Shell Game?

By Robert W. Wood • Wood & Porter • San Francisco

These days, any mention of oil companies is likely to provide fodder for hyperbole about hyperbolic gas prices. Whether or not the petroleum companies have anything to do with prices, it's hard enough for me to understand business purpose, economic substance and similar concepts, let alone venturing into the vicissitudes of oil pricing. If the oil companies feel battered by talks of windfall profits taxes, maybe they'll be happy by a bit of counterbalancing in the form of tax victories. At the least, Shell should be happy.

In *Shell Petroleum, Inc.*, Tax Analysts Document 2008-14880, 2008 TNT 131-10 (S. Dist. Ct. Tex. July 3, 2008), Shell was granted a refund of $18.9 million for its 1990 tax year. The refund was based on the carry-back of a 1992 consolidated net capital loss. The facts arose out of some financial difficulties Shell experienced in the early 1990s.

In response to losses, in 1992, Shell transferred some of the assets of one of its affiliated group members (Shell Western) to a new corporation called Shell Frontier. Shell Frontier then raised cash by selling Shell Frontier preferred stock (to unrelated investors). Shell Oil's general tax counsel got credit for this plan.

The clear idea was that it would raise cash, and notably, that Shell Western would likely have a loss from the sale of Shell Frontier preferred stock. Shell's general tax counsel reasoned that while Shell Frontier would have income, gain, *etc.*, regarding assets received by Shell Frontier from Shell Western, there would be offsetting losses. That would make for some enviable tax efficiency.

On the surface, the formation of Shell Frontier looks like a garden variety Code Sec. 351 transaction. That is certainly what Shell thought it was. Yet, the IRS argued that nonproducing properties transferred to the transferee company did not qualify as "property" under Code Sec. 351. These properties had no discounted net cash flow value. Plus, they were not otherwise appraised when they were transferred. The district court rejected the notion that these were fatal flaws, construing the term "property" broadly.

M&A TAX REPORT readers are well aware that Code Sec. 351 has pretty low thresholds—and pretty big benefits. On the benefits side, the transferee does not (at the time of the transfer) recognize gain or loss on the receipt of the property given in exchange for its stock. The transferor's basis in the transferred property becomes its basis in the stock received. The basis carry-over, of course, is what ensures that unrecognized gain or loss realized will not escape taxation.

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Double Benefit

Under the law in effect at the time of the Shell transaction, the transferor's basis in the transferred property carried over to become the transferee's basis, *even if* that basis exceeded the fair market value of the property. Thus, under the law pertinent to the Shell deal, one could achieve a double loss: (1) one on the part of the transferee, on disposition of the transferred property; and (2) another by the transferor on disposition of the stock received.

Easily clearing the Code Sec. 351 hurdle, the question was whether Shell was entitled to the portion of a claimed loss attributable to the carried-over cost basis in the nonproducing properties. That hinged on an application of our newest best friend, the substance over form doctrine. The IRS argued that Shell Western's transfer of non-producing, high basis properties—with no discounted net cash flow value—had neither economic substance nor a nontax business purpose. In fact, the IRS said the transfer of these

"assets" served only to artificially inflate Shell's tax basis in the Shell Frontier stock received and sold by Shell Western.

Predictably, Shell argued that a transfer of nonproducing properties served legitimate nontax goals. It improved management of the nonproducing properties, as well as helped to preserve assets that Shell believed had significant long-term potential.

How Strange …

The court relied on a now famous Fifth Circuit case, *A. Strangi*, CA-5, 2002-2 USTC ¶60,441, 293 F3d 279 (2002). There, the Fifth Circuit affirmed a Tax Court holding that even without persuasive proof of *any* business purpose for a family limited partnership, proving objective economic substance was enough for a partnership to be recognized. In *Shell*, the court concluded that two inquiries were relevant when determining whether a transaction's substance matches its form:

- Whether it was undertaken for a business purpose separate from tax consequences
- Whether it possessed objective economic substance

Recognizing that the courts are split on whether transactions must satisfy *both* subjective and objective inquiries, the court in *Shell* rejected the reasoning of *Coltec Industries, Inc.*, CA-FC, 2006-2 USTC ¶50,389, 454 F3d 1340 (2006). M&A TAX REPORT readers will recall that *Coltec* requires a taxpayer to prove *both* a nontax business purpose and economic substance.

The district court in *Shell* endorsed the notion that a transaction can pass muster under the substance-over-form doctrine with *either* a nontax business purpose or economic substance.

Last Gasp

The district court in *Shell* found the transfers of Shell Western's nonproducing properties, in exchange for Shell Frontier preferred stock, did serve a valid business purpose, quite apart from tax benefits. Plus, the court found the transaction possessed economic substance (so both tests were met).

Still, the government had another argument: The IRS can disallow Shell Western's losses under Code Sec. 482, reallocating them to Shell Frontier. The court just said "no" to this one. Although the *Shell* court reached this either/or decision, it turned out to be an academic point.

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