

# LEGAL UPDATE

CLIENT NEWSLETTER OF  
**CARR, MORRIS & GRAEFF, P.C.**

1120 G STREET, N.W., SUITE 930 • WASHINGTON, D.C. 20005-3801 • (202) 789-1000

AUGUST - SEPTEMBER 2007

## TAX

### RECENT DEVELOPMENTS IN THE ECONOMIC SUBSTANCE DOCTRINE--PART I

The "economic substance doctrine" is a judicially-created revenue rule of construction which allows a court to disregard for tax purposes transactions that fall within the literal terms of the Internal Revenue Code but lack economic substance or reality. The doctrine has the approval of the Supreme Court of the United States as well as Federal appellate courts. Sometimes the doctrine is framed as one requiring a transaction to have a business purpose other than tax avoidance. The purpose of the doctrine is to prevent taxpayers from avoiding the intent of revenue legislation by complying with its literal terms by the utilization of fictitious transactions.

Over the years there have been many proposals to codify the doctrine but they have failed. It is easy to see why. The Code is long and complex. Taxpayers have displayed almost limitless ingenuity in devising transactions to avoid taxation while complying with the words of the Code. In turn, Congress has shown nearly identical ingenuity in plugging loopholes, whether existing or anticipated. This has been the partial cause for the monstrous complexity of our revenue laws. Were the economic substance doctrine to be codified it would not be long before creative taxpayers found a way around the literal words of the codification, with subsequent Congressional attempts to

*continued on page 3*

## IN THIS ISSUE

TAX: Recent Developments In The Economic Substance Doctrine.....	1
ESTATE PLANNING: Planning Should Include A Letter Of Last Instruction .....	1
LITIGATION: Appellate Court Addresses Choice Of Laws Issue.....	2
EVIDENCE/IMPEACHMENT: Court Clarifies Rule On Impeachment For Prior Felony .....	2
STAFF NOTES.....	4

## ESTATE PLANNING

### MAKE IT EASIER FOR YOUR FAMILY BY PREPARING A "LETTER OF LAST INSTRUCTION"

At the increasingly pronounced insistence of your spouse, you begrudgingly met with your attorney to plan for life's eventualities. You navigated the maze of wills, living trusts, life insurance trusts, powers of attorney and advance medical directives. You learned the truth of the dreaded estate tax and made the tough decisions regarding your life savings and children. You completed your estate plan. A lawyer never tires of extolling the virtues of organizing the legal framework for the distribution of your assets and care of loved ones following your death. Yet an oft-overlooked adjunct to the estate planning process is the preparation of a "Letter of Last Instruction," the purpose of which is to provide your family members with timely information and advice concerning the administration of your estate. Whereas your wills and trusts provide the game-plan for your estate, the Letter of Last Instruction gives your personal representative the insider's playbook to its execution.

A Letter of Last Instruction is not a legal document and cannot be used to make testamentary gifts to your heirs or otherwise modify your estate plan (if you wish to change your estate plan, please do so by consulting an attorney). A Letter of Last Instruction is simply a centralized consolidated recording of information that you believe will prove helpful to your family upon your passing. The letter is a private statement to your survivors; it need not be in any particular form and should only include information you warrant notable. Below please find some suggested information for inclusion:

Identity. Provide your birth date, place of birth, social security number and any former names, and that of your parents (such information will be required for the death certificate).

Funeral & Burial. Describe your wishes and identify your place of burial and desires concerning the memorial service; or, if you

desire to be cremated, specify the disposition of your ashes.

Genealogy. With the intention of preserving your personal family history, you may wish to record and memorialize biographical information concerning your late ancestry.

Testamentary Documents. Identify and provide the location of your original wills and other estate planning documents, along with the contact information of your immediate family, personal representatives, and trustees.

Professionals. Identify and provide contact information for all attorneys, accountants, insurance agents, brokers, business partners, clergymen, etc.

Insurance Coverage. Describe in detail all insurance coverage you may have, identifying the agent, insurer, policy numbers, levels of coverage and contact information.

Governmental Benefits. Identify the government benefits for which you or your family may be eligible (such as social security, medicare, military benefits, etc.).

Safe Deposit Boxes. Identify any safe deposit boxes you may have, as well as any other items of personal property not in your possession (or items in your possession which are the property of others).

Pets & Family Memorabilia. If you do not have any close family members, you may wish to leave instructions for the care of your pets and safe keeping of family memorabilia.

Produce an Inventory. Produce an inventory of all of your significant assets and liabilities, both those held individually and those held jointly with a spouse or others. For each entry, identify the type of asset, its approximate value, its location, its ownership, and any characteristics of note. Regarding liabilities specify the term thereof and any security offered for repayment. If you are owed debts from others, you should identify the debtor, the amount, evidence of indebtedness, and any security which you hold for repayment. You may choose to identify the location of your financial records and tax returns as well.

*continued on page 3*

## **LITIGATION APPELLATE COURT ADDRESSES CHOICE OF LAW ISSUE**

“Choice of law” refers to the procedure by which a court decides which state’s substantive law to apply to a particular matter. Typically, courts of general jurisdiction apply the law of that state. There are some situations, though, where the law of another state may have a paramount interest and should be applied. In the case of a breach of contract, the contracting parties may specify that a particular state’s law apply regardless of where suit is filed.

The District of Columbia Court of Appeals recently clarified and applied its own *choice of laws* precedent in a medical malpractice case. In the case of *Drs. Groover, Christie and Merritt v. Burke*, Nos. 04-CV-1115, 04-CV-1116, 05-CV-545, 05-CV-546 (Mar. 8, 2007), the D.C. Court of Appeals determined that, while suit may properly be brought in D.C., Maryland law should apply for purposes of imposing a *cap* on non-economic damages.

In this case Sharon Burke had suffered a debilitating stroke in 2000. She filed two (later consolidated) medical malpractice actions in D.C. Superior Court against various doctors who had treated her. The jury determined that the defendant practice group had failed to diagnose and treat a blockage in Ms. Burke’s right carotid artery before she suffered her stroke. The jury awarded Ms. Burke nearly \$5.8 million, including \$2 million for *non-economic* losses. On appeal the D.C. Court of Appeals concluded that Maryland had a more “significant relationship” to this dispute than the District and remanded the case to reduce the non-economic damages portion of the verdict under Maryland law.

The impact of the court’s choice of law decision is evident. Maryland law imposes a ceiling or “cap” on non-economic damages in personal injury actions. Non-economic damages include damages for pain and suffering—a variable that often leads to large plaintiff’s verdicts. In D.C. there is no such limitation. Applying Maryland law reduces Ms. Burke’s non-economic damages to \$590,000, the current Maryland maximum. The Court of Appeals explained that in examining choice of law issues it attempts to determine which jurisdiction’s governmental policies will be most advanced by applying its law to the facts of the case. The court also examined a number of factors—including place of injury, place where the conduct

causing injury occurred and domicile and/or place of incorporation—to identify the jurisdiction with the “most significant relationship.” In this case the court determined that Maryland enacted a cap on non-economic damages in response to concerns about the affordability and availability of liability insurance. Thus, Maryland had a demonstrated interest in having its law apply. Further, examination of the other delineated factors led the court to conclude Maryland had the *most significant* relationship to the dispute. In summary the court found that Ms. Burke suffered her stroke in Maryland, she lived and was employed in Maryland, the medical services were rendered in Maryland, the doctors misdiagnosed her condition in Maryland, the doctors worked in Maryland and Ms. Burke’s medical consultations and MRI’s were conducted in Maryland. The court concluded that, given all of these factors, “[t]he public policy underlying Maryland’s statutory cap is directly implicated and would be advanced by applying the Maryland law.”

As this case demonstrates state laws vary and the determination as to which law will apply can have a dramatic impact on the outcome of a case. To the extent possible business owners and others entering into agreements (particularly those with parties in different states) should attempt to control the litigation process by specifying the state in which any suit, arbitration and/or mediation must be filed and the substantive law which will be applied to resolve any dispute. Courts are more likely to uphold a contractual choice of law provision if the state chosen has a logical connection to the parties and the matter.

DANA THERIOT

---



---

## **EVIDENCE/IMPEACHMENT COURT CLARIFIES RULE ON IMPEACHMENT FOR PRIOR FELONY**

The importance of witness credibility at trial cannot be understated. Jurors, obviously, can choose to believe or disbelieve witnesses for good reason, bad reason, or no reason whatever. The trial attorney’s challenge is often to discredit opposing witness—and a key means of discrediting witnesses is by impeachment. A witness can be impeached in a number of ways, such as by confronting him or her with evidence of a “prior inconsistent statement.” (*So, were you lying then or are you lying now?*) Another, less commonly

encountered means of impeachment is by presenting proof that the witness is a felon or has been convicted of a crime involving dishonesty or false statement.

The District of Columbia has a specific statute, D.C. Code §14-305, governing impeachment by proof of felonious conduct. A key limitation of that form of impeachment is that *remote* offenses cannot be used to impeach a witness. Generally, ten years after completion of one’s sentence for a felony conviction or conviction of any offense of dishonesty, that offense cannot be used for impeachment. But in something of a qualifier to the qualifier, a remote impeachable offense can be *revived* by commission of another offense.

In the recent—and ongoing—case of *U.S. v. Jackson*, D.C. Sup. Ct. Case No. 2006 CFI 750 (May 22, 2007), Judge Neal Kravitz addressed and resolved the novel issue of whether the *reviving* offense must itself be of an impeachable nature. That is, can a recent misdemeanor that does not involve dishonesty or false statement revive remote impeachable convictions?

The situation Judge Kravitz confronted was certainly not theoretical. The defendant is charged with first-degree premeditated and felony murder for an exceptionally brutal 1983 killing. He had been identified recently by DNA analysis. The prosecution moved *in limine* for permission to use the defendant’s impressive but remote record of nine prior criminal convictions to impeach his general credibility at trial. All of the convictions would be too remote in time to use but for a 2006 Arlington conviction for assault and battery. That conviction, which actually arose from an incident in 1996, was a misdemeanor. Defense counsel argued that a misdemeanor that does not involve dishonesty or false statement should not trigger revival of the stale convictions.

Judge Kravitz disagreed and determined that the recent misdemeanor did bring the earlier convictions back into play. The judge explained, “Section 14-305(b)(2)(B) (emphasis added) provides that a witness’ remote convictions are revived, and are admissible, if the period of confinement, probation, or parole imposed for the witness’ ‘most recent conviction of *any* criminal offense’ expired less than ten years before the time of the witness’ testimony.” Thus, if the defendant testifies, he can be impeached with his criminal record.

LAWRENCE CARR

**TAX***Continued from page 1*

shut down the circumvention. In this case, Congress has wisely allowed the courts to apply the doctrine on a case-by-case basis.

The doctrine is composed of several factors depending on which cases one reads, but they can be summarized as follows:

1. Economic reality. Tax benefits may only be reaped from transactions with economic reality. Put another way transactions must have a business purpose or function. Transactions which do not change the flow of economic benefits may be disregarded. Some courts have insisted taxpayer must have intended the business purpose. It is doubtful whether this particular requirement is realistic in view of the difficulty of establishing intent. "Intent" is a particularly slippery concept in revenue legislation, which ought to attempt to be as objective and precise as possible.
2. Burden of proof. When a taxpayer claims a deduction taxpayer has the burden of proving the deduction has economic substance.
3. Objectivity. The reality of a transaction is judged objectively and not subjectively. This is a particularly important requirement. Often taxpayers attempt to justify a transaction by the uncorroborated testimony of corporate executives. This will not do. Taxpayer must prove by objective means there is a reasonable possibility of profit from the transaction in question, the transaction affected the taxpayer's financial position, or there is a realistic financial benefit.
4. Relevant transaction. The relevant transaction is the one which gives rise to the tax benefit. For example, if the last, substantive transaction in a series of transactions is not the one which gave rise to the tax benefit the doctrine would apply if an intermediate fictitious transaction gave rise to the tax benefit. Thus, a taxpayer may structure a real transaction in the most advantageous tax way, but may not create a transaction without a business purpose just to obtain a tax benefit. The relevant transaction aspect of the doctrine is hard to apply in those cases where each step is arguably necessary for the next one, even though the last step is the only one with a specific business purpose and only an intermediate step provides a tax benefit. In such

cases breaking down a transaction into constituent parts becomes somewhat artificial.

5. Subsidiary transactions. Arrangements with subsidiaries which do not affect the economic interests of unrelated third parties are subject to close scrutiny. This aspect of the doctrine is tax-logical. Just as inter-family transactions among individuals are closely scrutinized to ensure they are at arm's-length, transactions between parent companies and subsidiaries or among subsidiaries are reviewed for their economic logic. The test is usually whether the transaction creates a genuine, enforceable obligation to an unrelated party which is not under taxpayer's control. Alternatively, one could test whether the transaction released the corporate group from an obligation to unrelated parties.

### CONTINGENT LIABILITY TRANSACTIONS

The case explored in this article involves a contingent liability transaction. In order to make this exploration easier we first set forth the stylized facts of such transactions and then discuss the case itself.

Contingent liability transactions are designed to shelter capital gains taxation. In a typical transaction a corporate taxpayer which has or anticipates a substantial capital gain transfers intercompany notes payable or cash to a subsidiary in exchange for stock and the subsidiary's assumption of a contingent liability of the parent. The parent-taxpayer claims its basis in the stock received is equal to the value of the notes without reduction for the liability transferred. When the stock is sold the taxpayer claims a substantial loss which offsets unrelated capital gains.

For example, assume taxpayer has a contingent liability of \$99 million. It transfers to the subsidiary notes payable or cash worth \$100 million in exchange for the subsidiary's stock. The subsidiary assumes the \$99 million contingent liability so the subsidiary's net worth is only \$1 million. Taxpayer, however, claims its basis in the shares is the full \$100 million unreduced by the \$99 million liability. When taxpayer sells the stock for only \$1 million taxpayer claims a \$99 million capital loss which can offset up to \$99 million in unrelated capital gain. Many corporate taxpayers have received opinions from their outside tax advisors that they will be more likely than not to prevail if the transactions were to be challenged on

audit. In Notice 2001-17 (2001-1 CB 730) the Internal Revenue Service (IRS) listed such transactions as abusive because in the Service's view they fail to comply with statutory requirements and lack economic substance or effect.

In Part II we will discuss *Coltec Industries, Inc. v. United States*, 454 F. 3d 1340, decided on July 12, 2006 by the United States Court of Appeals for the Federal Circuit. This decision clarifies the role of the economic substance doctrine in contingent liability transactions.

**NÉSTOR CRUZ**

Ed. note: This article originally appeared in the Fall 2006 issue of the *Journal of Taxation of Investments* and is reprinted here with the Journal's permission.

### ESTATE PLANNING

*Continued from page 1*

Organizations & Persons to Contact. You may wish to include a list of organizations and persons who should be contacted concerning your death.

Residences. Consider describing unique information about your residence, and provide a list of persons familiar with its maintenance, repair and lawn care.

Fiduciary Duties. If you are serving as a fiduciary for any other person or estate, provide identification and contact information.

Business Interests. Should you have a substantial interest in a closely held business, the successful sale or liquidation (or continuation, if so provided for) of such business may depend on your guidance to your successors via a memorandum or other writing.

The above information, however seemingly intuitive or easily retrievable, can become lost following one's death without proper safe keeping. A Letter of Last Instruction can prove infinitely valuable to your family members tasked with administering your estate. It can take any form you desire and include any information you wish to pass along. Consider the above list a non-exhaustive sampling of suggested information. The information included should be updated regularly and the letter sensibly stored in a highly visible location, such as included amongst your estate planning documents. Administering a loved one's estate can be an overwhelming task; with a Letter of Last Instruction in place you may be remembered more fondly.

**JUSTIN BANFORD**

**CARR, MORRIS  
& GRAEFF, P.C.**

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial Litigation; Criminal Representation; Alternative Dispute Resolution; Employment/Labor; Discrimination; and Wage-Hour.

The firm maintains its office in the Metro Center region of downtown Washington. It has attorneys admitted to all of the local judicial jurisdictions—the District of Columbia, Maryland and Virginia.

**STAFF NOTES**

*Hang on, darlin'.* Displaying remarkable powers of persuasion, Roy Morris enticed his wife, Marie, to join him in August on a challenging 1,200-mile motorcycle trek through the mountains of western North Carolina. The destination was the “curviest road in America”—an 11 mile section of Rt. 129 through Deal’s Gap on the Tennessee/N.C. border known to sports car drivers and motorcyclists as the “tail of the dragon,” which is claimed to have 318 turns.

\* \* \*

*Everything Lobster.* While recently touring the Maine coast, Phil Schwartz was intrigued by a Bar Harbor shop’s Lobster Ice Cream. One taste confirmed Phil’s initial instinct...everything lobster is not good. Butter flavored ice cream with chunks of lobster just doesn’t work. Lobster rolls, lobster bisque and plain old lobster on the other hand...

---

**CARR, MORRIS & GRAEFF, P.C.**  
1120 G STREET, N.W., SUITE 930  
WASHINGTON, D.C. 20005-3801

PRSR STD U.S. POSTAGE PAID Springfield, VA Permit No. 6082
--

**RETURN SERVICE REQUESTED**