**Not Enough Substance: the Eighth Circuit Looks at a Lease Restructuring Transaction.**

The economic substance doctrine was developed by courts to address transactions that appeared to comply with the Internal Revenue Code but generated results that seemed to be inconsistent with Congressional intent. The doctrine's modern application is usually traced to the Supreme Court's decision in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). While Congress has codified the doctrine, courts continue to apply pre-codification case law to older transactions.

Recently, the Eighth Circuit applied the doctrine to a refund claim brought by WFC Holdings Corporation, which controls Wells Fargo Bank, N.A. and other related entities. *WFC Holdings Corp. v. United States*, 2013 U.S. App. LEXIS 17566 (8th Cir. Aug. 22, 2013).

WFC had leases that it had essentially inherited when Wells Fargo & Company ("Old Wells Fargo") acquired First Interstate Bancorp in 1996. It remained obligated on the leases, some of which were in overlapping markets, and, to make matters worse, some leases could not be sublet for enough to cover the contractual rent. 2013 U.S. App. LEXIS 17566, slip op. at *1. In 1998, Old Wells Fargo merged with Norwest Corporation, creating WFC Holdings, which was now encumbered with the underwater leases, which were held by its banking subsidiaries, including Wells Fargo Bank, N.A.

The banking subsidiaries were subject to the National Bank Act, which requires banks to dispose of "other real estate owned" within five years. *Id.* at *2-*3 (citing 12 U.S.C. § 29; 12 C.F.R. § 34.82(a)). Since the First Interstate leases were former banking locations, they fit within the definition of other real estate owned, triggering the regulatory disposition requirement.

WFC Holdings was approached by its accounting firm concerning a potential transaction that would accelerate future tax deductions associated with these leases in three steps:

- First, Old Wells Fargo would find or create a subsidiary for the transaction.
- Second, Old Wells Fargo would make a tax-free transfer of both assets and liabilities to the subsidiary in return for stock in accordance with Section 351 of the Code; the stock's basis would not be reduced to reflect the liabilities because they were going to generate tax deductions for the subsidiary.
- In the third step, Old Wells Fargo would sell the stock. When this happened, the value of the stock would be lower that its basis because the liabilities assumed by the subsidiary would reduce the amount that a purchaser would be willing to pay for it. As a consequence, Old Wells Fargo would generate a loss on the transaction. *Id.* at *4-*7.

There was just one catch: to work, the accountants warned that the transaction would need to have a business purpose. Consequently, Old Wells Fargo set out to find one. Ultimately, after a couple of attempts, it settled on three: avoiding the OCC restrictions on retaining the leases; enhancing its negotiating posture with subtenants and incentivizing the managers of the leases. *Id.* at *10-*11.

Old Wells Fargo then executed the strategy; one of its banking affiliates transferred a $426 million portfolio of valuable and twenty-one commercial leases to Charter Holdings, which WFC controlled, receiving 4,000 shares of stock in return. This stock was transferred to WFC for $4 million, and WFC sold the shares to an investment bank for $3.7 million in a couple of months. *Id.* at *12.

The case reached the Eighth Circuit after an unsuccessful refund action in which the district court concluded that the relevant transaction lacked a business purpose and lacked economic substance. The Court of Appeals affirmed.

In terms of economic substance, the court rejected WFC's argument that the transaction had substance because it allowed it to manage its lease obligations without the OCC's restrictions. The court concluded that the district court had properly found that those benefits could have been obtained by simply contributing the leases to a subsidiary without engaging in the remainder of the transaction. *Id.* at *22-*24.

The court also affirmed the district court's determination that the transaction lacked a substantive business purpose. There were some problems for WFC in the record, since it wasn't altogether clear that the properties were other real estate owned. The district court had concluded that at most eleven of the twenty-one leases fell into that category. The pool of leases included some that would expire before the required disposition date, and it excluded some leases that were underwater. *Id.* at *28-*30. It certainly didn't help WFC that the leases were selected before it came up with the rationale that the transaction would resolve the other real estate owned concern. WFC's other rationales received short shrift.

To me this case illustrates two things: *First*, adverse findings are very difficult to overcome on appeal; while I don't know the record in detail, this is a case where the taxpayer's position seemed at least plausible. *Second*, appearances count; the fact that the tax strategy was marketed to the taxpayer hurt, as did the fact that the business purpose was determined after the strategy was presented to the taxpayer.

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