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MEMORANDUM

TO: Commissioners

FROM: Commissioner Sandstrom KS

DATE: November 8, 1999

SUBJECT: MUR 4250 - Response to Vice Chairman's Memorandum Dated October 26, 1999

On October 26, 1999, the Vice Chairman circulated a memorandum that challenged portions of the General Counsel's Probable Cause Brief for MUR 4250. The memorandum also raised questions about the step transaction doctrine which I had discussed in a memorandum circulated to the Commission on September 27, 1999. I have taken this opportunity to respond to those questions.

Although I find the guarantee by a foreign national of a loan, the proceeds of which are expressly earmarked and provided to a political party, to be a clear violation of §441e, I included a discussion of the step transaction doctrine in my memorandum to illustrate that courts would not analyze individual, seemingly permissible, transactions without also considering the surrounding facts and intent of the parties. For decades courts have analyzed interconnected transactions as a whole, looking to their intended result, to prevent similar end-runs around statutory provisions.

Though unnecessary to the proper resolution of this matter, I believe a step transaction analysis is a useful adjunct to a straightforward statutory analysis of this case. Courts have applied the step transaction doctrine to arrangements far less transparent, and intentions far less certain, than those of the instant case. Nonetheless, I believe it would be helpful to respond to the arguments made by the Vice Chairman that relate specifically to the usefulness of a step transaction analysis in this matter.

In his memorandum, Vice Chairman Wold stated that the application of the step transaction doctrine "is triggered *only* when it appears that a taxpayer is resorting to an artificial structure for a transaction that puts form over substance to achieve a result not intended by the statutory

scheme of the IRC," and to apply the step transaction doctrine in MUR 4250, "we would need to show that the transaction in question lacked substance in at least one particular. That is, that at least one leg did not have economic significance, was a sham, or was not undertaken for valid business purposes."[1] Memorandum at 2 (emphasis added). This, in my opinion, too narrowly interprets the clear language courts have consistently used when applying the step transaction doctrine.

While resorting to an artificial structure may trigger the application of the step transaction doctrine, this is not a necessary component or a condition precedent to its application. The court in *True v. U.S.*, 1999 WL 699838, stated that the end result test combines "into a single transaction separate events which appear to be component parts of something *undertaken to reach a particular result.*" *True v. U.S.*, 1999 WL 699838 (no page numbers available)(10th Cir. 1999) citing *Associated Wholesale Grocers*, 927 F.2d 1517, 1523 and *Kornfeld v. Commissioner of Internal Revenue*, 137 F.3d 1231, 1235 (10th Cir. 1998)(emphasis added), and "if the court finds that a series of closely related steps in a transaction *are merely the means to reach a particular result*, we will not separate those steps, but instead treat them as a single transaction." *True* citing *Kanawha Gas & Utils. Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954)(emphasis added).

In describing the appropriate application of the interdependence test, the court in *Kornfeld* focused on the relationship between the individual steps and whether, under a reasonable objective view, the steps were so interdependent "*that the legal relations created by one of the transactions would be fruitless without a completion of the series.*" *Kornfeld* at 1235 (emphasis added).

In short, it is not an artificial structure courts seek to expose when applying the step transaction doctrine, but the circumvention of the intent of a statute or regulation. As was stated in *True*, "the Trues changed what would have been the natural result of a direct purchase of the ranch land by engaging in a series of steps designed from the outset *to circumvent the intent of the tax code.*" *True* at 9 (emphasis added).

Assuming application of the step transaction doctrine is appropriate, the memorandum next argues that it would be an "artificially truncated application of the doctrine" not to apply it to the original loan from RNSEC to NPF. Memorandum at 3.

First, the memorandum does not explain how this earlier application of the doctrine would affect the conclusion that Haley Barbour and the RNC violated §441e, though it does state that this would make application more "problematic." Id. Second, the memorandum cites no authority in support of its conclusion that the doctrine should be applied to the original loan, and gives no explanation why this is the appropriate point at which to begin the analysis. In fact, I would argue that it would be an improper application of the doctrine to apply it to the original loan from RNSEC to NPF.

[1] Even if I were to accept this constricted read of the step transaction doctrine, I would find that the guarantee was purely politically motivated and lacked any business or charitable purpose. On this point the documentary evidence is compelling.

The approach advocated in the memorandum seems to imply that the doctrine should be applied beginning with any transaction with which there is some factual connection. This is not an approach supported by the courts.

An examination of *Associated Wholesale Grocers*, cited by the Vice Chairman, illustrates how courts apply the doctrine – not to every connected fact or transaction in a particular case – but beginning with the first transaction in an interconnected series of transactions in which the intended result was planned. In that case, the court held that certain merger and reorganization agreements were sufficiently interdependent to conclude that the corporation's transfer of a subsidiary was not a sale, but rather a complete liquidation from which it was precluded from recognizing a business loss.

In 1976, Super Market Developers ("SMD"), whose parent was Associated Wholesale Grocers, made a tender offer for all outstanding stock of Weston Investment ("Weston"), a company that owned a number of supermarkets. By 1980, SMD had acquired 99.97% of the Weston stock. One of Weston's subsidiaries was Weston Market, a grocery operated by Thomas Elder. Elder expressed a desire to buy Weston Market, and Elder formed a company, Elder Inc., for that purpose. An agreement was executed between Elder and SMD, the terms of which provided for the merger of Elder Inc. and Weston, and the exchange of $300,000 in cash and a promissory note, with a face value of $9 million, for the Weston stock, with the minority shareholders entitled to receive $28.50 a share. SMD then immediately bought back all the assets acquired by Elder Inc. under the merger agreement. In exchange for those assets, SMD paid an amount equal to the principal amount of the promissory note plus an amount equal to the cash received by the minority shareholders. *Associated* at 1518-1519. SMD treated the transaction as a taxable sale of Weston's assets and declared a tax loss. The IRS denied the loss and concluded the transaction was not a sale but rather a complete liquidation of SMD's subsidiary, Weston. The court agreed with the IRS, and in reaching its conclusion, applied the doctrine, collapsing the transactions *beginning with the merger*. *Associated* at 1519.[2]

The court could have collapsed the original tender offer by SMD for Weston and the continuous acquisition of Weston stock by SMD. The court did not do this, however, as this would have rendered the application of the interdependence test meaningless. The acquisition of Weston stock was not an interdependent step in the merger and claim of a loss, and therefore was not included with the transactions that were collapsed, even though these acquisitions were as factually connected to the merger as the original loan from RNSEC to NPF was to the payment years later to the RNSEC.

The court collapsed the transactions beginning with the exchange between Elder and SMD, not because it arbitrarily chose a point to begin its analysis, but because the Elder-SMD exchange was the starting point at which the parties structured their transactions with a particular outcome in mind. *Associated* at 1528.

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[2] While this is a factually complex case, I used it here because it was cited both by the Vice Chairman and myself, and because it was a good example of the court's application of the doctrine to a confined set of transactions.

In addition, like in MUR 4250 in which the transactions at issue took place virtually simultaneously, the court in *Associated* made clear that the contemporaneous nature of the transactions was a critical factor in their decision to apply the step transaction doctrine. "[U]nder the 'Agreement and Plan of Reorganization,' *which took effect 'immediately following the time of effectiveness of the merger,'* SMD bought back all the assets acquired by Elder, under the merger agreement except for the stock of Weston Market." *Associated* at 1518-1519 (emphasis added).

The memorandum next asks whether it is appropriate to import the step transaction doctrine from its application in the tax code to the FECA, arguing that "the courts have repeatedly recognized the uncertainty of the application of the step transaction doctrine in the tax area, stated probably most colorfully by the court in *Security Industrial Insurance Company v. U.S.* 702 F 2d 1234, at 1244." Memorandum at 3. The memorandum then quotes the court: "the types of step transactions are as varied as the choreographer's art. there are two steps, waltzes, fox trots, and even Virginia reels. As a consequence, the court's applications of the step transaction doctrine have been enigmatic . . ." While this is an accurate quotation, I should note that the court went on to apply the step transaction doctrine in that case. In addition, the step transaction doctrine has been applied in over one hundred cases, by virtually every federal court, over the last thirty years. See *Commissioner of Internal Revenue v. Clark*, 489 U.S. 726 (1989), *True v. U.S.*, 190 F.3d 67 (10th Cir. 1999), *Greene v. U.S.*, 185 F.3d 67 (2nd Cir. 1999), *G.M. Trading Corp. v. C.I.R.*, 121 F.3d 977 (5th Cir. 1997), *Lerman v. C.I.R.*, 939 F.2d 44 (3rd Cir. 1991), *Owen v. C.I.R.*, 881 F.2d 832 (9th Cir. 1989), *Kirchman v. C.I.R.*, 862 F.2d 1486 (11th Cir. 1989), *Estate of Schneider v. C.I.R.*, 855 F.2d 435 (7th Cir. 1988), *Russell v. C.I.R.*, 832 F.2d 349 (6th Cir. 1987), *Federal Nat. Mortg. Ass'n v. C.I.R.*, 896 F.2d 58 (D.C. Cir. 1990), *Clark v. C.I.R.*, 828 F.2d 221 (4th Cir. 1987), et al. If its application was fraught with such uncertainty, courts would probably not apply it as often or as widely as they have.

The memorandum next asks "whether the Commission can apply a doctrine that it has not heretofore applied in any enforcement action, promulgated in a regulation, or even enunciated in an advisory opinion, to find a violation of the law." Wold at 4.

As I stated above, it is unnecessary to apply the step transaction doctrine to the facts in MUR 4250. The language of §441e provides the statutory basis for a finding of a violation of the Act. However, it is not the step transaction doctrine itself I suggest be applied to MUR 4250. It is merely *the concept* underlying the doctrine that should be applied -- that persons should not be permitted to circumvent statutory provisions by undertaking a series of steps which, when examined individually, appear permissible, but when taken as a whole are violative of a particular provision. This concept is as relevant in election law as it is in tax law. The courts' response to naked attempts to elevate form over substance is more developed in the tax law context. Nevertheless the principles applied I think have equal validity in the election law context.[3] The logic of the ends results, mutual interdependence and binding commitment tests is as compelling in election law as it is in tax law. Consequently, I find it to be by analogy persuasive authority for pursuing this matter.

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[3] The best precedents in the election law context are probably found in the §441f area.

If the Commission should adopt this analysis in conjunction with a more straightforward statutory finding of a violation, the courts can of course find our arguments wanting, but nothing in this case would suggest such an outcome Therefore I would continue to recommend that we find probable cause where the intent, the execution and the result are manifest in the documents before us