Chemtech—The Fifth Circuit Reins in But Upholds the District Court

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The Fifth Circuit determined that the SLIP tax shelters were sham partnerships but avoided the question of whether the substance of the transactions was different from their form. The issue of penalties was sent back to the district court, and it will be interesting to see if the court will apply a negligence penalty in this situation.

The Fifth Circuit's recent decision in *Chemtech Royalty Associates, L.P.*, 766 F.3d 453, 114 AFTR2d 2014-5940 (CA-5, 2014), is the latest court opinion scrutinizing the Special Limited Investment Partnership or SLIP tax shelter, which was marketed in the early to mid-1990s. Like many other tax shelters involving partnerships, the essential concept of a SLIP is to pay a third-party who is indifferent to U.S. tax to become a "partner" and in, exchange, the third-party allows its counterparty to use partnership allocations to acquire beneficial tax attributes from the third-party or to dump detrimental tax attributes onto the third-party. The Supreme Court in *Tower*, 327 U.S. 280, 34 AFTR 799 (1946) and *Culbertson*, 337 U.S. 733, 37 AFTR 1391 (1949), provided the judicial mechanism by which to address abuses of this nature, establishing what later became known as the "sham partnership" doctrine, which disregards formal partnerships when the circumstances show that the so-called partners never intended to pursue an enterprise as partners; instead, dressing-up an arm's-length transaction in the clothing of a joint venture.

In analyzing SLIPs and other transactions using formal partnerships to execute arm's-length arrangements, courts, including the District Court for the Middle District of Louisiana (the District Court) in *Chemtech*, have gone on to expand their analyses to apply conceptually similar doctrines, such as debt-versus-equity and the economic substance doctrine, even when the additional inclusion of such doctrine does not affect the result of a case. One of the most compelling elements of the Fifth Circuit's decision in *Chemtech* is

NEWSLINE

Taxpayer Denied Research Tax Credits for "Capped Contracts"

In *Geosyntec Consultants, Inc.*, 115 AFTR2d 2015-644 (CA-11, 2015), the Eleventh Circuit, affirming the district court, found that the taxpayer was not eligible for research tax credits under Section 41 because its research had been funded by a third party.

The taxpayer was a specialized consulting and engineering firm that provided services to clients involving environment, natural resources, and geological infrastructure. The taxpayer engaged in two capped cost-plus contracts, under which it was paid for its labor and expenses, plus a mark-up, subject to an agreed-upon maximum price. It sought research tax credits under Section 41 for both contracts.

Under Section 41, a taxpayer may claim a 25% tax credit based on the amount of "qualified research expenses" paid or incurred. There are seven categories of research expressly excluded from the definition of qualified research, including a funded research exclusion, which excludes any research to the extent funded by any grant, contract, or otherwise by another person (or government entity). Under the regulations, the research tax credit is allocated to the entity or person that bears the financial risk of failure of the research to produce the desired product or result.

For both contracts, the taxpayer argued that it bore the costs of research and should be eligible for the research tax credit. The taxpayer contended that the capped contracts should be treated as unfunded since it faced substantial financial risk because it would be paid only for expenses incurred, eliminating an opportunity to make a profit on the research should it come under budget, and it bore the risk that expenses would exceed the ceiling price for each contract.

The Eleventh Circuit held that neither the taxpayer's cost-of-performance argument focusing on the amount it would be paid or the likelihood that its contracts would be profitable were relevant in determining whether the taxpayer bore the financial risk for purposes of the research tax credit analysis. The relevant inquiry was whether payment was contingent on success of the research. The court determined that the taxpayer would have been paid regardless of the outcome of its research, placing the contract money within the definitional boundaries of funding as disallowed by Section 41. In both contracts, the clients contracted to reimburse the taxpayer for labor and costs for pre-defined tasks at pre-defined rates. The taxpayer was entitled to payment regardless of success. Therefore, the taxpayer did not bear the financial risk of its own failure, and was not eligible for research tax credits for research expenses incurred under those contracts. ●

IRS Disallows Claims for Refund of Employment Taxes on Severance Payments

The IRS in Ann. 2015-8, 2015-9 IRB xxx, provides guidance on the application of the Supreme Court's decision in *Quality Stores, Inc.*, 113 AFTR2d 2014-1326 (2014), to claims for refund of employment taxes paid with respect to severance payments.

In *Quality Stores*, the Supreme Court held that the severance payments at issue in the case were wages subject to Federal Insurance Contributions Act (FICA) tax. Prior to the Supreme Court's decision, the IRS received claims for refund of FICA, Railroad Retirement Tax Act (RRTA), and Federal Unemployment Tax Act (FUTA) taxes paid with respect to severance payments from over 3,000 taxpayers. The IRS disallowed all such claims for refund from taxpayers located outside the jurisdiction of the Sixth Circuit, which had previously held that severance payments were not wages for FICA purposes. Many of these taxpayers appealed the disallowed refund claims to the IRS Office of Appeals, but the IRS suspended action of these appeal requests pending the resolution of the *Quality Stores* litigation.

Under Rev. Rul. 90-72, 1990-2 CB 211, supplemental unemployment compensation benefits that are linked to the receipt of state unemployment compensation and satisfy certain other requirements are excludable from wages for FICA, FUTA, and income tax withholding purposes, and are excludable from compensation for RRTA tax purposes. In *Quality Stores*, the parties agreed that the payments at issue did not satisfy the requirements for the narrow exclusion from FICA tax contained in Rev. Rul. 90-72. Accordingly, the Supreme Court did not address whether the exclusion from FICA taxes set forth in Rev. Rul. 90-72 for certain payments linked to state unemployment benefits is consistent with the broad definition of wages under FICA. Rev. Rul. 90-72 continues to be in effect.

In Ann. 2015-8, the IRS stated that as a result of the Supreme Court's decision in *Quality Stores*, the Service will disallow all claims for refund of FICA or RRTA taxes paid with respect to severance payments that do not satisfy the narrow exclusion contained in Rev. Rul. 90-72. This includes all refund claims held in suspense pending the resolution of *Quality Stores* and claims filed by taxpayers located within the Sixth Circuit's jurisdiction. The Service will take no further action on the appeal requests that were suspended pending the decision in *Quality Stores*.

Because the definition of wages contained in Section 3121(a) is generally the same as the definition of wages in Section 3306(b) with respect to FUTA, the IRS will also continue to disallow claims for refund of FUTA taxes paid with respect to such severance payments. ●

its decision not to follow this trend and to appropriately limit its holding and its discussion of law to the doctrine on-point, the sham partnership doctrine. The Fifth Circuit's approach is particularly important with respect to the sham partnership doctrine, debt-versus-equity, and economic substance doctrine, which, by nature, are difficult to differentiate. In that respect, it is not only important for courts to remain on point as a matter of jurisprudence, but also as a practical matter to avoid confusion and distortions with respect to each doctrine. Both as a matter of jurisprudence and practically, these concerns become especially important with respect to the economic substance doctrine in light of the Service's recent release of Notice 2014-58, 2014 IRB 746.

The SLIP tax shelter is designed to provide a U.S. taxpayer with the benefit of depreciation or amortization deductions from fully depreciated or amortized assets.

BACKGROUND

The SLIP tax shelter is designed to provide a U.S. taxpayer with the benefit of depreciation or amortization deductions from fully depreciated or amortized assets. The transaction calls for the contribution of high-value, low-basis depreciable or amortizable property to a partnership where the partnership then leases or licenses the property back to the contributor who is a U.S. taxpayer. The lease or license strips away the U.S. taxpayer's income and, then, based on the particular SLIP strategy employed, the partnership structure is used to absorb or reallocate the income from the lease or license, so that it is not realized by the U.S. taxpayer. In *Chemtech*, Dow used two similar but different SLIP transactions, Chemtech I and Chemtech II, to accomplish this goal.

CHEMTECH I

In the Chemtech I transaction, Dow Chemical Company (Dow) formed two domestic subsidiaries, Diamond Technology Partnership Co. (DTPC) and Ifco, Inc. (Ifco). Along with Dow's preexisting Swiss corporate subsidiary, Dow Europe, S.A. (DESA), DTPC and Ifco formed Chemtech as a Delaware limited partnership. Through these subsidiaries, Dow contributed $110 million in cash; 73 patents, worth approximately $867 million and with an aggregate basis of approximately $54,000; and a preexisting corporation with no assets, Chemtech Portfolio, Inc. (CPI). The key contribution, as will become clear, was the contribution of the highly valuable, yet almost fully amortized patents.

In the next step of the Chemtech I transaction, five foreign banks contributed $200 million to Chemtech in exchange for priority interests. Chemtech's partnership agreement laid out a set of complex terms for the banks' priority interests. By these terms, the banks were entitled to receive 99% of Chemtech's profits until they received an annual priority return of 6.947% on their contributions. However, even if profits were insufficient to pay the priority return, Chemtech was still obligated to pay the banks 97% of the priority return. A key feature in computing profits, however, was the treatment of the book amortization of the patents, which was counted as an expense against Chemtech's revenue. Chemtech's partnership agreement also contained a number of protections to ensure that the foreign banks would receive their priority return, including strict limits on expenditures, limitations on the assets that Chemtech could hold (only the assets originally contributed) and requirements to keep cash and cash equivalent funds on hand at all times. Moreover, Chemtech was set to terminate after an approximately seven-year period. Additionally, Dow indemnified the foreign banks against any liability arising from the assets.

Chemtech entered into a license agreement with Dow, granting Dow the right to use the patents, allowing Dow to use the patents in the same way that Dow had used them prior to their contribution to Chemtech. Dow was obligated to pay a royalty to Chemtech based on the profitability of the patents, but subject to a guaranteed minimum payment that was not contingent on Dow's use of the patents. Furthermore, under the indemnity noted above, royalty payments were mandatory even if, for example, all of the patents that Chemtech held were invalidated.

In selecting the patents to contribute, Dow chose those patents that had the desired tax profile, high value, and low basis. In doing so, there was no synergy in the patent portfolio's held by Chemtech, guaranteeing that Chemtech could never enter into third-party license agreements. Unsurprisingly, virtually all of Chemtech's income was derived from these royalty payments, which, after reduction by book depreciation, turned a profit that was roughly the amount that Chemtech was required to pay the foreign banks on their priority return.

Although book amortization was charged as an expense against the revenue received from the royalty payments, such book amortization gave rise to no actual expense, allowing Chemtech to contribute most of the royalty proceeds to CPI and then to lend the funds back to Dow under demand notes (the CPI Notes). The tax benefit from this transaction was achieved through Chemtech's allocation of virtually all of Chemtech's taxable income to the foreign banks, while Dow took the entire amount of the royalty payment as a deductible expense against its own income.

The Chemtech I transaction continued from 1993 to 1997, when Dow brought Ifco back into the picture to buy out the foreign banks' interests in Chemtech. In the buy-out, the banks received a full return of their contri-

butions, but only a paltry 1% of the appreciation in the value of the patents.

CHEMTECH II.

In the Chemtech II transaction, Dow dusted off a dormant wholly-owned subsidiary, Dow Chemical Delaware Corp. (DCDC), contributing a Louisiana hydrocarbon plant with a basis of $18 million, but that was valued at $715 million to DCDC. In turn, DCDC contributed the plant to Chemtech, which leased the plant back to Dow. The shares of Chemtech Portfolio II, Inc. (CPI II) were also contributed to Chemtech, with the plan being for CPI II to be the entity to loan Chemtech's rent receipts back to Dow.

Next, Dow wanted to extract the patents and CPI from Chemtech by causing DTPC to liquidate its interest in Chemtech, receiving, as a distribution, the patents and 70% of the shares of CPI. CPI held hundreds of millions of dollars worth of CPI Notes generated in the Chemtech I transaction. On account of those CPI Notes, Dow was concerned that the shares of CPI could be treated as "marketable securities," causing DTPC to have gain on the distribution of the CPI shares. To remedy this, prior to the distribution from Chemtech, the CPI Notes were refinanced in exchange for deeply subordinated 33-year notes. Chemtech also made a Section 754 election prior to the distribution. As a result of these two preparatory steps, the refinance and the election, DTPC was not required to recognize gain from the distribution of the shares of CPI, and Chemtech was able to increase the inside basis if its assets, specifically the basis of the almost fully depreciated chemical plant. The non-recognition of gain on the distribution of the CPI shares and the increase to the basis of the chemical plant formed the basis for the tax benefit in the Chemtech II transaction. In Chemtech I, the tax benefit of the transaction was achieved through allocating most of Chemtech's taxable income to a foreign party. This strategy was not used in the Chemtech II transaction nor was it necessary because in Chemtech II, Chemtech's income was offset through depreciation deductions available from the chemical plant's increased basis.)

In Chemtech II, RBDC, Inc. (RBDC), an affiliate of one of the banks that had participated in the Chemtech I transaction, was brought in as a partner, contributing $200 million in exchange for an interest with a priority return rate of 6.375%. Unlike in Chemtech I, however, most of Chemtech's income was allocated to DCDC and Ifco and only slightly more than the amount of income distributed to RBDC was allocated to RBDC. The Chemtech II transaction went on between 1998 and 2006.

THE DISTRICT COURT OPINION

The IRS challenged both the Chemtech I and Chemtech II transactions, adjusting Chemtech's partnership items in every year, 1993 through 2006, and asserted accuracy-related penalties, claiming, among other things, that: (1) Chemtech was a sham partnership; (2) the Chemtech I and Chemtech II transactions lacked economic substance; and (3) the foreign banks' interests in Chemtech were debt and not equity. The district court found for the Service on all three grounds.[1]

Debt v. Equity

First, the district court found that the banks' interests in Chemtech were debt and not equity, employing the familiar debt-versus-equity factors. The court indicated that "risk and return" was the "primary factor when distinguishing between debt and equity interests." The court noted the numerous terms of Chemtech's partnership agreement that mitigated the banks' risks and guaranteed a return in sum certain to the banks. In particular the court made note of the requirement for Dow to make minimum payments for the patents in the Chemtech I transaction, regardless of use; the severe restrictions on Chemtech's ability to make expenditures; Dow's indemnification requiring Dow to make payments to Chemtech even if Chemtech's patents were invalidated or if Chemtech's chemical plant burned down; and the various liquidation powers granted to the banks giving the banks' leverage to assure Chemtech's and Dow's compliance with these guarantees. Additionally, while the banks were entitled to share in residual profits, Dow had the power to retire patents that produced higher-than-expected profits, granting Dow the ability to prevent excess profits from the patents from leaking through to the banks. This was a power that Dow actually used for the purpose of preventing the banks from sharing in the upside of one of Chemtech's patent portfolios.

Economic Substance

Second, the district court addressed the issue of economic substance, applying the Fifth Circuit's three-part test for economic substance (prior to the enactment of Section 7701(o)). The test asks whether a transaction: (1) has economic substance compelled by business or regulatory realities; (2) is imbued with tax-independent considerations; and (3) is not shaped totally by tax avoidance features. The first factor comprises the "objective" economic substance test that addresses whether the transaction had a reasonable possibility of profit. The second and third factors comprise the "subjective" test, which considers whether a taxpayer had a legitimate non-tax business purpose in entering the transaction.

With respect to the objective test, the district court focused on the fact that (1) there was no change in the way that Dow used the patents, (2) there was no profit potential to Dow in the transaction, and (3) cash flowed in a circle from Dow to Chemtech and back to Dow. This application of what the District Court calls the "objective test," may be somewhat heavy

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handed. For example, Section 7701(o) now states that economic substance looks at whether "the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position."[2] Therefore, although there may not have been a meaningful change in the way that Dow ran its business, it was relatively clear that Dow entered into economically meaningful agreements with the foreign banks that created enforceable obligations on Dow and gave the banks real rights that they had every intention to enforce. Thus, it appears questionable to assert that the transaction had no objective economic substance.

As for the subjective test, Dow claimed that it had a bona fide business purpose for entering into the Chemtech transactions, explaining that the transactions resulted in "off balance sheet financing" treated as equity that helped to maintain a strong debt-to-equity ratio to improve Dow's credit rating, and that the transactions monetized assets like the patents and the chemical plant that otherwise were carried at near zero on Dow's balance sheet. The district court, however, found that the record of communications between Dow's officers and employees reflected that the tax benefit was really the only material consideration in entering the transaction. The court also noted that there were cheaper and simpler options for Dow to pursue to reach its balance sheet objectives and that the government's expert had testified that the transactions had no net economic value to Dow. On these bases, the district court found that Dow's only real motivation for entering the Chemtech transactions was to create a U.S. tax benefit. The one curious point, however, is that if the entire transaction had been motivated by tax, there does not appear to have been any reason for Dow to seek the participation of RBDC as a partner in the Chemtech II transaction because, as discussed above, the tax savings in the Chemtech II transaction had nothing to do with the inclusion of a foreign partner.

The Fifth Circuit also deserves credit for staying on point and limiting its analysis to the sham partnership issue only.

It is further notable that the district court went out of its way to decide that without a doubt (but also without any substantial consideration), the refinancing of the CPI Notes in exchange for a subordinated 33-year note (prior to the Chemtech II transaction) lacked economic substance, as there was no business purpose for the transaction. This analysis by the district court is just plain wrong. Authoritative precedent abounds verifying that a taxpayer is entitled to undertake transactions solely for tax planning reasons to prevent adverse tax consequences or to obtain a tax benefit in preparation for a subsequent transaction that has economic substance.[3] Therefore, while the district court could have argued that the distribution of the shares of CPI to DTPC did not have economic substance, a preparatory transaction to render nontaxable a distribution that has economic substance should not itself require discrete economic substance justification.

Sham Partnership

Finally, the district court considered the sham partnership issue. Citing the Supreme Court in *Culbertson*, which had stated that "the partners really and truly intend to join together for the purpose of carrying on [a] business and sharing in the profits and losses or both," the district court held that Dow had no business purpose in the Chemtech transactions. Dow attempted to argue that the partnership's business purpose had been patent management, but that argument unraveled as the district court pointed out that Dow selected patents based on their tax profile, with no consideration for how they could be used together with other patents in a unified portfolio to be licensed to third-parties or otherwise. Furthermore, the circular flow of funds indicated that Chemtech's partners had no intention to use the partnership to engage in any substantive economic transaction. Finally, the court pointed out that the banks' insulation from risk and lack of access to any meaningful upside could lead to no conclusion other than the banks had no intention of engaging in an enterprise along with Dow and sharing in the profits and losses reaped through a joint venture.

Continuing the sham partnership analysis, the district court fell back on the debt-versus-equity analysis, citing the Second Circuit in *Castle Harbour II*[4] for the proposition that the determination of whether a purported partnership interest is debt or equity is "helpful" in analyzing whether a purported partner intended to participate as a partner in a partnership. The district court in *Chemtech* made numerous comparisons between the Chemtech transactions and the transaction that was the subject of *Castle Harbour II*.[5] Of

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1 Chemtech Royalty Assocs., L.P., 111 AFTR2d 2013-953 (DC La., 2013).

2 Section 7701(o)(1)(A).

3 *See, e.g.*, Rev. Rul. 79-250, 1979-2 CB 156; Rev. Rul. 78-330, 1978-2 CB 147; Rev. Rul. 77-227, 1977-2 CB 120. These rulings discuss the non-application of the step-transaction doctrine to steps taken solely for tax purposes to achieve a tax benefit in a subsequent transaction, respecting the transactions in each circumstance. If a preparatory transaction had no economic substance if undertaken solely for tax reasons, aside from ruling incorrectly, the issues in the rulings would have been non-starters.

4 TFID III-E, Inc., 459 F.3d 220 (CA-2, 2006).

5 Mr. Lipton has written numerous articles on the Castle Harbour cases, including: Lipton and Austin, "Lessons From Castle Harbour: The Service Loses a Significant Tax Shelter Case", 102 JTAX 32 (January 2005); Lipton and Austin, "Partner or Lender? Debt/Equity Issues Arise in Second Circuit's Reversal of Castle Harbour", 105 JTAX 236 (October 2006); Lipton, "Castle Harbour III: A Taxpayer Victory as the District Court Refuses to Surrender," 112 JTAX 4 (January 2010); Lipton, Second Circuit Sinks Castle Harbour (Again)—Did It Sink the Fisc, Too?," 116 JTAX 206 (April 2012); Lipton, "Castle Harbour V—The Government Loses (Again) in the District Court," 121 JTAX 164 (October 2014).

course, the district court in *Castle Harbour II* had originally held that the taxpayer's transaction was legitimate. The Second Circuit reversed the district court, but the district court later explained with respect to a late assertion of negligence penalties by the Service that "[s]imply put, the objective reasonableness of a tax position becomes virtually unassailable when the taxpayer actually prevails at trial before a district judge who was not compromised by conflict, substance abuse, or senility."[6] It is paradoxical that the district court in *Chemtech* seemed enthusiastic in comparing *Chemtech* to *Castle Harbour II*, but this did not prevent it from upholding negligence penalties against Dow.

THE FIFTH CIRCUIT OPINION

The Fifth Circuit affirmed the district court, holding that Chemtech was a sham partnership for both of the Chemtech transactions. The Fifth Circuit judiciously declined to comment on the application of economic substance and debt-versus-equity.

Like the district court, the Fifth Circuit applied the *Culbertson* test, stating that to form a partnership, the parties must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, as demonstrated by an intent to share profits and losses. The determination of the parties' intent depended on the facts and circumstances, and the court provided a non-exclusive list of relevant facts to consider. Like the district court, the Fifth Circuit cited and analyzed the Second Circuit's opinion in *Castle Harbour II*, mentioning the Second Circuit's assertion that a debt-versus-equity analysis was "helpful" in the sham partnership context. Dow attempted to take this point a step further, arguing that a debt-versus-equity analysis was necessary prior to any sham partnership analysis and that the foreign banks' interests under Fifth Circuit precedent required a finding that the interests were debt. Responding to Dow's argument, the Fifth Circuit explained that there is no precedent that requires any preliminary debt-versus-equity analysis before a sham partnership analysis or that a debt-versus-equity analysis requires a finding one way or another in a sham partnership analysis. Furthermore, the Fifth Circuit stated that if such precedent existed, it would run counter to the position of the Fifth Circuit and the Supreme Court, which provide the proper framework for a sham partnership analysis. The Fifth Circuit declined to engage in any discussion of debt-versus-equity or economic substance in this situation, deciding *Chemtech* on the basis of the sham partnership doctrine alone.

The Fifth Circuit opinion finishes with a discussion of penalties, vacating the district court's finding on penalties in light of the Supreme Court's recent decision in *Woods*, 112 AFTR2d 2013-6974 (2013). The district court had not considered the application of substantial and gross valuation penalties because the district court believed that such penalties did not apply to mis-valuations arising from the misapplication of legal rules. In *Woods*, the Supreme Court recently held that a valuation misstatement could arise from a legal error. The Fifth Circuit expressed no opinion on the district court's application of the negligence and substantial understatement penalties, instructing the district court to consider the extent to which imposing those penalties remains consistent with the Fifth Circuit's opinion.

It will be interesting to see whether the district court will continue to assert a penalty for negligence.

ANALYSIS

The Fifth Circuit's decision that Chemtech was a sham partnership is certainly defensible, as the facts seem to demonstrate that the foreign banks did not agree to bear the downside risks of the partnership nor were the banks entitled to the upside profits of the partnership. Furthermore, the limitation of Chemtech's business to re-leasing or re-licensing back to Dow property that had been contributed by Dow, coupled with the fact that the cash from those activities invariably circled its way back to Dow, tended to show that Dow intended to deal with the foreign banks at arm's-length and not as partners in a joint-venture.

The Fifth Circuit also deserves credit for staying on point and limiting its analysis to the sham partnership issue only. The sham partnership doctrine was one clean way to address this case, and the court was able to fully resolve the dispute by applying the sham partnership issue alone. Any discussion of the application of the economic substance doctrine or debt-versus equity was not necessary if the court disallowed the claimed tax benefits on the grounds that the partnership was a sham.

Although the court's singular focus on the sham partnership doctrine is laudable, the question arises whether this was the most appropriate way to decide this case. An argument could be made that this case should have been decided more squarely on the grounds that the substance of this arrangement was a loan from the foreign banks (rather than an equity investment in a partnership). This may be just another way to express the concept that the partnership involved in this transaction should not be respected as such, but the Fifth Circuit did not clearly state that it was looking at the substance of the transaction rather than its form in deciding to disregard the partnership for tax purposes. More clarity on this point would have been helpful in understanding the court's reason for its decision.

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[6] TFID III-E, Inc., 8 F. Supp. 3d 142 (DC Conn., 2014).

There are collateral reasons why it would have been preferable for the court to have clearly stated that the substance of this transaction was different from its form. Such a determination recognizes that a transaction is "real" (and therefore not subject to challenge under the economic substance doctrine), so that the court is simply determining the tax consequences of the "real" transaction in which the foreign banks lent money (indirectly) to Dow. One of the potential implications of calling a transaction a "sham" partnership is that it makes it sound as if there was no "real" transaction, whereas there can be little doubt that there was a "real" loan here—if bankruptcy had occurred, the foreign banks would have suffered substantial losses.

In this regard, the decision in *Chemtech* highlights one of the problems in the tax lexicon. The "sham partnership" doctrine is really a subset of the substance-over-form doctrine, but it uses words (like sham) that are more commonly associated with whether a transaction has economic substance. It is important that the courts not conflate, or fail to distinguish between, these doctrines, however, because of the enactment of Section 7701(o) and its no-fault penalties. The IRS has recognized the important differences between the various judicial doctrines (see Notice 2014-58)[7] and hopefully the courts will be cognizant of these distinctions in their future opinions. Similarly, the IRS should be drawing these distinctions in litigation in the future; the district court opinion in *Chemtech* shows the problems that arise when the separate documents are treated as fungible or interchangeable.

Aside from the general proposition that judicial precedent should be created only on the basis of the actual grounds for a decision, as a practical matter, when courts choose to discuss other grounds on which the decision "could also" be based, they create confusion and distortion by comingling legal doctrines. The Fifth Circuit wisely avoided this trap.

Turning to the issue of penalties, the Fifth Circuit sent the issue back to the district court for a decision. It will be interesting to see whether the district court will continue to assert a penalty for negligence. As mentioned above, it seems odd to uphold the assertion of a negligence penalty for the Chemtech transactions, which are substantially similar to the transaction discussed in *Castle Harbour II*, a transaction that had been upheld as a legitimate transaction at trial. On top of that, the argument not to impose negligence penalties is potentially made stronger by courts who conflate the sham partnership issue with the debt-versus-equity issue, making the argument that Dow could reasonably have believed that the foreign bank's interests were equity and that such a belief was sufficient also to believe that the banks were partners in a partnership with Dow.

While distinctions can be drawn between this case and *Castle Harbour*, there was a real advance of real money by the banks in Chemtech, with the only legitimate question being the tax characterization of that transaction. As the district court observed in *Castle Harbour*, it is questionable to penalize a transaction when the issue is how such advance should be characterized for tax purposes.

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7 See Lipton, "New Guidance Sheds Light on Economic Substance Doctrine and Related Penalties," 121 JTAX 266 (December 2014).