

Don't Make *Coltec* Problem Worse

The Supreme Court has left the economic-substance doctrine alone, despite its flaws. Congress should do the same.

BY GREGORY N. KIDDER

Although the Supreme Court has declined to review an important case on the “economic substance doctrine,” Congress still may take up the issue. If it does, new legislation may unfortunately introduce more confusion into tax law and penalize American businesses.

On Feb. 20, the Supreme Court declined to review the U.S. Court of Appeals for the Federal Circuit’s 2006 decision in *Coltec v. United States*. This lets stand a decision for the government that provided that, although the Internal Revenue Code produced the federal income-tax benefits claimed by the taxpayer from the transaction at issue, the taxpayer, nevertheless, was not entitled to those benefits because the transaction violated the economic-substance doctrine—a judicial doctrine that generally overlays the detailed provisions of the code.



Coltec is not the only recent such pro-government decision. For example, in the 2006 case of *Black & Decker v. United States*, the 4th Circuit remanded a pro-taxpayer decision on a similar transaction for further consideration of the economic-substance doctrine, ultimately resulting in a recent settlement between the taxpayer and the government. Yet despite the government’s victories in court, Congress is now considering proposals to create a legislative version of the economic-substance doctrine.

Although many tax practitioners believe the consequences of *Coltec* may be bad for the administration of the tax law, particularly because of the decision’s ambiguity and focus on an individual step in a larger transaction, the consequences of codifying the economic-substance doctrine would likely be even worse.

ECONOMIC SUBSTANCE

The transaction in *Coltec* was engaged in by numerous other

taxpayers. In general, it involved the transfer of assets and contingent liabilities to a subsidiary followed by a sale of stock in that subsidiary.

Unlike other notable transactions labeled by many as “abusive tax shelters,” the contingent-liability transaction combined an arguably sensible business management strategy— isolating contingent liabilities in a subsidiary and treating their management as a business itself—with a favorable tax result—the ability to claim an immediate capital loss. The favorable tax result was obtained because the liabilities reduced the fair-market value of the stock in the subsidiary, but those liabilities did not reduce the taxpayer’s basis in the stock of that subsidiary. Accordingly, upon a sale of the stock, the taxpayer recognized a capital loss because of the unreduced basis in the stock.

On audit and in litigation, the government challenged the technical merits of the position articulated by taxpayers supporting the benefits of this so-called contingent-liability transaction, but the government’s technical arguments were regarded by most as untenable and have been rejected by every court that has considered them. In fact, Congress changed the law regarding transfers of liabilities to subsidiaries in 2000—after the transactions like those in *Coltec* and *Black & Decker* became public—by adding Section 358(h) to change the tax code to eliminate the result claimed by taxpayers most viewed as technically accurate under prior law.

The government’s stronger argument to undo the consequences of the transactions before the legislative change was that the transactions violated the economic-substance doctrine. The economic-substance doctrine is a judicially created doctrine. It is generally regarded as a two-part test: (1) whether the transaction had real economic consequences, and (2) whether the taxpayer had a business purpose for engaging in the transaction (other than to generate tax benefits). If a transaction fails this two-part test, the tax consequences flowing from such a transaction may be disregarded, and the taxpayer pays taxes as if the transaction had never occurred.

Different courts have applied this two-part test differently. Certain courts require taxpayers to fail both parts of this test

before a transaction is disregarded, and certain courts require taxpayers to fail only one. Still other courts apply the test by making both inquiries and reaching an overall conclusion.

COLTEC'S PROBLEMS

The Federal Circuit's application of the economic-substance doctrine in *Coltec* was controversial primarily for two reasons.

First, the Federal Circuit's opinion was unclear about whether a taxpayer must fail both parts of the test before a transaction will be disregarded. Although a footnote appeared to make clear that the opinion rejected the view of the 4th Circuit that both parts of the test must be failed before a transaction is disregarded, other parts of the opinion were unclear. Moreover, the court did not address the relative importance that should be granted to each inquiry, nor did it articulate a coherent standard for those inquiries.

Second, in applying its version of the economic-substance test, the Federal Circuit focused solely on a single step in the transaction giving the taxpayer the high stock basis—the transfer of the liabilities to a subsidiary—and concluded that *Coltec* had not demonstrated any business purpose for that specific step in the transaction. The court rejected *Coltec*'s claim that isolating contingent liabilities in a subsidiary would strengthen its position against potential veil-piercing claims on the reasoning that the actions affected relations only among *Coltec* and its own subsidiaries and had no effect on third parties.

The conception that the economic-substance doctrine should be applied to individual steps in a transaction is new ground broken by the court in *Coltec*. It represents a marked change from the general application of the test previously to the transaction as a whole.

There is a good reason for the accepted position of focusing on the transaction as a whole: Individual steps in a larger transaction might serve little purpose standing alone but may be an integral part of accomplishing an economically motivated result. Under these circumstances, the transaction as a whole, including individual steps that would not be performed in isolation, should be entitled to respect.

The overall transaction in *Coltec* may or may not have met this standard. Good arguments can be made that the taxpayer's facts in *Coltec* were not particularly strong and that other contingent-liability transactions engaged in by different taxpayers may have passed scrutiny.

Regardless of the specific facts at issue, isolating one piece of the transaction and narrowing the focus of the economic-substance doctrine to that individual piece represents a troubling expansion of the court's authority that may cause unnecessary uncertainty regarding legitimate transactions. It is for this reason that many tax practitioners fear that the consequences of *Coltec* will be the application, or at least the attempted application, of the economic-substance doctrine in many unforeseen cases.

This would shift the focus of audits and tax litigation from the correct technical application of the Internal Revenue Code to a subjective evaluation of taxpayers' motives, not only for the transaction itself but for each step in the transaction.

ACTION IN CONGRESS?

At the same time, taxpayers such as the one in *Coltec* have

been defending their transactions in court from attacks by the government under the economic-substance doctrine, Congress has been considering a steady stream of proposals to create a legislative version of the same doctrine.

At first blush, one could view such legislative efforts as beneficial. On the surface, they appear to decrease the amount of ambiguity inherent in the application of the economic-substance doctrine. They would at least articulate one standard to be applied in all cases, rather than leaving the interpretation of complex precedent to the courts, which has resulted in conflicts among circuits.

Upon a deeper examination of the codification proposals, however, the amount of ambiguity would increase—which would hurt both taxpayers and the government. The proposals are ambiguous with respect to both when and how the economic-substance doctrine will apply. Private practitioners, taxpayers, and even Internal Revenue Service and Treasury Department officials have all opposed past proposals to create a legislative economic-substance doctrine generally for this reason.

The recent proposals, including S. 96 Section 202, introduced by Sen. John Kerry (D-Mass.) on Jan. 4, provide that a transaction should be tested for economic substance if a court determines that the economic-substance doctrine is "relevant" to the transaction. The proposals provide that, when a court finds the doctrine "relevant," a transaction will have economic substance only if, among other requirements, the transaction changes in a "meaningful way" the taxpayer's economic position. The proposals also provide that the taxpayer have a "substantial" nontax purpose for "entering into" such transaction and the transaction must be a "reasonable" means of accomplishing this purpose.

The proposed statute adds nothing to current law regarding when the doctrine should be applied. It simply adds words to describe the subjective discretion that already exists in the judicial application of the doctrine. "Relevant," "meaningful," "substantial," and "reasonable" are just as subjective and uncertain, if not more so, than the current judicial authority. In effect, the proposal would simply add new words for the judicial interpretations, which would replace the current legal authority developed over decades in finely nuanced cases with specific facts.

A FRIGHTENING PENALTY

Further, the most recent version of the codification proposal contains a frightening penalty provision. The proposal would cause taxpayers like *Coltec*, whose transactions were upheld as legitimate by lower courts, not only to lose the tax benefits of their transactions when the IRS takes a different view but also to be charged an additional 40 percent penalty.

Under the current proposal, the reasonable-cause exceptions that normally apply to all other accuracy-related tax penalties would not apply. The only way to avoid this penalty would be to obtain the personal approval of the commissioner of internal revenue.

This proposed structure effectively makes the penalty a 40 percent "no-fault" penalty that is imposed without any deliberate

wrongdoing by the taxpayer. This seems particularly unwise. There is no justification for imposing such a severe penalty when the standards are subjective and ambiguous.

The inclusion of the “no-fault” 40 percent penalty is evidence of what many regard as the real motivation for the codification proposals. In today’s political climate, in order to extend expiring tax cuts, Congress generally must pay for such constituent benefits by increasing revenue in some other fashion. Congress has estimated that proposals to codify the economic-substance doctrine might raise billions of dollars, creating a revenue raiser that is not as politically damaging as, for example, raising individual income-tax rates.

Although it is unclear how the aggressive and effective application of current authority against taxpayers in cases like *Coltec*

affects these estimates, many believe the perceived revenue boost is the driving force behind the continued congressional push for codification.

The continuing subjectivity in the current proposal, combined with the unjustifiable (but potentially lucrative) 40 percent penalty, leaves little room for a different conclusion. Despite the perceived shortcomings in the *Coltec* decision, the Supreme Court decided to leave the economic-substance doctrine alone. Congress would be wise to do the same.

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