

No. 06-478

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IN THE  
**Supreme Court of the United States**

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THE DOW CHEMICAL COMPANY AND SUBSIDIARIES

*Petitioner,*

v.

UNITED STATES OF AMERICA,

*Respondent.*

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ON PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE SIXTH CIRCUIT

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**REPLY TO BRIEF IN OPPOSITION**

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**RULE 29.6 STATEMENT**

The Dow Chemical Company has no parent corporation, and there is no publicly held company owning 10% or more of its stock. It is the parent of the subsidiaries included within the consolidated group for tax purposes as of the date of this petition, and no other publicly held company owns 10% or more of the stock of any of those subsidiaries. Subsidiaries that were members of the consolidated group for tax purposes during the tax years at issue, but are no longer included in The Dow Chemical Company's consolidated tax group, are not financially interested in the outcome of this litigation.

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## REPLY TO BRIEF IN OPPOSITION

Dow's petition presents two vital issues involving the economic substance doctrine on which the rulings by the panel majority below conflict with precedents of this Court and other circuits. The government seeks to perpetuate these conflicts for tactical advantage in other cases, and to defend the unwarranted outcome below, by mischaracterizing the majority's decision, the record, and the standards for a writ of certiorari. Recently, the Chief Counsel of the Internal Revenue Service ("IRS") has endorsed the importance of this case, as have members of the business community concerned about its substantial adverse impacts on *bona fide* business practices. See Br. *Amici Curiae* of the American Chemistry Council, U.S. Chamber of Commerce, and National Association of Manufacturers in Support of Petitioner ("Amici Br."). Review of both *Dow* issues is imperative.

### A. EVENTS SINCE THE FILING OF DOW'S PETITION CONFIRM ITS EXTRAORDINARY IMPORTANCE

1. Recent public statements by the IRS – nowhere acknowledged by the government – explicitly attest to the importance of the *Dow* decision. As summarized in *Tax Notes Today*, in a series of speeches in October 2006, IRS Chief Counsel Donald Korb<sup>1</sup> discussed recent cases – starting, notably, with *Dow* – and “emphasized the importance of the courts’ analyses.” Sheryl Stratton, 113 *Tax Notes* (TA) 394 (Oct. 30, 2006). Korb “believes” that “[t]he principles from those cases will be cited 20 years from now . . .” *Id.* “[He said the] important principle to be taken from . . . [*Dow*] is that companies have to be able to show that they’ve engaged in a particular course of conduct before the transaction for a court to believe they are likely to do

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<sup>1</sup> The Chief Counsel represents the IRS in litigation and is the chief expositor for the IRS on all legal issues. See I.R.M. 1.1.6.1 (July 29, 2005) (Internal Revenue Manual).

something in the future . . . .” *Id.* Furthermore, “[Korb] acknowledged the U.S. Supreme Court may need to clarify controversial economic substance issues . . . .” Daily Tax Rep. (BNA) (Oct. 27, 2006), at GG-1. *Dow* is only the tip of the iceberg, as “Korb noted” economic substance cases “are coming down the pike . . . .” 113 Tax Notes (TA) 394.

2. Coltec Industries, Inc. has filed a separate certiorari petition involving the economic substance doctrine. *See Coltec Indus., Inc. v. United States*, No. 06-659 (Nov. 8, 2006). That petition seeks review of a Federal Circuit decision that repeatedly relies on *Dow* and is similarly applauded by the IRS. *See Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1355 & n.13, 1356 & n.15 (Fed. Cir. 2006), *discussed in, e.g.*, 113 Tax Notes (TA) 394. The first issue presented in both *Coltec* and *Dow* is *identical*: the correct standard for appellate review of economic substance determinations. The two petitions also have closely related second issues. Coltec asks the Court to determine the role of business purpose in judging a transaction’s economic substance, while *Dow* asks the Court to confirm that all pertinent facts, including business purpose, are legally relevant in reaching that judgment. Thus, the *Coltec* decision and petition illustrate the increasing IRS focus on economic substance and the importance of *Dow*’s petition.

#### **B. THE FIRST QUESTION PRESENTED BY DOW WARRANTS THIS COURT’S REVIEW**

1. The government concedes (at 17) that, in “at least some” of the decisions in the five circuits following the “clear error” standard of review, the courts “were deferring to the ultimate determination on economic substance” and not “merely to underlying factual determinations.” In fact, any fair reading of the case law shows that the lower courts are in complete disarray on the standard for appellate review of the trial court’s ultimate determination. *See* Pet. 13-16.

2. This circuit split merits this Court’s attention. As demonstrated by numerous decisions cited in *Dow*’s petition

(at 16-17) – including decisions in which the standard of review was the only issue addressed – this Court has routinely ruled on this question in other areas because of its importance to the administration of the law. The issue has great significance here, especially because it is intolerable to have taxpayers treated differently based solely on which circuit has jurisdiction over the appeal. Indeed, the government opposes certiorari to preserve its ability, at least in the several circuits where the issue is still open, to advocate the standard of review of its choice depending on whether it won or lost at trial – a practice that is antithetical to a fair and just legal system.<sup>2</sup> *See also* Pet. 18-19.

3. The government contends (at 16-17) that *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978), establishes *de novo* review as the correct answer to the circuit split. But that contention ignores that the split is pervasive, has persisted long since *Frank Lyon* was handed down, and will not go away without this Court's intervention. In fact, the government itself has argued for deferential review despite *Frank Lyon*'s assertedly contrary holding.<sup>3</sup> Moreover, it is difficult to reconcile *de novo* review of factually based economic substance determinations with decisions such as *Comm'r v. Duberstein*, 363 U.S. 278, 290-92 (1947), and *Comm'r v. Heininger*, 320 U.S. 467, 475 (1943), where the Court called for deferential review of trial court determinations regarding "gift" and "ordinary and necessary business" expenses, respectively. *Frank Lyon* also

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<sup>2</sup> In *American Electric Power Co. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003), *cert. denied*, 540 U.S. 1104 (2004), *Cashman v. United States*, 1991 U.S. App. LEXIS 8658, at \*12 (9th Cir. 1991), *cert. denied*, 502 U.S. 1075 (1992), and *Newman v. Comm'r*, 902 F.2d 159, 162 (2d Cir. 1990), the government won at trial and then argued for clear error review. But in *Dow*, having lost at trial, the government argued for *de novo* review. *See* Gov't C.A. Br. 33.

<sup>3</sup> *See Rexnord, Inc. v. United States*, 940 F.2d 1094, 1096 (7th Cir. 1991), and cases cited in note 2 above.



largely predates this Court's articulation of general standard of review principles. Those principles argue strongly for deferential review of the trial court's determination that Dow's programs had "substantial [non-tax] effects on [its] beneficial interest." App. 153a; *see* Pet. 16-18.

4. The government also errs in arguing (at 18), without citation of any authority, that Dow did not preserve its right to contest the Sixth Circuit's standard of review ruling. An issue *is* preserved if *either* the court addressed the issue *or* the petitioner presented it below.<sup>4</sup> In this case, *both* bases for review have been satisfied. First, the Sixth Circuit expressly addressed the standard of review. *See* App. 9a & n.8. That by itself preserved the question, "particularly" because "the issue is . . . in a state of evolving definition and uncertainty, and one of importance to the administration of federal law." *Williams*, 504 U.S. at 41-42, *quoting Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1099 n.8 (1991) (citations and internal quotation marks omitted). Indeed, in *Lebron v. Nat'l Railroad Passenger Corp.*, 513 U.S. 374, 378-79 (1995) (alternative holding), the Court made clear that an issue may be raised so long as "it was addressed . . . below," *even if* the petitioner "disavowed" it in both lower courts.

Second, contrary to the government's selective quotation from Dow's brief below, Dow did not concede the issue. Rather, it vigorously argued that the correct standard of review is clear error, which is why the panel majority considered the question. A full reading of the pertinent portion of Dow's brief (*see* App. 214a & n.15) shows that all Dow did was to acknowledge that the debatable standard of review on the ultimate economic substance determination did not need – under the law as it then existed – to be decided

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<sup>4</sup> *See United States v. Williams*, 504 U.S. 36, 41 (1992) (emphasizing that "this rule operates . . . in the disjunctive"); *see also, e.g., Verizon Communications Inc. v. FCC*, 535 U.S. 467, 530 (2002) (exercising the Court's "broad discretion" to review "[a]ny issue 'pressed or passed upon below'").

where the government had simply challenged the district court's key factual findings as clear error. This was because, in Dow's words before the Sixth Circuit, under that law the "ultimate determination [on economic substance] follow[ed] directly from affirmance or reversal of" those findings – a point with which the dissenting judge below agreed (*see* App. 21a). Neither the circuit court nor the government was misled, as Dow expressly argued its side of the unsettled standard of review issue. In fact, if any party was misled, it was Dow, as the majority *sua sponte* changed the rules mid-game by inventing its exclusionary rule.<sup>5</sup>

5. Finally, despite the fact that the majority opinion below devoted significant attention to the standard of review, the government argues (at 19-20) that the majority's ruling was useless dictum because it "did not pass on *any* subsidiary factual issues in reversing the district court's ultimate determination on economic substance . . . ." The premise of this argument is false. The majority applied its novel exclusionary rule to the facts of the case itself rather than remand to the district court to do so, even though that court could easily have found that Dow's planned \$30 million cash infusion in its Great West policies was *not* a drastic departure from the \$60 million investment Dow actually made in the early years of that plan. *See* Pet. 29. The majority (App. 17a-20a) also reversed the district court's alternative holding that Dow's COLI programs had economic substance due to "risk transfer and the possibility of a mortality profit." App. 200a; *see* Pet. 11 n.4. The majority reasoned that the trial court had raised too "high" a "hurdle" as a prerequisite to finding that Dow's plans were designed

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<sup>5</sup> Contrary to the government's claim (at 18 n.4), Dow also questioned the standard of review in its rehearing petition (at 14) by criticizing the panel majority's effort to legalize the determination of economic substance through adoption of the *de novo* standard. *See* App. A hereto at 2a. In addition, it specifically argued for deferential review in a Rule 28(j) letter in support of its petition. App. 217a-19a & n.1.

to neutralize mortality gains.” App. 20a. But, again, the majority failed to remand to the trial court to determine whether Dow’s programs offered a sufficient degree of potential mortality profit to imbue them with economic substance, even though they transferred substantially more mortality risk to the insurers than existed in the prior COLI cases.<sup>6</sup> Instead, the majority substituted its own judgment “that Dow would not significantly benefit from mortality gains.” App. 20a. The majority’s actions would have been impermissible under the clear error standard of review.<sup>7</sup>

**C. THE SECOND QUESTION PRESENTED BY DOW WARRANTS THIS COURT’S REVIEW**

1. The government concedes (at 19) that the majority below ruled as a matter of law on the permissibility of considering future cash investment by the taxpayer in assessing economic substance. But the government gravely mischaracterizes the majority’s actual holding. Contrary to the government’s repeated refrain (*see, e.g.*, (I), 9), the majority did not rule that “the possibility” that the taxpayer would make “uncharacteristically large [future] cash contributions” should be “discounted.” Rather, the majority held that “future profits contingent on some future taxpayer action” that is “a drastic departure from . . . past conduct” must be totally “*ignored*” in judging economic substance – regardless of “*the likelihood of the investment*” based on

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<sup>6</sup> The trial judge, for example, specifically found that, even apart from the possibility of mortality profit from catastrophic loss, an 18% probability (almost double what MetLife considered appropriate) existed that death benefits would exceed the “stop-loss” limitation on mortality costs that MetLife could charge Dow. *See* App. 151a-52a. *Compare, e.g., American Electric Power Co.*, 326 F.3d at 743 (COLI program “*ensur[ed]*” that risk transfer to insurer, and hence potential for mortality gain by policy owner, “*ceased to exist*”) (emphasis added).

<sup>7</sup> *See, e.g., Duberstein*, 363 U.S. at 291-92; *United States v. Thomas*, 327 F.3d 253, 256-57 (3d Cir.), *cert. denied*, 540 U.S. 974 (2003); *see also, e.g., Pullman-Standard v. Swint*, 456 U.S. 273, 291-92 (1982).

“*the taxpayer’s plans*” and its economic incentives arising from “*the profitability of the transaction.*” App. 13a-15a & n.13 (emphasis added). By disregarding the italicized language, the government tries to paper over the broad sweep of the majority’s ruling, its inconsistency with precedents of this Court and other circuits, and the havoc that it wreaks on everyday *bona fide* financial planning.

2. The government argues that the majority did not violate *Knetsch v. United States*, 364 U.S. 361 (1960), in excluding consideration of Dow’s planned future cash investments because “[t]he better reading” of the *Knetsch* footnote on which the majority relied is that such exclusion is proper “when those contributions are ‘wholly unlikely,’ as an objective matter, in light of the taxpayer’s previous conduct . . . .” Br. in Opp. 11-12 (emphasis added). This gloss is inconsistent with the rule that the majority actually adopted, which excluded *objective* evidence demonstrating “the likelihood of the investment” as a result of “the profitability of the transaction.” See App. 14a n.13; see also, e.g., Pet. 8 (factors (2)-(4)). More importantly, it ignores the fact that the majority established an *irrebuttable presumption* that taxpayers who enter into transactions contemplating large future cash contributions may not rely on those contributions to establish economic substance regardless of contrary proof – based on actual business plans and financial incentives – that the investments in fact will be made. The *Knetsch* footnote surely established no such presumption, as the dissent below showed and tax practitioners have concluded. See Amici Br. 3. To the contrary, as previously explained (Pet. 19-21), the ruling below defies *Knetsch*’s overarching premise that future profitability due to future taxpayer action *must be* considered in judging economic substance – which is exactly what the majority did not do.

3. The same sleight of hand in the government’s treatment of *Knetsch* infects its discussion (at 13-15) of the other conflicting precedents cited by Dow (Pet. 21-27). In

fact, by conceding that this Court in *Frank Lyon* “credited the district court’s finding that ‘it was highly unlikely, as a practical matter, that any purchase option . . . would ever be exercised,’” the government admits that this Court does not indulge in arbitrary irrebuttable presumptions like the one erected by the majority below and, to the contrary, regards the likelihood of future cash contributions and other taxpayer action as highly relevant in determining economic substance. *Dubenstein* likewise establishes that tax benefits may not be withheld based on “overstatements of possible evidentiary inferences relevant to a factual determination.” 363 U.S. at 287 (emphasis added). The circuit court decisions cited by Dow similarly show that the taxpayer’s plans and financial incentives must be consulted in assessing a transaction’s economic substance. Thus, they establish a direct conflict with the ruling below.<sup>8</sup>

4. Finally, the government asserts (at 10, 15) that this case is “a poor vehicle” for consideration of the exclusionary ruling. But, contrary to the government’s claim, reversal of that holding *would be* outcome-determinative. As explained in Dow’s petition (at 11 n.4), but overlooked in the government’s opposition, the generation of net cash value establishes economic substance under Sixth Circuit law regardless of the potential for mortality gain. Further, the

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<sup>8</sup> The government ignores the holding in *Bailey v. Comm’r*, 912 F.2d 44 (2d Cir. 1990), that projected cash expenditures could *not* simply be disregarded, even though they dwarfed the taxpayer’s initial cash outlay. See Pet. 26. Moreover, contrary to the government’s arguments (at 14-15), in *Shirar v. Comm’r*, 916 F.2d 1414, 1416, 1418 (9th Cir. 1990) (quotation at 1418), the court specifically distinguished *Knetsch* and upheld the economic substance of the insurance program on the ground that Shirar, who had previously relied on policy loans to pay premium and interest, “did not plan to borrow the entire increased cash value . . . on an annual basis.” Here the district court also found that Dow did not intend to continue borrowing cash value. See Pet. 8. Also like Shirar, Dow had legitimate costs to fund (see Pet. 5) and purchased real insurance to do so. See, e.g., note 6 above.

government's prospect for success on other remaining issues is remote, as shown by the dissent's cogent rejection of them. App. 25a-27a, 31a-33a. In any event, the government's insistence (at 11) that an issue be "clearly outcome-dispositive" to justify review overlooks what this Court's frequent remands for consideration of other issues document: the Court withholds certiorari where an issue is "*irrelevant* to the ultimate outcome," but grants review where the issue appears to have a potential effect on the outcome and thus presents a case or controversy. See Robert L. Stern, *et al.*, SUPREME COURT PRACTICE 231 (8th ed. 2002) (emphasis added). That test is more than satisfied here.

The government's attempt (at 15) to relegate this case to "a context of little if any prospective importance" is similarly unfounded. The majority's exclusionary ruling already has left companies in such a quandary about the tax consequences of many important capital financing strategies having nothing to do with COLI that leading business associations have called for its prompt correction. Amici Br. 9. Moreover, the government disingenuously states (at 15) that it knows "of only one other pending case concerning the application of the economic-substance doctrine to . . . 'broad-based' COLI plans." While acknowledging that *post-1986* "broad-based" programs were being settled, the government itself advised the court below in a verified statement that *Dow* is "of *vital* importance in resolving the deductibility of the tax benefits claimed for *pre-1986* COLI programs" and that those programs "are expected to have a monetary impact *even exceeding* the \$4 billion dollar fiscal effect of *post-1986* broad based COLI plans."<sup>9</sup> This impact confirms the pressing need for review of both rulings below,

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<sup>9</sup> United States' Motion for Reconsideration of Order Denying Its Motion for Expansion of Word Limit, 6th Cir. No. 03-2360, at 2-3 (Nov. 19, 2003) (emphasis added) (excerpted in App. B hereto; see p. 4a). The 1996 legislation cited by the government (at 15) grand-fathered all pre-1986 policies for continued favorable tax treatment. See Pet. 4.

even apart from the effect on other business practices.

Finally, the government suggests (at 15) that the Court defer review until another circuit rejects the majority's exclusionary rule. As *amici* explain, the need for review is urgent because the rule *currently* has substantial adverse effects on business planning, and, as explained in Point A.1. above, the IRS has now pledged to enforce a broad reading of the rule. Moreover, the rule's conflicts with other decisions already are manifest, as are its legal errors that the government does not even attempt to address.<sup>10</sup> It suffices for certiorari that "the court of appeals has allegedly misconstrued, misapplied, or misconceived an applicable Supreme Court opinion . . ." Stern, *supra*, at 233. As the parties' disagreement on the meaning of the *Knetsch* footnote shows, and the dissent below confirms, that test is plainly met here.

#### CONCLUSION

Dow's petition for a writ of certiorari should be granted. If review is granted, Dow is prepared to comply with a briefing schedule shortened to permit argument this Term.<sup>11</sup>

Respectfully submitted,

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<sup>10</sup> The government, for example, offers no defense of the majority's irrebuttable presumption or exclusion of evidence critical to establish the very terms of the transaction to be reviewed. *See* Pet. 27-30.

<sup>11</sup> The Court may wish to grant review in both *Dow* and *Coltec* and hear the cases in tandem. This would enable a broader array of issues to be addressed. Despite the cases' substantial overlap, *Coltec* does not deal directly with the exclusionary rule raised in the *Dow* petition, while *Dow* does not directly address the circuit split on the test for economic substance raised in the *Coltec* petition (at 18-22). In tandem consideration of the two cases also would deepen the Court's understanding of all the issues presented because of different factual contexts and interdependent legal principles. *See* Point A.2. above. Further, *Dow* would be entitled to application in its favor of any ruling that calls into question the "disjunctive" test for economic substance applied by the panel below (*see* App. 8a).

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**APPENDIX A**

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UNITED STATES COURT OF APPEALS  
FOR THE SIXTH CIRCUIT

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No. 03-2360

THE DOW CHEMICAL COMPANY  
AND SUBSIDIARIES,  
*Plaintiff-Appellee,*

v.

UNITED STATES OF AMERICA,  
*Defendant-Appellant.*

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ON APPEAL FROM THE JUDGMENT OF THE  
UNITED STATES DISTRICT COURT FOR THE  
EASTERN DISTRICT OF MICHIGAN

---

PETITION FOR REHEARING WITH SUGGESTION FOR REHEARING  
EN BANC

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Beyond this, the majority's rulings reverse the proper relationship between appellate and trial courts. Appellate courts are supposed to defer to trial judges in assessing the evidence. *Anderson v. City of Bessemer*, 470 U.S. 564, 574-75 (1985). Historically, this Circuit observed this division of labor so scrupulously that even the ultimate judgment on economic substance – itself at bottom a factual determination – was reviewable only under the “clearly erroneous” test. *Ratliff v. Comm’r*, 865 F.2d 97, 98-99 (6th Cir. 1989), adopting *Yosha v. Comm’r*, 861 F.2d 494, 499 (7th Cir. 1988). But now, concluding that the standard of review has become *de novo* (see Slip op. at 5 n.8), the majority embarked on “legalizing” the determination of economic substance through the development of judge-made rules that second-guess and supersede the trial court’s factual findings. This will invite argument for more such rules and embroil this Court in factual disputes that should be decided in the district court on individual merit based on all relevant evidence.

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**APPENDIX B**

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UNITED STATES COURT OF APPEALS  
FOR THE SIXTH CIRCUIT

---

No. 03-2360

UNITED STATES OF AMERICA,  
*Appellant,*

v.

THE DOW CHEMICAL COMPANY  
AND SUBSIDIARIES,  
*Appellee.*

---

ON APPEAL FROM THE JUDGMENT OF THE  
UNITED STATES DISTRICT COURT FOR THE  
EASTERN DISTRICT OF MICHIGAN

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UNITED STATES' MOTION FOR RECONSIDERATION OF ORDER  
DENYING ITS MOTION FOR EXPANSION OF WORD LIMIT

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[ Received ]  
[ Nov 20 2003 ]  
[ By Fedex ]

\* \* \*

2. This case is of critical importance to the resolution of other COLI cases and will have a major impact on the federal fisc. The tax impact of this case for suit and non-suit years is over \$100 million. Moreover, this case has significance for other broad based COLI programs. Contrary to Dow's claim that all but five of the broad based COLI cases pending at the administrative level have settled (Op. at 2), settlement in some of these cases with a substantial monetary impact has not yet been finalized. Some, if not many, of those taxpayers could decide to rescind their non-binding elections to settle depending on the outcome of this appeal. Further, this case is also of vital importance in resolving the deductibility of the tax benefits claimed for pre-1986 COLI programs. *See*, TAM 200213010, 2002 TNT 62-19. (IRS recently stated that the economic sham doctrine is equally applicable to disallow deductions attributable to highly leveraged COLI programs purchased prior to June 20, 1986. This was the effective date of the \$50,000 per policy loan limitation of Section 264 (a)(4)(1986), which spawned the advent of broad based COLI programs as at issue in the instant case.) The open and future tax years for pre-1986 COLI programs are expected to have a monetary impact even exceeding the \$4 billion dollar fiscal effect of post-1986 broad based COLI plans.

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