recharacterize rational business deals at market prices into fundamentally different transactions—or to disregard, or even reverse, the text of the statute when it deems a transaction to be overly tax-driven.

That approach is both fundamentally unfair and unworkable. Examined closely enough, almost any complicated business transaction can be argued to resemble something else. The tax code sometimes treats relatively similar transactions in very different ways. See Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859, 869 (1982) ("The Code creates numerous tax differences between economically equivalent transactions"). When haled into court years later, with whatever evidence it still retains, a company cannot be sure that its genuine economic decisions will really be respected.

The demand for "objective economic substance" and "subjective business purpose" can also be utterly indeterminate unless made in the context of the entire business. Under the district court's analysis, almost any form of lawful tax planning can appear to lack any non-tax substance. Consider an employee who makes tax-free contributions to his 401(k), contributing the maximum just before year-end. Of course the decision to invest money for retirement has both economic substance and a business purpose. But if the taxpayer is asked to justify the form and timing of a particular contribution—*i.e.*, his reason for making a contribution

on December 31 rather than January 1, or his reason for choosing the tax-deferred 401(k) over an after-tax plan, there may be no non-tax answer. We are all tax planners.

Similarly, the choice to use or not use the corporate form for a given enterprise is frequently motivated, at least in part, by tax considerations. But it is unquestioned that businesses are "free to adopt such organization for [their] affairs as [they] may choose." *Higgins* v. *Smith*, 308 U.S. 473, 477 (1940). The only thing that distinguishes these everyday transactions from ones the IRS has chosen to attack under the economic substance doctrine is the government's say-so. "I know it when I see it," *Jacobellis* v. *Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring), is entirely unsuited as a test for imposing millions of dollars of tax liability on companies that endeavor, at great expense, to comply with the law.

Notably, there has never been a Supreme Court decision invalidating a transaction under the aggressive form of the economic substance doctrine invoked here and in other recent cases. And the Court has "stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 253-54 (1992); see also, *e.g.*, *Carcieri* v. *Salazar*, 129 S. Ct. 1058, 1063 (2009). The Court shows no signs of deviating from that principle, even in tax cases. In *Gitlitz* v. *Comm'r*, for example, the lower courts had refused to apply the text of a

tax statute in a way that would provide a "double windfall" to the taxpayer. The Supreme Court reversed, explaining that, "because the Code's plain text permits the taxpayers here to receive these ['double windfall'] benefits, we need not address this policy concern." 531 U.S. 206, 219-220 (2001). Similarly, in *Cottage Savings Ass'n* v. *Comm'r*, 499 U.S. 554, 566-567 (1991), the Court upheld a swap of economically identical mortgage pools by two savings and loan associations in a transaction designed to recognize tax losses without corresponding accounting consequences. Of course, transactions must be "bona fide," not substantive shams, *id*. at 567, but the Supreme Court has never authorized the sort of freewheeling, unpredictable inquiry that the government now regularly launches under the banner of the economic substance doctrine.[2]

The consequences of the *legal* uncertainty of the economic substance doctrine are exacerbated by the *practical* uncertainty of the IRS's enforcement decisions and lengthy investigations. The IRS declared Schering-Plough's transaction impermissibly tax-motivated, even as it told an identically situated taxpayer (Brunswick) to report its taxes in the very way for which Schering-Plough

[2] The recent statute codifying part of the economic substance doctrine, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067-1068 (2010) (amending 26 U.S.C. § 7701(o)), which is not applicable here, *id.* § 1409 (e)(1) ("[T]he amendments made by this section shall apply to transactions entered into [after March 30, 2010]."), does not decrease the need for predictability. It *heightens* it. In many respects, the statute codifies the existing, limited inquiry. *Id*. § 1409(a). So misapplications of the existing judicial doctrine might be erroneously written into the U.S. Code in the future or presumed to be part of the existing statute.

is now being punished. So far as this record shows, the IRS had no rational reason for treating the two companies differently. See Op. 27 (quoting Summary Judgment Op. at *5-7). *Ex ante*, no tax lawyer or accountant could predict that decision with any more accuracy than a coin flip. And the threat of random enforcement has a very long horizon. The transactions in question here are more than 15 years old, and Schering-Plough's successor and its shareholders still do not know what its tax bill will eventually be.

This is no way to do business. Long, complicated tax litigation may be good for tax lawyers and accountants but not for the most *productive* engines of the economy. Above all else, businesses must know what they can do and how much it will cost them. The IRS's version of the economic substance doctrine makes that impossible.[3]

[3] In the short time since the district court's decision, it has been widely criticized. Phil Stoffregen & Lynne Edelstein, *An Analysis of* Schering-Plough v. United States, 126 Tax Notes 1599, 1612 (2010) ("[T]he *Schering-Plough* decision is confusing and misleading. The court . . . misapplied important legal doctrines in an overzealous attempt to buttress its holding."); Mark J. Silverman & Amanda P. Varma, *The Future of Tax Planning: From* Coltec *to* Schering-Plough, 126 Tax Notes 341, 342 (2010) ("[T]he court's analysis is . . . fundamentally flawed in several respects."); Adam C. Kobos, Schering-Plough Corp. *Creates Confusion*, J. Corp. Taxation 32, 36 (Jan.-Feb. 2010) ("[A] number of the arguments supporting the decision are troubling."); Lowell D. Yoder, Schering-Plough v. U.S.: *Subpart F Analysis Gone Awry*, BNA Tax & Accounting Center (Nov. 24, 2009) ("[T]he court 'missed the trees for the forest.'"). That outcry is deserved.

III. Planning And Litigating Under An Amorphous Economic Substance Doctrine Imposes Massive Burdens On Taxpayers.

In addition to subjecting companies to unpredictable tax risks and making it impossible for them to rely on the tax code or the IRS's own pronouncements, the district court's misapplication of the economic substance doctrine would impose further costs as businesses struggle to comply with it. For example, the district court's opinion punishes tax planning. The court criticized Schering-Plough for having sought thorough tax advice about the tax consequences of the swap-and-assign transactions, deriding the swap-and-assign transactions as "meticulously crafted" and "tax-motivated." Op. 45; see also Op. 11, 42-43. And it did so despite the repeated recognition in other cases that business tax planning is entirely legitimate. *E.g.*, *Frank Lyon*, 435 U.S. at 580; *UPS*, 254 F.3d at 1019; *Sullivan*, 618 F.2d at 1007 n.6.

If, as the district court would have it, engaging in extensive tax planning renders a taxpayer blameworthy, then companies will receive less (or less candid) advice. Under the amorphous variation of the economic substance doctrine applied by the district court, however, businesses need just the opposite. Planning in the face of the government's recent assertions of the economic substance doctrine requires even more detailed advice than would otherwise be required. By simultaneously applying such a hopelessly imprecise doctrine and then punishing a

company for devoting significant resources to trying to predict how it will turn out, the district court places businesses in a Catch-22.

Litigation against the IRS is not a reasonable, cost-effective means for addressing such uncertainty. Tax lawsuits are protracted and expensive, and thus impose massive costs that businesses can ill afford. And most taxpayers will not be as well financed as a major corporation like Schering-Plough. Many companies—particularly smaller businesses that represent a significant portion of the American economy—will abandon legitimate tax savings for fear of truly crippling litigation. Even those that litigate will succeed first and foremost in diverting resources to accountants and lawyers rather than to fueling economic growth. See Isenbergh, 49 U. Chi. L. Rev. at 883 ("[W]ho ultimately benefits from this approach? The only unequivocal beneficiary is the tax bar. The heavier the layers of judicial divination superimposed on the Internal Revenue Code, the richer tax lawyers are apt to get.").

We express no opinion in this case about the best policy for taxing financial instruments like notional principal contracts. But the best tax system for business and the government is one in which the answers—whatever they may be as a matter of tax policy—are readily ascertainable by those who must comply with them.

CONCLUSION

The decision of the district court should be reversed.

Respectfully submitted,

/s/ Roy T. Englert, Jr.
Roy T. Englert, Jr.
Mark T. Stancil
William P. Baude
ROBBINS, RUSSELL, ENGLERT, ORSECK, UNTEREINER & SAUBER LLP
1801 K Street, NW
Suite 411
Washington, DC 20006
(202) 775-4500

Robin S. Conrad
Amar D. Sarwal
NATIONAL CHAMBER LITIGATION CENTER, INC.
1615 H Street, NW
Washington, DC 20062
(202) 463-5337

CERTIFICATE OF SERVICE

I certify that on September 7, 2010, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Third Circuit by using the CM/ECF system. Participants in the case who are registered CM/ECF users will be served by the CM/ECF system.

/s/ Roy T. Englert, Jr.

Roy T. Englert, Jr.

CERTIFICATE OF BAR MEMBERSHIP

I certify pursuant to Local Rule 46.1 that I am a member in good standing of the bar of the United States Court of Appeals for the Third Circuit.

Dated: September 7, 2010

/s/ Roy T. Englert, Jr.

Roy T. Englert, Jr.

CERTIFICATE OF COMPLIANCE

I hereby certify as follows:

1. This brief complies with the type-volume limitations of Fed. R. App. P. 29(d) and Fed. R. App. P. 32(a)(7)(B)(i) because this brief contains 6980 words (as counted by Microsoft Word 2003), excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii) and Local Rule 29.1(b).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2003 in 14-point Times New Roman typeface.

3. The electronic version of this brief has been scanned for viruses using Symantec Antivirus 10.1.5.5000 and no viruses were detected.

4. The text of the electronic and hard copies of the Brief of the Chamber of Commerce of the United States of America as *Amicus Curiae* is identical.

Dated: September 7, 2010

/s/ Roy T. Englert, Jr.

Roy T. Englert, Jr.