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MEMORANDUM

DATE: October 26, 1999

TO: Commissioners

COPY: Office of General Counsel

FROM: Commissioner Darryl R. Wold DRW

RE: MUR 4250

This memorandum briefly discusses three of the legal issues that I still have substantial questions about.

My research and analysis thus far indicates that there may not be a sufficient legal basis to find that these issues can be resolved to support a finding of probable cause, but my research has not been what I would call definitive, and I would like to consider any further research or analysis that might be offered by OGC or any Commissioner.

Commissioner Sandstrom's application of the step transaction doctrine.

My research indicates that Commissioner Sandstrom's memorandum fairly describes the three approaches that the IRS and the courts have taken in applying the step transaction doctrine. Further, the memorandum persuasively applies each approach to the facts of this case to the extent that they are set out in the memorandum, and fairly presents the facts which are relied on.

My research also indicates, however, that there are several questions about the application of the step transaction doctrine that are not dealt with in the memorandum, but which need to be satisfactorily resolved or answered before that doctrine could be applied in the context of the FECA. As far as I know, the step transaction doctrine is unique to tax law; if we are to import it into the FECA, we need to be sure at least that we apply it in the same circumstances as justify its application in tax law, that we apply it in the same manner, and that in the end it is appropriate to apply it in the FECA.

(1) Are the necessary prerequisites for the application of the step transaction doctrine present in this case?

In the tax area, the step transaction doctrine is not automatically applied to every transaction which might fit into one of the three variations described in the memorandum. The application of the 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 Internal Revenue Code. The statement in *Associated Wholesale Grocers, Inc. v. U.S.* (10th Cir., 1991) 927 F.2d 1517, 1521 that "the step-transaction doctrine developed as part of the broader tax concept that substance should prevail over form" is repeated in a various forms in many of the cases. It is clear from the facts of those cases that the "form" that the court refers to is form without substance. In *Gregory v. Helvering* (1935) 293 U.S. 465 the court described the form of the transaction designed by the taxpayer as "an operation having no business or corporate purpose -- a mere device," and "a contrivance" (at 469) and an "artifice" (at 470). The court rejected the artificial form of the transaction because that would defeat the "plain intent" of the statute (at 470). In *Minnesota Tea Co. v. Helvering* (1938) 302 U.S. 609, the court refused to give tax effect to a "transparently artificial" and unnecessary step taken by the taxpayer in an attempt to avoid an adverse tax result. In *Court Holding Company v. Commissioner* (1945) 324 U.S. 331, at 334 the court said that "the incidence of taxation depends on the substance of a transaction. . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

That element of an artificial device, created by the taxpayer solely for the purpose of avoiding tax liabilities, is reflected in the IRS' position in Revenue Ruling 79-250, 1979-2 C.B. 156: "The substance of each of a series of steps will be recognized and the step transaction doctrine will not apply, if each such step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes."

Thus, before we could apply the step transaction doctrine here, 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. That does not appear to be the case in the transactions in this matter: The loan from the RNSEC to NPF, the loan/security from Signet/YBD to NPF, and the repayment from NPF to the RNSEC each had economic significance, none were a sham because each was real, and each had a substantive purpose other than just to play a role as a leg of a transaction.

(2) Assuming that the threshold conditions for application of the step transaction doctrine are present (see (1) above) can the elements of that doctrine in any of its variations be applied to the entire transaction in this case?

The memorandum applies the doctrine only to the steps in the transaction that begin with the secured loan from Signet/YBD to NPF. This ignores the earlier stage, predating this latter stage by some period of time, when the RNSEC made the initial loan to NPF. Including that stage would appear to be necessary to avoid an artificially truncated application of the doctrine itself, but would appear at first blush to make its application much more problematic.

(3) Assuming that issues (1) and (2) above are resolved in favor of the literal requirements for application of the step transaction doctrine, is it nevertheless appropriate to import that doctrine from its application in the tax code into the FECA?

Among the concerns that should be addressed are:

- Whether a doctrine that has such substantial uncertainty as the step transaction doctrine has even in the tax area could constitutionally be applied to regulate activity protected by the First Amendment. 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.* (5th Cir., 1983) 702 F.2d 1234, at 1244:

> "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 courts' applications of the step transaction doctrine have been enigmatic. As the Seventh Circuit observed:
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> "'The commentators have attempted to synthesize from judicial decisions several tests to determine whether the step transaction doctrine is applicable to a particular set of circumstances . . .. Unfortunately, these tests are notably abstruse -- even for such an abstruse field as tax law.'"

The court in *Security Industrial* applied the doctrine to the taxpayer in its case, concluding that "Only if Security dances to the Codal choreography is it entitled to favorable tax treatment." (*Security Industrial*, at 1251.) Similarly, the court in *Kuper v. Commissioner* (5th Cir., 1976) 533 F.2d 152, at 159 candidly stated that "we are unable to draw a single bright line separating in all instances unacceptable artifice from valid tax planning."

Yet it is a "bright line" that the First Amendment requires in informing persons what activity will be permitted and what will not, as the court said in *Buckley*. The memorandum deals with *Buckley*'s requirement of a bright line only as it pertains to the meaning of the statutory phrase in §441e "directly or through any other person". That phrase appears simple enough -- it appears to be the statutory equivalent in §441e of §441f's prohibition against contributions "in the name of another person" -- but that is not the issue of certainty -- or uncertainty -- that would be raised by the application of the step transaction doctrine. The issue is whether there is a sufficiently clear test for application of that doctrine. The courts in the tax area, where the doctrine has been applied, suggest not.

- 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.

Regardless of whether MURs 4000 and 4314 are distinguishable or not (arguably refusing to adopt an approach at least analogous to the step transaction doctrine), can we for the first time apply a doctrine that would be new to the FECA, without any prior warning?

The question of whether the payment from NPF to the RNSEC was a "contribution."

It is not at all clear to me whether under OGC's analysis it is necessary or not necessary to determine that the payment from NPF to the RNSEC was a "contribution."

It would seem that this payment would have to be considered as a "contribution" in order for the loan/security from Signet/YBD to be considered a "contribution" made "*through another person*" to the RNSEC. For instance, I am not aware of any application of the parallel provision in 441f to find that a "contribution" was "made in the name of another" where the second leg of the transaction was not itself a contribution.

On the face of it, the payment from NPF to the RNSEC is clearly a repayment of a loan. OGC's probable cause brief appears to argue that it should not be considered as a repayment of a loan because the original loan was not *bona fide*, and it was not *bona fide* because it was not commercially reasonable OGC's brief, however, does not cite any authority for the proposition that a loan that is not commercially reasonable in the sense that a commercial lending institution would make it is nevertheless not *bona fide*. Loans are made all the time that an institutional lender would not make, and are enforceable on their terms. OGC's position strikes me as somewhat of a unique proposition, but I would appreciate a further analysis.

<u>The question of whether the payment from NPF to the RNSEC was "in connection with an election."</u>

My question here concerns the Commission's position on this fundamental issue. I simply do not know what our position is.

It appears that the circuit court's opinion in *Kanchanalak* validated the Commission's position that §441e applies to <u>any</u> election. That leaves open the question, however, whether it also applies to donations to a party non-federal committee that are used only for "issue ads." It is my understanding that OGC did not develop any evidence on the actual use to which the funds received by the RNSEC from NPF were used, on the theory that funds from a foreign national may not be donated to a party committee no matter what the use. I need some explanation of that theory.