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***Coltec* and Its Consequences**

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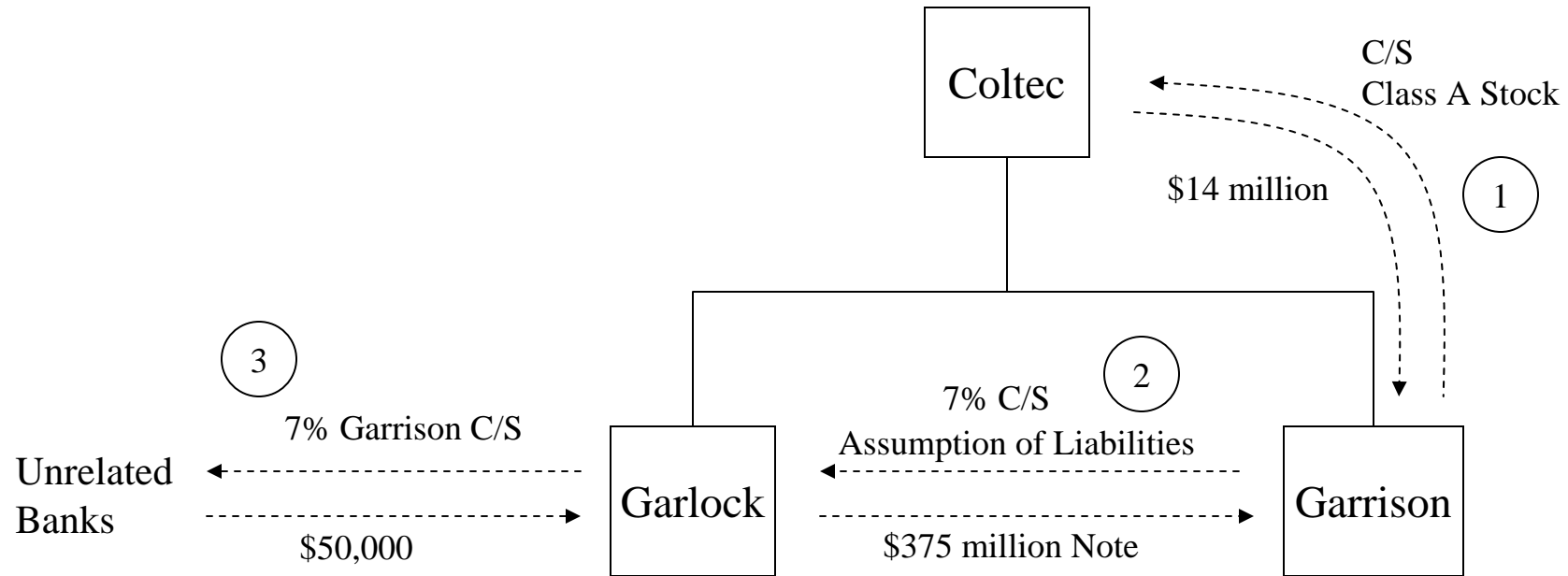
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Introduction

- On July 16, 2006, the Federal Circuit issued its opinion in *Coltec v. United States*, reversing the Court of Federal Claims and holding that the contingent liability transaction at issue lacked economic substance.
- This presentation examines the transaction at issue, the opinion of the Federal Circuit, and the potential implications for other transactions.
- Attached are two appendices.
 - The first is an outline discussing the issues in this presentation in greater detail.
 - The second is an article published by Tax Executive Magazine discussing these issues.

Coltec Transaction



Facts: Coltec, a publicly traded company with numerous subsidiaries, sold the stock of one of its businesses in 1996 and recognized a gain of approximately \$240.9 million. Garlock, a subsidiary of Coltec, and its own subsidiary had both previously manufactured or distributed asbestos products and faced substantial asbestos-related litigation claims. Coltec caused another one of its subsidiaries, Garrison, to issue common stock and Class A stock to Coltec in exchange for approximately \$14 million. In a separate transaction, Garrison issued common stock to Garlock that represented approximately a 6.6% interest in Garrison and assumed all liabilities incurred in connection with asbestos related claims against Garlock, as well as the managerial responsibility for handling such claims. In return, Garlock transferred the stock of its subsidiary, certain relevant records to the asbestos-related claims, and a promissory note (from one of its other subsidiaries) in the amount of \$375 million. Garlock then sold its recently acquired Garrison stock to unrelated banks for \$500,000. As a condition of sale, Coltec agreed to indemnify the banks against any veil-piercing claims for asbestos liabilities. On its 1996 tax return, Coltec claimed a \$378.7 million capital loss on the sale of Garrison stock, which equaled the difference between Garlock's basis in the stock (\$379.2 million) and the sale proceeds (\$500,000).

Coltec Decision – Court of Federal Claims

- The Court of Federal Claims entered judgment in favor of Coltec, upholding the capital loss claimed by Coltec from the contingent liability transaction at issue in this tax refund litigation.
- The Court of Federal Claims relied on the District Court analysis in *Black & Decker* to hold that the operation of the applicable code sections justified a capital loss.
- The contribution of assets in exchange for stock and the assumption of the liabilities qualified as a nontaxable exchange under section 351.
- Under section 358, the transferor received a basis in the stock equal to the basis of the assets contributed. Ordinarily, when a transferee in a section 351 exchange assumes liabilities of the transferor, the transferor's basis in the transferee's stock is reduced by the amount of the liabilities. However, under sections 358(d)(2) and 357(c)(3), if the satisfaction of the liabilities would have given rise to a deduction to the transferor, the assumption of such liabilities does not reduce basis. Because satisfaction of the liabilities assumed by the transferee would have given rise to a deduction to the transferors (had the liabilities not been transferred), the basis of the stock is not reduced by the liabilities assumed under section 358(d)(2). After the transfer, payment of the liabilities would give rise to a deduction by the transferee. See Rev. Rul. 95-74, 1995-2 C.B. 36 (1995). The government argued that section 357(c)(3) requires that payment of the liabilities would give rise to a deduction by the *transferor*. The court held that this interpretation was incorrect.
- In addition, the court held that section 357(b) did not require basis to be reduced because there was a bona fide business for the assumption of the liabilities.

Coltec Decision – Court of Federal Claims

- The Court of Federal Claims rejected the government's argument that the capital loss should nonetheless be disallowed under the economic substance doctrine.
- The court refused to apply the economic substance doctrine to the transaction because the transaction satisfied the statutory requirements of the Code. The court stated: “[I]t is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare.... Where the taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the ‘economic substance’ doctrine to trump ‘mere compliance with the Code’ would violate the separation of powers.”

Coltec on Appeal – Federal Circuit

- The Federal Circuit (Judges Bryson, Gajarsa and Dyk) reversed the opinion of the Court of Federal Claims and held that the taxpayer was not entitled to a capital loss because the assumption of the contingent liabilities in exchange for the note lacked economic substance.
- The Federal Circuit upheld the technical analysis of the Court of Federal Claims.
- The court concluded that section 357(c)(3) applies because payment of the liability would give rise to a deduction. The court stated that the government's interpretation that the liabilities must be transferred with the underlying business was plainly inconsistent with the statute.
- The court concluded that if a liability was excluded by section 357(c)(3), then section 357(b)(1) was not relevant. The court reasoned that the exception in section 358(d)(2) for liabilities excluded under section 357(c)(3) does not contain any reference to section 357(b), nor does section 357(b) contain any reference to the basis provisions in section 358.

Coltec on Appeal – Federal Circuit

- However, the Federal Circuit reversed the Court of Federal Claims decision with respect to economic substance and held that the transfer of liabilities in exchange for the note should be disregarded.
- The Federal Circuit identified five (5) principles of economic substance.
 - The law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality;
 - It is the taxpayer that has the burden of proving economic substance;
 - The economic substance of a transaction must be viewed objectively rather than subjectively;
 - The transaction to be analyzed is the one that gave rise to the alleged tax benefit;
 - Arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

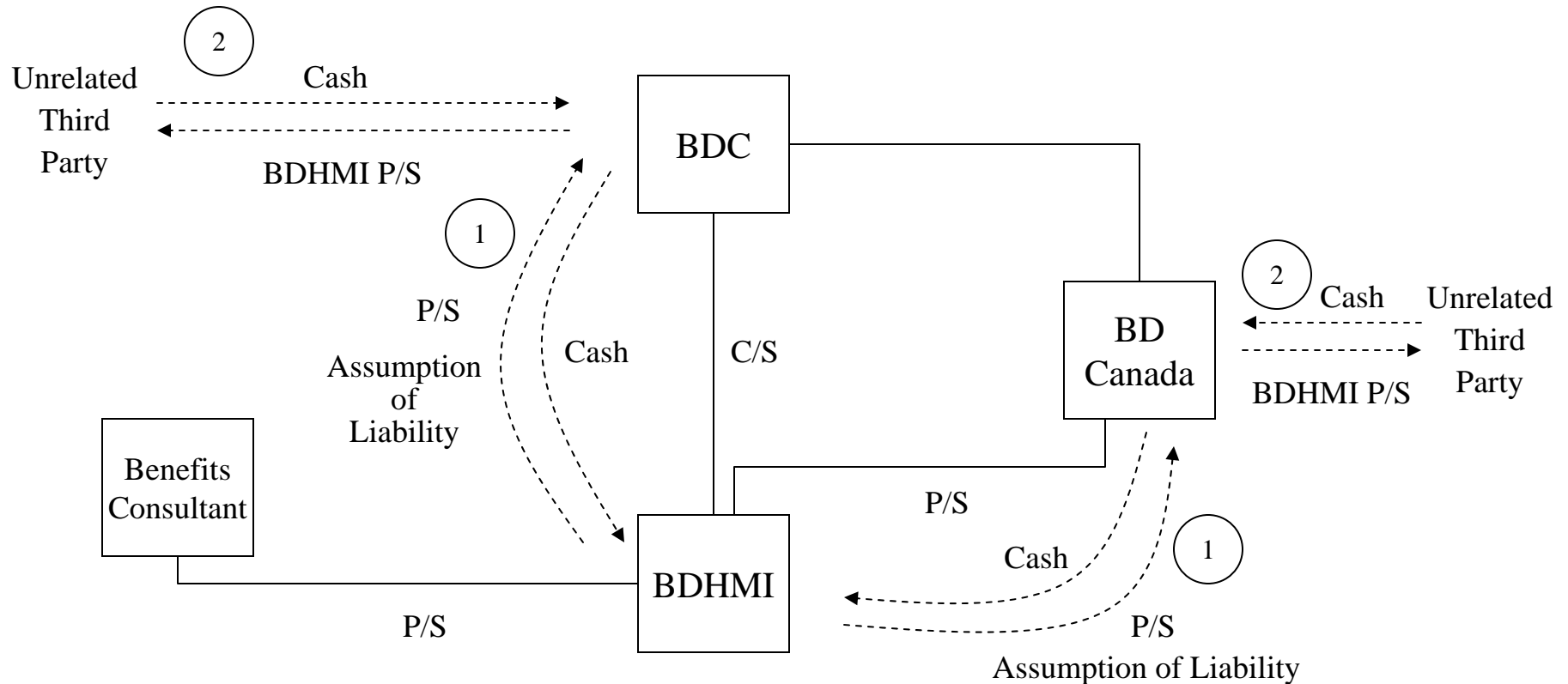
Coltec on Appeal – Federal Circuit

- In applying the economic substance test, the Federal Circuit focused solely on the transaction giving Coltec the high stock basis (i.e., the assumption of the liabilities in exchange for the note) and concluded that Coltec had not demonstrated any business purpose for that transaction.
- The court rejected Coltec's claim that it would strengthen its position against potential veil-piercing claims, since it only affected relations among Coltec and its own subsidiaries and had no effect on third parties.

Coltec Cert Petition

- Coltec has filed a cert petition with the Supreme Court.
- One of the two questions presented for review in the cert petition relates to the disjunctive vs. conjunctive nature of the economic substance test and the current circuit split.
 - The cert petition stated the question as follows: "Where a taxpayer made a good-faith business judgment that the transaction served its economic interests, and would have executed the transaction regardless of tax benefits, did the court of appeals (in acknowledged conflict with the rule of other circuits) properly deny the favorable tax treatment afforded by the Internal Revenue Code to the transaction based solely on the court's "objective" conclusion that a narrow part of the transaction lacked economic benefits for the taxpayer?"
- The other question presented for review in the cert petition relates to the standard of review in economic substance cases.
 - The cert petition stated the question as follows: "In determining that a transaction may be disregarded for tax purposes, should a federal court of appeals review the trial court's findings that the transaction had economic substance de novo (as three courts of appeals have held), or for clear error (as five courts of appeals have held)?"
- Dow Chemical Co. filed a cert petition on October 4, 2006 that presented similar questions.

Black & Decker Transaction



Facts: BDC owned all of the common stock of BDHMI. The preferred stock of BDHMI was owned by a third-party Benefits Consultant and BD Canada, which was a subsidiary of BDC. The following two-step transaction occurred. First, BDC and BD Canada contributed \$561 million in cash to BDHMI in exchange for \$1 million of BDHMI preferred stock and BDHMI's assumption of future health benefits claims against BDC and BD Canada, which the parties valued at \$560 million. Second, BDC and BD Canada sold to the same unrelated third party all of the BDHMI preferred stock received in the exchange 34 days after the exchange for \$1 million. BDC and BD Canada reported a \$560 million capital loss from the sale, the difference between the claimed basis in the preferred stock (\$561 million) and the consideration received in the sale (\$1 million). The Service disallowed the \$560 million capital loss.

Black & Decker – District Court of Maryland

- The Service and the taxpayer filed motions of summary judgment in the District Court of Maryland.
- The District Court denied the Service’s motion for summary judgment, finding that the taxpayer had satisfied the technical requirements under the Code to claim the \$560 million capital loss on the sale of the BDHMI preferred stock. See 2004-2 U.S.T.C. (CCH) ¶ 50,359 (D. Md. 2004).
 - The District Court found that the taxpayer was entitled to claim a high basis in the BDHMI preferred stock because, in the section 351 transfer, the contingent liabilities assumed by BDHMI would give rise to a deduction and, thus, by operation of section 357(c)(3), that assumption of such liabilities would not be treated as a cash transfer by BDHMI to BDC and BD Canada under section 358(d) to reduce the basis in the BDHMI preferred stock received by BDC and BD Canada.
- The District Court granted the taxpayer’s motion summary judgment, rejecting the Service’s argument that the transaction at issue lacked economic substance. See 2004-2 U.S.T.C. (CCH) ¶ 50,390 (D. Md. 2004).

Black & Decker On Appeal – Fourth Circuit

- In *Black & Decker Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006), the 4th Circuit agreed with the lower court's denial of the Service's motion for summary judgment, finding that the transaction satisfied the literal requirements of the Code.
- However, the 4th Circuit remanded the case back to the District Court to determine whether the underlying transaction lacked economic substance.
 - Although the District Court quoted the two-prong test as set out in *Rice's Toyota World*, the Circuit Court found that it misapplied the economic substance prong by focusing on Black and Decker's general business activities rather than "whether a reasonable possibility of profit from the transaction existed apart from tax benefits." (citing *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985))
 - Furthermore, the Circuit Court emphasized the District Court's failure to consider and evaluate the Service's expert witness reports, which would have raised questions about Black and Decker's reasonable expectation of profiting from the transaction. These expert reports, according to the Circuit Court's opinion, created triable issues of fact.
 - Citing to *Hines v. United States*, 912 F.2d 736 (4th Cir. 1990), the 4th Circuit stated that the "ultimate determination of whether an activity is engaged in for profit is to be made...by reference to objective standards." *Id.* at 740.
 - Accordingly, the Circuit Court remanded the economic substance issue to the District Court for trial.

Audit/Litigation Issues Raised by *Coltec*

What Test for Economic Substance Does the Federal Circuit Apply in *Coltec*?

- How does the test compare to the more commonly applied two prong test for (i) economic reality and (ii) business purpose?
 - The Court of Federal Claims described the test as a two prong test and declared the test satisfied because *Coltec* had a business purpose.
 - See also *Rice's Toyota*, 752 F.2d 89, 91 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction and that the transaction has no economic substance because no reasonable possibility of a profit exists.”)
 - In *Drobny v. United States*, the Federal Circuit quoted the *Rice's Toyota World* two-prong test as the applicable standard. *Drobny*, 86 F.3d at 1174. Further, the Federal Circuit made it clear that a taxpayer could avoid sham transaction treatment even if it failed one prong of the test, stating: “If the only expectation of profit is one based on tax deductions and credits, the transaction is not necessarily a sham.” See *Johnson v. United States*, 32 Fed. Cl. 709 (Cl. Ct. 1995), *aff'd sub nom, Drobny v. United States*, 86 F.3d 1174 (Fed. Cir. 1996).
- Is the test applied by the Federal Circuit in *Coltec* (i) a unitary test for economic reality, (ii) a unitary test for business purpose, or (iii) a conjunctive test for both?
- Some support can be found in the opinion for all three theories

Theory 1: Unitary test for economic reality; Business purpose irrelevant

- “While the doctrine may well also apply if the taxpayer’s sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer’s sole motive is tax avoidance.”
 - Conclusion cited above speaks in terms of economic reality, stating that the court found “nothing indicating that the transfer of liabilities in exchange for the note effected any real change in the “flow of economic benefits,” provided any real “opportunity to make a profit,” or “appreciably affected” Coltec's beneficial interests aside from creating a tax advantage.”

Theory 2: Unitary test for business purpose; Economic reality irrelevant

- “The ultimate conclusion as to business purpose is a legal conclusion, which we review without deference, and the underlying relevant facts are in large part undisputed.”
- The opinion is structured as a rebuttal to two business purpose theories offered by Coltec.
 - “Coltec offered two arguments for why the liabilities-note transaction had economic substance in this context: (1) because the creation of Garrison to manage the asbestos liabilities would make Coltec more attractive and (2) because the transaction would add a barrier to veil-piercing claims against Coltec. Neither of these theories suggests that the transaction at issue has economic substance.”
 - The court addresses each of these business purposes and rejects them as valid reasons to do the transaction.
- The court cites *Black & Decker*, *Nicole Rose Corp.* and *ACM Partnership* and concludes, “These cases recognize that there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate).” This assertion by the court appears to suggest the critical distinction is the taxpayer’s motive or purpose for the transaction.
- The court’s reliance on *Basic, Inc.* suggests it is focused exclusively on business purpose. The court cites *Basic, Inc.* for the proposition that the transaction should be analyzed for economic substance on a step-by-step basis and describes *Basic, Inc.* in footnote 16 as finding “the inter-company transaction should be disregarded because it had no “*valid business grounds*”).

Theory 3: Conjunctive test; Economic reality and business purpose required or transaction is a sham

- It's possible to interpret the two previous slides as in effect creating a conjunctive test that requires both economic reality and business purpose for a transaction to survive economic substance scrutiny and not be disregarded.
- Footnote 14 in the opinion rejects the disjunctive formulation of the test.
 - “We think that the rule adopted by the Fourth Circuit and reiterated in *Black & Decker*—that a transaction will be disregarded only if it both lacks economic substance and is motivated solely by tax avoidance—is not consistent with the Supreme Court’s pronouncements in cases such as *Frank Lyon*.”
 - This footnote can be read to suggest that the Federal Circuit is adopting a conjunctive test instead.

Application of Economic Substance Test on a Step by Step basis

- One of the five principles articulated is “[t]he transaction to be analyzed is the one that gave rise to the alleged tax benefit.” The court uses this principle to justify breaking a larger transaction down into individual steps and applying the economic substance test to each step.
- The court states the proper “transaction to be analyzed” is “Garrison’s assumption of Garlock’s asbestos liabilities in exchange for the \$375 million note.” The court distinguishes this transaction from the transfer of management activities regarding the liabilities, which the court concedes “may have had economic substance.”
- This step-by-step application of the economic substance doctrine appears inconsistent with caselaw. The step transaction doctrine—whether applied as a binding commitment test, an interdependence test, or an end result test—treats transactions as a whole. This step-by-step formulation of the economic substance test by the Federal Circuit appears to be the exact opposite.
- How do we determine which piece of an overall transaction is the “transaction to be analyzed”?
- Isn’t the tax benefit of the transaction in *Coltec* realized on the stock sale? What if the stock was never sold? How can the court justify focusing its economic substance inquiry on a narrow piece of a transaction that does not produce the tax benefit at issue?

Higher Scrutiny for Related Party Transactions

- The last principle of economic substance cited by the Federal Circuit is “arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.”
- When does a transaction with a related party have economic substance under the Federal Circuit’s “close scrutiny” principle?

Effect of *Coltec* on Evaluating Forums to Resolve Tax Controversies

- How does the Federal Circuit decision in *Coltec* affect taxpayers' choices in evaluating whether to litigate in Tax Court, District Court, or the Court of Federal Claims?
- What is the importance of the high reversal rate in the application of the economic substance doctrine?
 - Taxpayers lost in trial court in *IES Industries*, *Compaq*, and *UPS*. In each case, the Appeals court reversed and found in favor of the taxpayer.
 - Taxpayers won in trial court in *Dow, TIFD, III, Inc. (Castle Harbour)*, *Black & Decker*, and *Coltec*. Appeals court reversed and found in favor of the government in *Dow, TIFD, III, Inc. (Castle Harbour)*, and *Coltec* and reversed and remanded for a revised application the economic substance doctrine in *Black & Decker*.
- Should taxpayers approach economic substance cases in trial courts differently in order to prepare for an appeal?

Transactional Tax Issues Raised by *Coltec*

Coltec Transactional Tax Issues

- How Would the Analysis Change if Certain Facts Were Altered?
 - What if Garlock did not guarantee up to \$200 million to cover Garrison's capital needs?
 - What if Garlock never sold the stock of Garrison? Does a taxpayer need a business purpose to transfer liabilities to a subsidiary even if no sale of the subsidiary is contemplated?
- What Does it Mean to Disregard a Transaction?
 - In Coltec, the Federal Circuit court disregarded both the transfer of the liabilities and the transfer of the note. The entire transaction was voided.
 - What happens when the subsidiary pays off the liabilities?
 - Who gets the deduction?
 - Are there other tax consequences? Is the payment of the liability by the subsidiary a deemed payment to the parent?
 - Why is the transfer of the note voided? Do you need a business purpose to transfer a note to a subsidiary? Why are the transfer of the note and the transfer of the liabilities treated as a single step and not analyzed separately under the courts theory that "the transaction to be analyzed is the one that gave rise to the alleged tax benefit?"
 - What happens when the subsidiary receives payments on the note?
 - What happens to the buyer of the Garrison stock if the transfer of the liabilities and transfer of the note are ignored? Is the purchase also ignored? Is the purchase price adjusted?

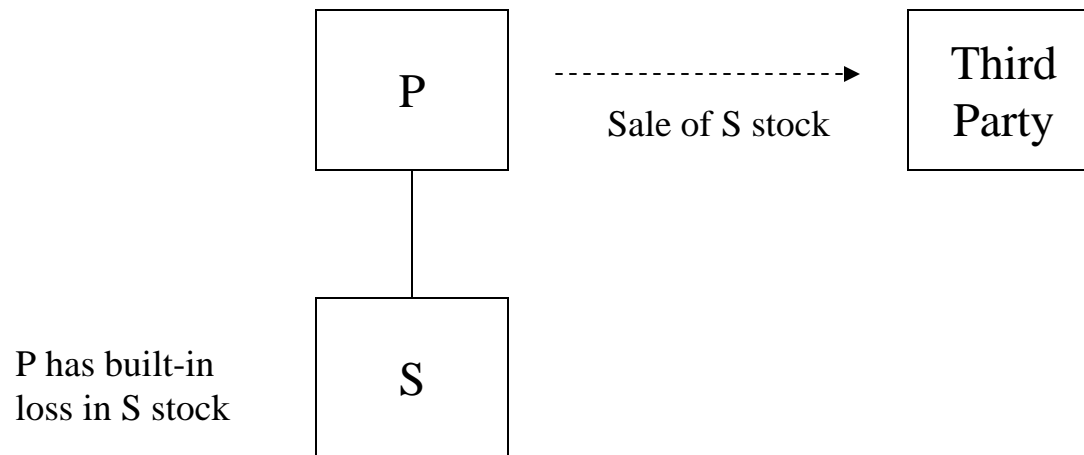
Coltec Transactional Tax Issues

- What are the implications of the technical analysis in *Coltec* for other Transactions?
- In light of the rulings by both the Fourth Circuit in *Black & Decker* and the Federal Circuit in *Coltec*, have any of the government's positions been revised with respect to the application of section 357(c)(3) in other rulings?
- What is the Service's current position with respect to contingent liability transactions? Is the position that section 358(h) applies? Or is the position that *Coltec* controls and section 358(h) does not apply because the transfer was a sham? If the later, does section 358(h) ever apply?
- There is a critical difference between the result under section 358(h) and the result in *Coltec*. Under section 358(h), the transaction is respected, but the basis in the stock of the subsidiary is reduced by the amount of the contingent liabilities. In contrast, the Federal Circuit in *Coltec* declared that the transfer of a note and the transfer of contingent liabilities should be completely ignored. These two different treatments could lead to different results (e.g., who gets the deduction when the liabilities are paid, what happens when payments are made on the note).
- Assuming that section 358(h) applies, will the government follow Rev. Rul. 95-74 and allow the transferee subsidiary to claim a deduction on payment of the liabilities?

Implications of the Step-by-Step Economic Substance Analysis in *Coltec* for Other Transactions

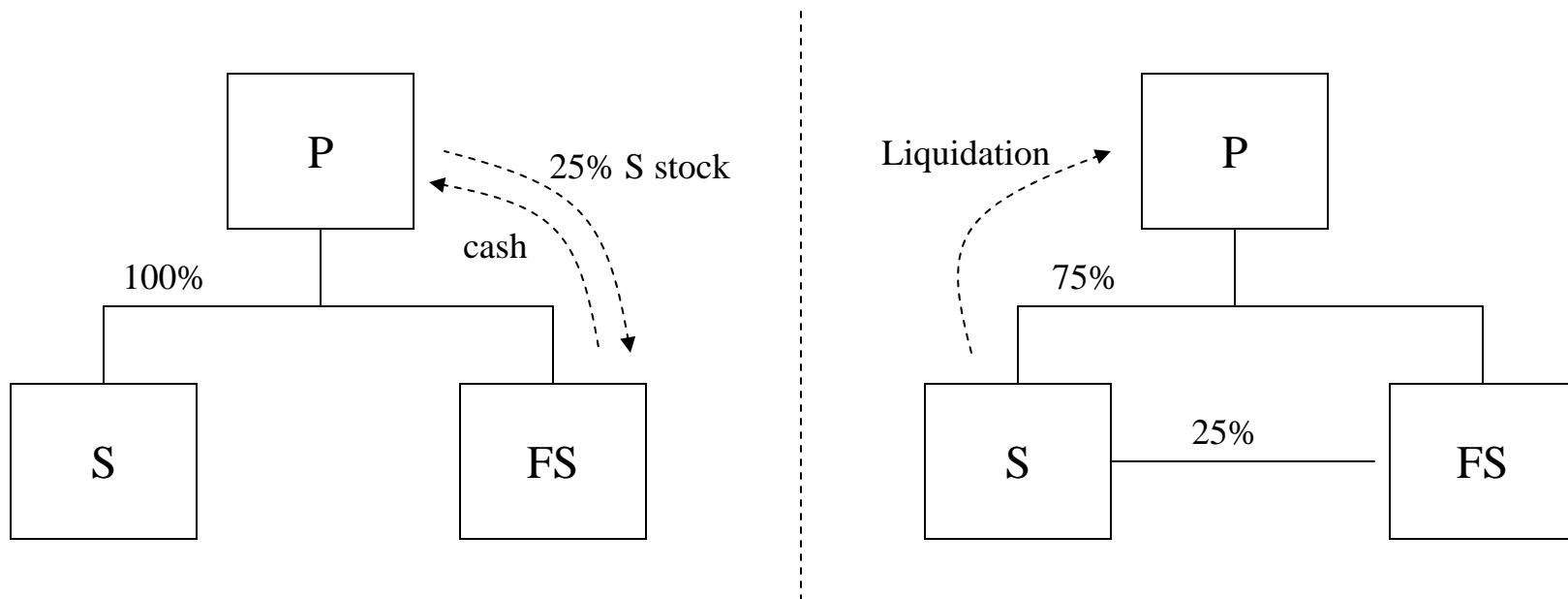
- Just as the Supreme Court's shifting and hard to define standards in its obscenity jurisprudence left many examining works to determine whether they were so offensive as to be prohibited speech, the Federal Circuit's new conception of the economic substance doctrine raises many questions about current common transactions and whether such transactions will be deemed prohibited by the courts, even if authorized by the Internal Revenue Code.
- The following slides depict common transactions that may be subject to review based on the analysis in *Coltec*.
- Under current law, all of these transactions should have clear results and these results should not be undone by the Federal Circuit's *Coltec* analysis.

Sale to Recognize Loss



- May a taxpayer sell stock solely to recognize a loss under the Federal Circuit's analysis in *Coltec*?
- The Supreme Court in *Cottage Savings* allowed a taxpayer to exchange mortgage securities for other mortgage securities and recognize a loss. The transaction was done solely for tax purposes and was disregarded for regulatory purposes. Can *Coltec* and *Cottage Savings* be reconciled?

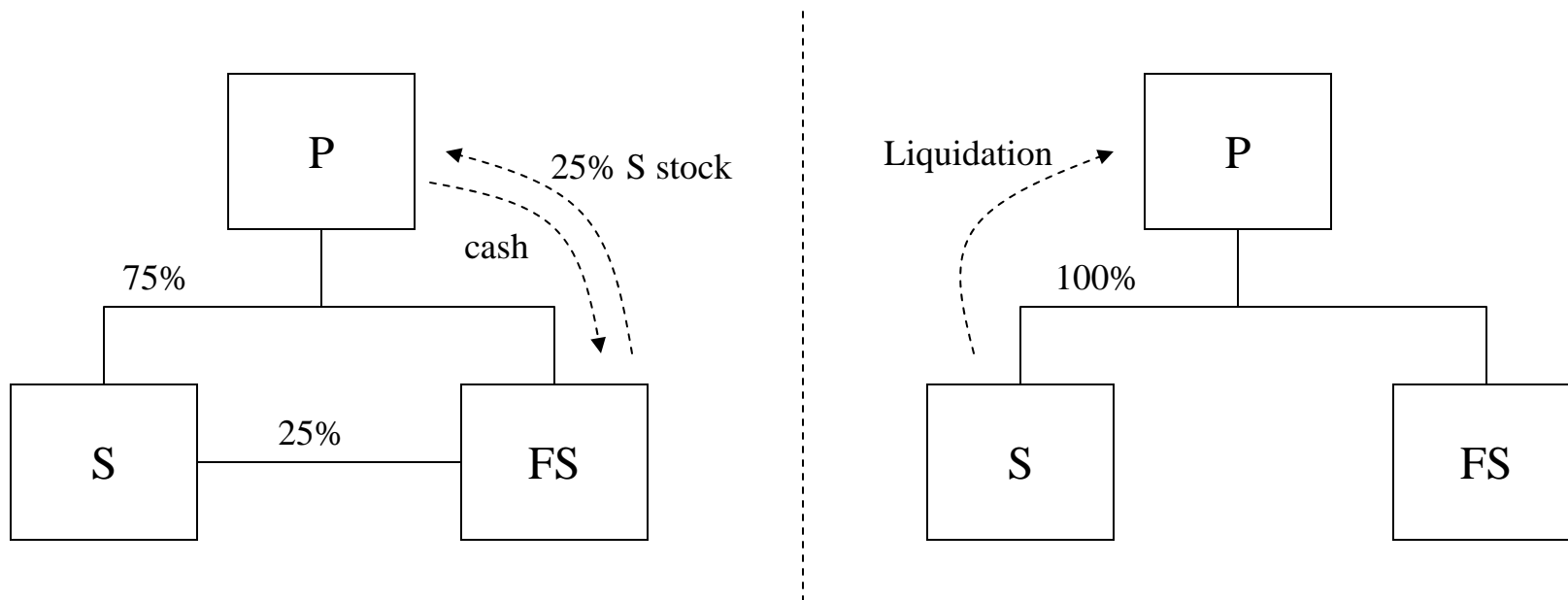
Section 331 Liquidation



Facts: P, a domestic corporation, owns all of the stock of S, which is a domestic subsidiary, and FS, which is a foreign subsidiary. P has a \$100 basis in its S stock. The value of its S stock is \$10. If P liquidates S, the loss in the S stock will not be realized. P therefore sells 25% of the S stock to FS and, after a period of time, S liquidates into P.

Result: P can recognize the loss on the remaining 75% of stock in S. However, is this result consistent with the business purpose and economic substance analysis in *Coltec*?

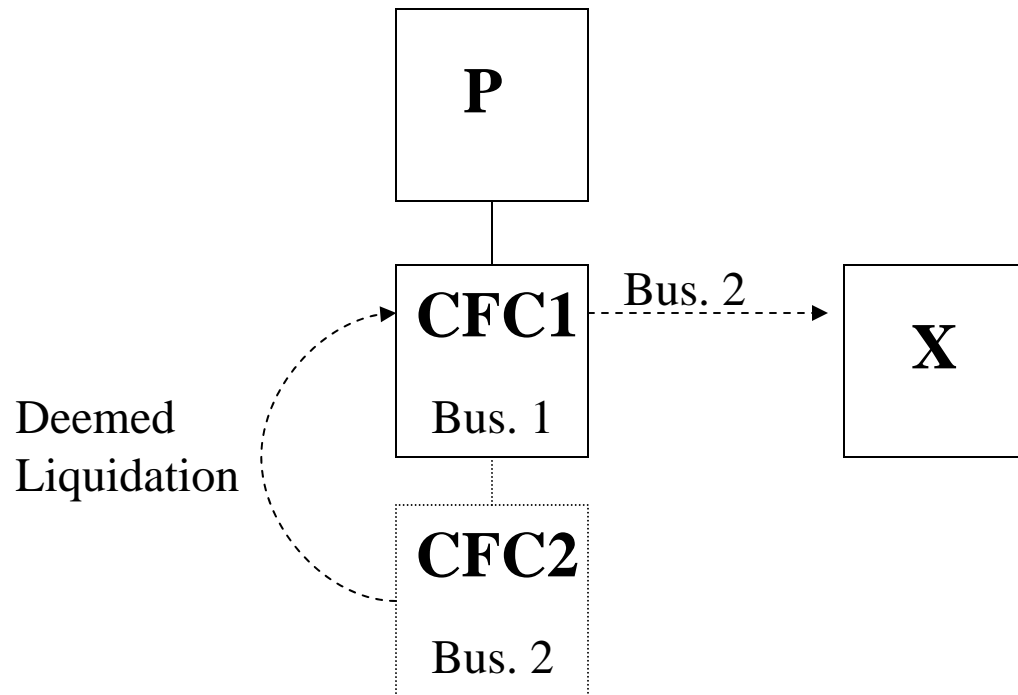
Section 332 Liquidation



Facts: P, a domestic corporation, owns 75% of the stock of S, which is a domestic subsidiary, and 100% of FS, which is a foreign subsidiary. P has a \$10 basis in its S stock. The value of its S stock is \$100. If P liquidates S, the gain in the S stock will be realized. P therefore purchases 25% of the S stock from FS and, after a period of time, S liquidates into P.

Result: P does not recognize the gain on the liquidation under section 332. However, is this result consistent with the business purpose and economic substance analysis in *Coltec*?

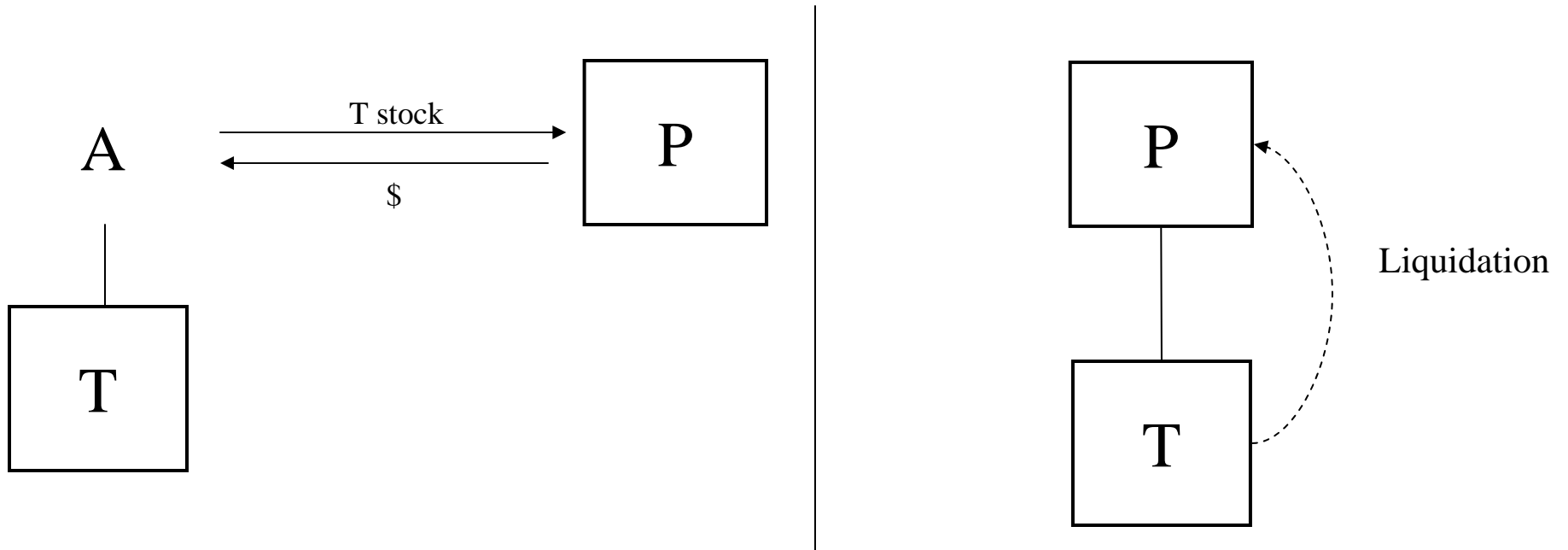
Check-and-Sell Transaction



Facts: P owns 100 percent of CFC1, which engages in business 1. CFC1 owns 100 percent of CFC2, which engages in business 2. CFC1 and CFC2 are controlled foreign corporations incorporated in the United Kingdom. On Date 1, P causes CFC1 to check-the-box for CFC2, which results in a deemed section 332 liquidation of CFC2. Immediately thereafter, P causes CFC1 to sell all of the assets of business 2 (i.e., CFC2 assets) to X for cash.

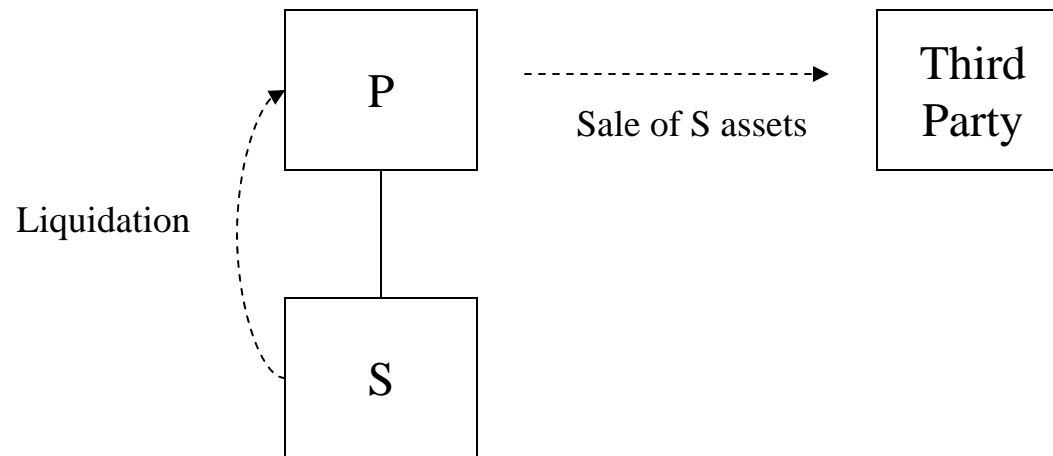
Issue: Under the rationale of *Dover Corp. v. Commissioner*, 122 T.C. No. 19 (May 5, 2004), the income generated from the sale does not constitute Subpart F income. However, does this transaction satisfy the step transaction doctrine and/or economic substance requirements in light of *Coltec*?

Purchase and Liquidation



- Section 269(b) states deductions, credits, or other allowances may be disallowed, but only if the liquidation occurs within 2 years.
- Does *Coltec* replace section 269(b)?

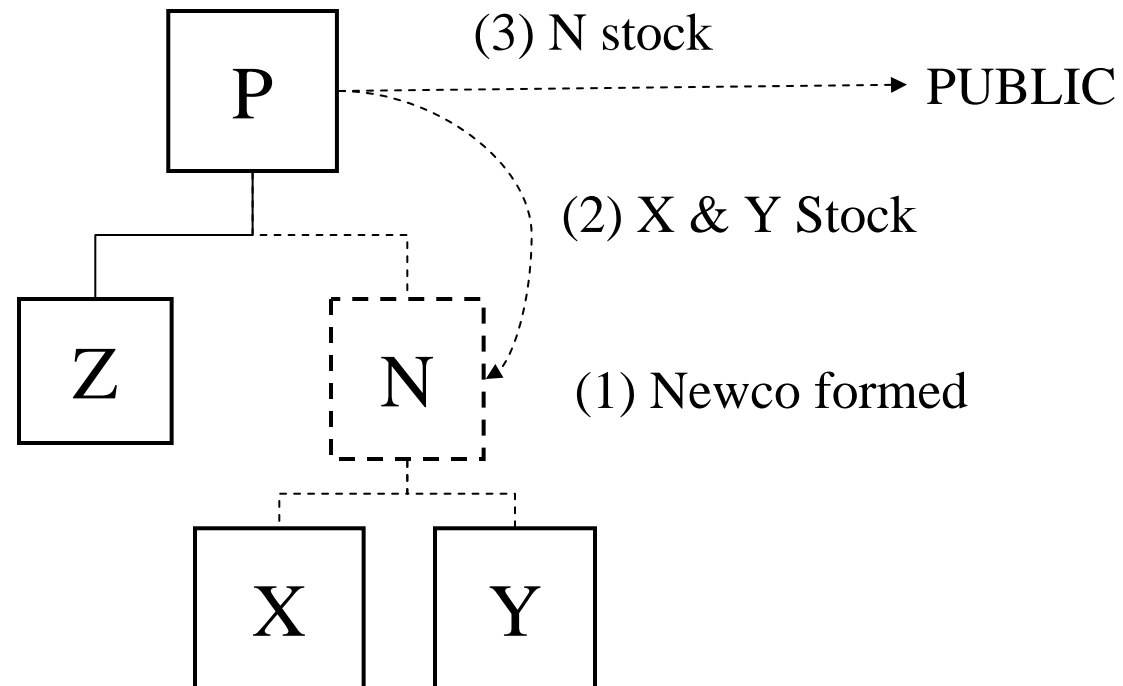
Liquidation and Sale



- In *Commissioner v. Court Holding*, the Supreme Court held that a liquidation of a corporation followed by a sale of the corporation's assets resulted in tax to the corporation because "a sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title." However, five years later, in *U.S. v. Cumberland Public Service Co.*, the Court held that a liquidation followed by a sale did not result in tax to the corporation. The Court stated, "The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes."
- In both *Court Holding* and *Cumberland* the sole purpose of the liquidation was to reduce tax. Under *Coltec*, could the Federal Circuit disregard the liquidation in each transaction?

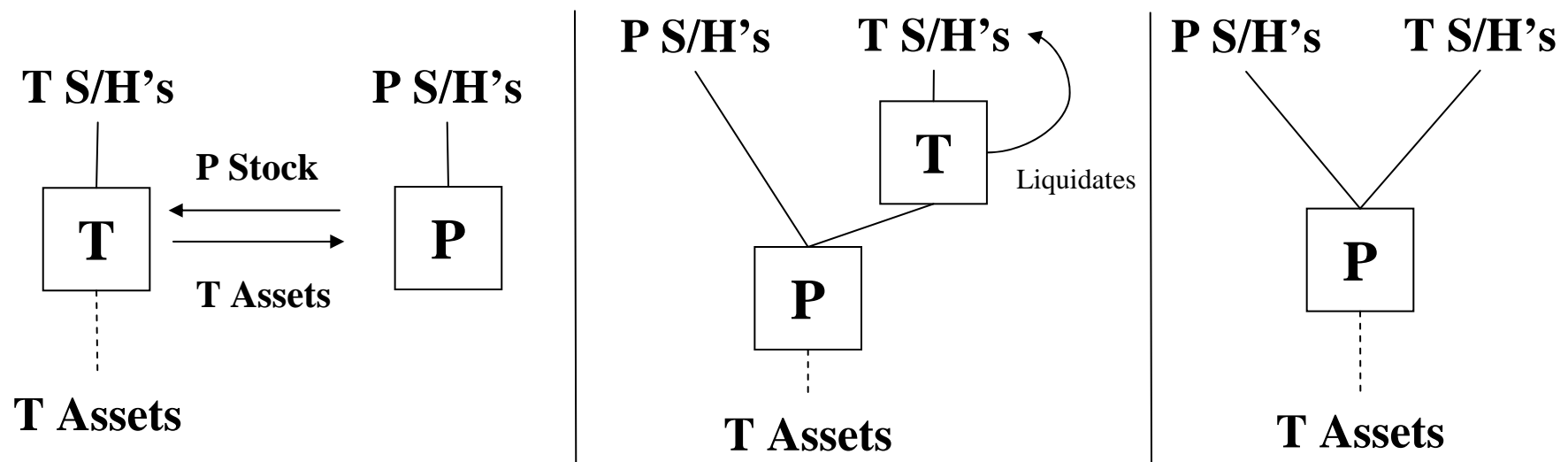
Busted Section 351 Transaction to Make Section 338(h)(10)

Election



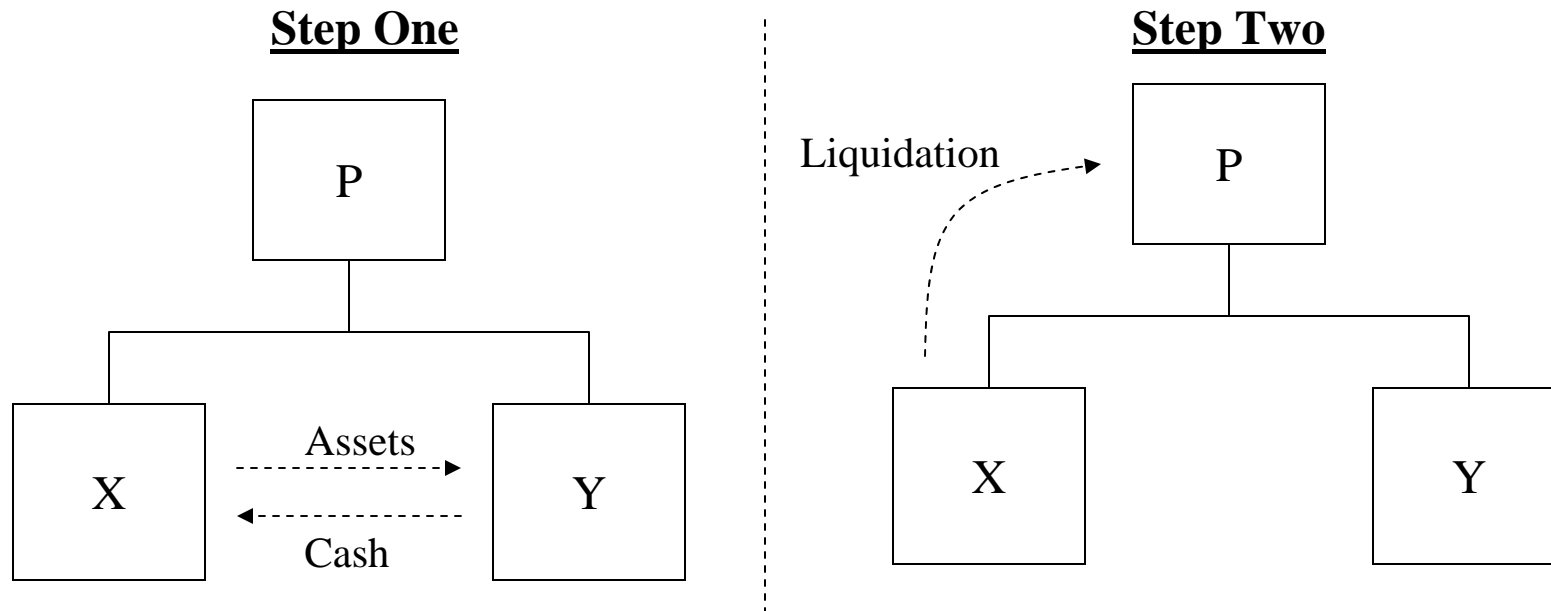
- If a corporation transfers stock of a subsidiary to a newly formed subsidiary (“Newco”) and sells the stock of Newco to the public to “bust” the section 351 transaction and to be eligible to make the section 338(h)(10) election, does the analysis in Coltec allow the sale to be disregarded?

“C” Reorganization



- What if, as is likely the case, certain steps are undertaken solely to come within the reorganization provisions in section 368? For example, assume that substantially all of a target corporation's assets are acquired by another corporation solely in exchange for voting stock. If that corporation liquidates following the asset transaction to come within the terms of a "C" reorganization, is the liquidation step subject to risk under *Coltec* because it occurred solely for tax reasons?

'D' Reorganizations – Cash – Rev. Rul. 70-240

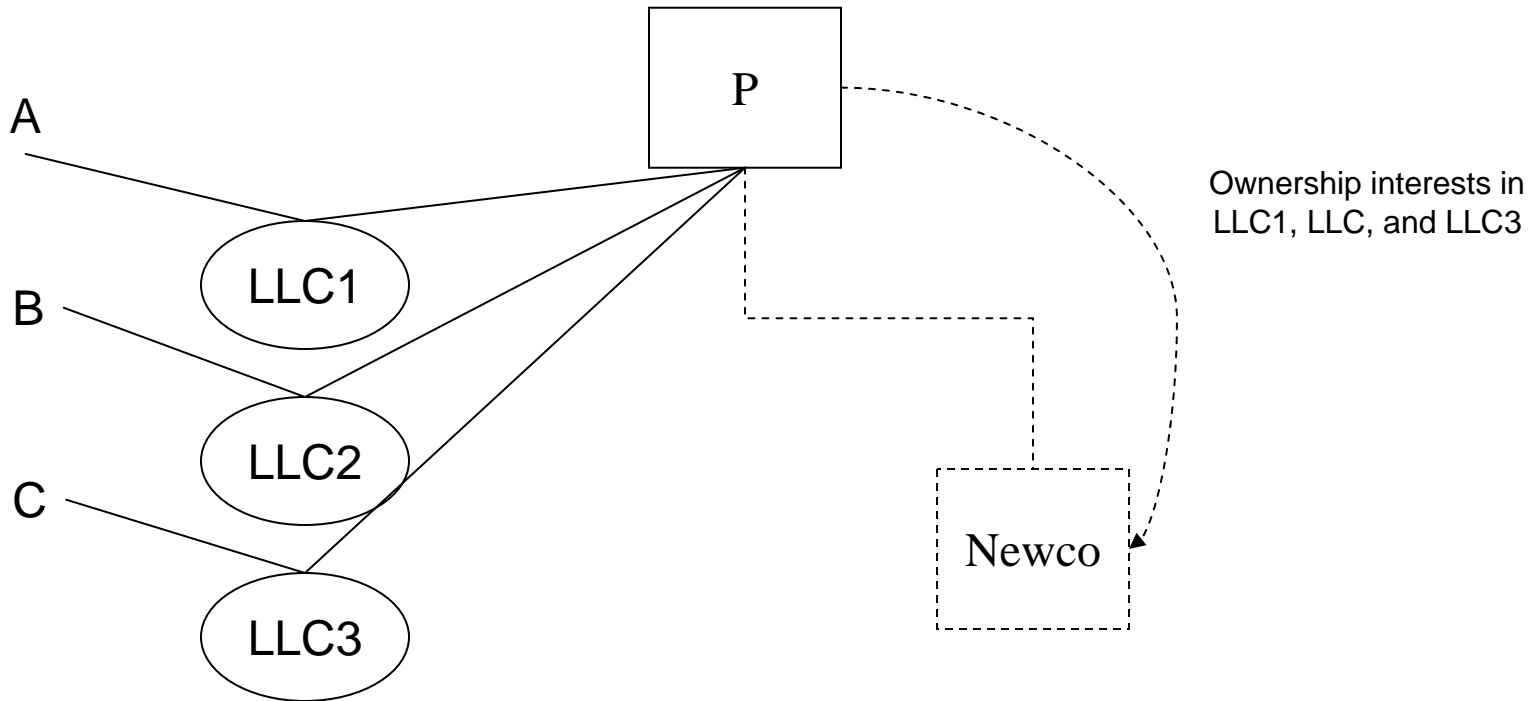


Facts: P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

Result: This transaction qualifies as a tax-free 'D' reorganization under section 368(a)(1)(D). A transfer by one corporation (X) substantially all of its assets to another corporation (Y) qualifies as a reorganization described in section 368(a)(1)(D) if, immediately after the transfer, one or more of its shareholders (P) is in control of the acquiring corporation (Y), and if stock or securities of the acquiring corporation (Y) are distributed in a transaction which qualifies under section 354, 355, or 356. See Section 354(b)(1).

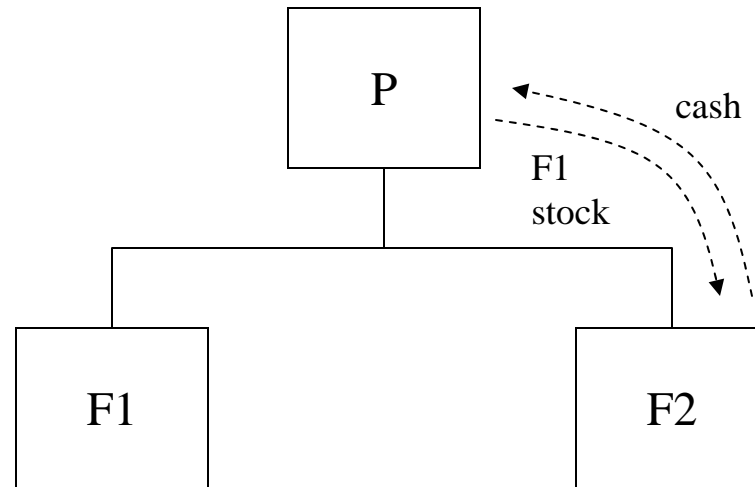
Does the analysis in *Coltec* affect this result?

Roll-up Transaction



- Assume that a parent corporation converts several LLCs or partnerships into a corporation in a roll-up transaction. Is this transaction subject to review under the Federal Circuit's analysis in *Coltec* if the roll-up was done in part to combine income and loss?

Section 304 Cross-Border Transaction



Facts: P, a domestic corporation, owns all of the stock of F1 and F2, both of which are foreign corporations. F2 has excess foreign tax credits. P sells F1 stock to F2 in exchange for cash in a transaction the sole purpose of which is to pull foreign tax credits out of F2.

Result: Section 304 applies to the transaction so that earnings are repatriated and foreign tax credits are pulled out of F2. However, does this transaction satisfy the economic substance and/or business purpose requirements in light of *Coltec*?