

**A New Form of Obscenity?
Sorting through the Federal Circuit’s “We Know It When We See It” Ruling in *Coltec*¹**

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It is perhaps unfortunate, but the most recognizable line from a Supreme Court opinion may be Potter Stewart’s explanation of obscenity as “I know it when I see it” in *Jacobellis v. United States*.² Justice Stewart’s declaration was made in a short concurrence to an opinion overturning the obscenity conviction of Nico Jacobellis for showing the film “Les Amants” (“The Lovers”) in his movie theater. The context of Justice Stewart’s statement is usually omitted when it is cited.

I have reached the conclusion, which I think is confirmed at least by negative implication in the Court's decisions since Roth and Alberts, that under the First and Fourteenth Amendments criminal laws in this area are constitutionally limited to hard-core pornography. I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that.

Justice Stewart’s declaration can be read as an honest admission of the limits of reason to discriminate between the acceptable and the offensive or it can be read as evasive and evidence of an unwillingness to pursue consistency in the application of the law.

¹ This article appears in slightly modified form in the November-December 2006 Issue of *The Tax Executive* magazine.

² 378 U.S. 184 (1964) (J. Stewart, concurring).

One might raise a similar question about the Federal Circuit's recent decision in *Coltec Industries, Inc. v. United States*.³ In *Coltec*, the Federal Circuit found that the taxpayer's capital loss on the sale of stock in a subsidiary was technically correct under the Internal Revenue Code (the "Code"), but that such loss should be disallowed because the transaction lacked economic substance. The Federal Circuit's opinion offers an ambiguous and potentially expansive view of the economic substance doctrine. The language of the opinion is very difficult to decipher and it is impossible to determine exactly what standard the Federal Circuit adopted and applied. In addition, the Federal Circuit applied its ambiguous standard of the economic substance doctrine to a single step of the transaction. The combination of the Federal Circuit's narrow focus on a single step of a transaction and its ambiguous and expansive view of the economic substance doctrine has the potential to dramatically expand the authority of the IRS to review whether the tax consequences of an individual transaction are appropriate. Although the Court made clear that it found the transaction at issue offensive, the opinion shows a striking disregard for the possible implications of the logic that the court used to disallow the capital losses at issue.

Before turning to the facts and decision in *Coltec*, it is useful to review the history of obscenity law. The Supreme Court first declared obscenity to be speech that was not protected by the First Amendment in *Roth v. United States*, and a companion case, *Alberts v. California*, in 1957.⁴ The general standard for obscenity set forth in Justice Brennan's majority opinion was material whose "dominant theme taken as a whole appeals to the prurient interest" to the "average person, applying contemporary community standards." This case started an increasing

³ 454 F.3d 1340 (Fed. Cir. 2006)

⁴ 354 U.S. 476 (1957)

wave of obscenity cases, culminating in *Miller v. California* in 1973.⁵ In 1966, the Court refined the obscenity test set forth in *Roth* in *Memoirs v. Massachusetts*,⁶ and stated that for material to be declared obscene "it must be established that (a) the dominant theme of the material taken as a whole appeals to a prurient interest in sex; (b) the material is patently offensive because it affronts contemporary community standards relating to the description or representation of sexual matters; and (c) the material is utterly without redeeming social value." Justice Stewart's famous "I know it when I see it" concurrence in *Jacobellis* occurred two years later in 1968 during the middle of a period in which the Court was flooded with obscenity cases. Finally, in 1973 *Miller* established a three prong test that must be satisfied for a work to be obscene and therefore unprotected speech: (i) the average person, applying contemporary community standards must find that the work, taken as a whole, appeals to the prurient interest; (ii) the work depicts or describes, in a patently offensive way, sexual conduct or excretory functions specifically defined by applicable state law; and (iii) the work, taken as a whole, lacks serious literary, artistic, political, or scientific value.

Reading the history of obscenity law and the test articulated in *Miller* it is striking to see the parallels to the judiciary's recent crusade against what appears to be a new form of a obscenity—tax shelters. Recent cases have demonstrated that the line between legitimate tax planning and obscene tax shelters is proving as equally difficult to draw as the line between art and obscene pornography. Substitute "tax avoidance purpose" for "appeals to the prurient interest" and "economic reality" for "serious literary, artistic, political, or scientific value," and you essentially have the tenets of the economic substance test. As the Federal Circuit's opinion

⁵ 413 U.S. 15 (1973)

⁶ 383 U.S. 413 (1966)

in *Coltec* demonstrates, the judiciary's effort to police tax shelters is quickly becoming as tortured as its past effort to police obscenity.

I. The Transaction in Coltec

A. History of Contingent Liability Transactions

Coltec was one of a series of cases in which the government challenged transactions involving the transfer of contingent liabilities and assets to a subsidiary followed by the sale of the subsidiary's stock. The contingent liabilities reduced the value of the stock of the subsidiary, but did not reduce the taxpayer's basis in the subsidiary's stock. Therefore the taxpayer realized a capital loss on the stock sale.⁷

On January 18, 2001, the Service "listed" the transaction in Notice 2001-17, 2001-9 I.R.B. 1 and announced that it will disallow losses generated by contingent liability transactions. Revenue Procedure 2002-67, 2002-43 I.R.B. 733, announced a settlement initiative giving taxpayers who engaged in transactions substantially similar to those described in Notice 2001-17 an opportunity to resolve their tax issues. The settlement initiative offered eligible taxpayers two methods to resolve their issues involving Contingent Liability Transactions--a fixed concession

⁷ The tax consequences of the typical contingent liability transaction were as follows. 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).

procedure and a fast track dispute resolution procedure. These settlement proposals were relatively taxpayer-friendly compared to other IRS settlement initiatives.⁸

Congress added section 358(h) to the Code in the Community Renewal Tax Relief Act of 2000. Section 358(h) provides that if the application of section 358 results in a stock basis that is higher than the fair market value, then basis shall be reduced by the liabilities, but not lower than the fair market value unless either of two exceptions applies: (i) The trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange; or (ii) Substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange. The enactment of section 358(h) presumably eliminated the tax benefits of contingent liability transactions, although, as discussed further below, certain questions remain. The transactions at issue in *Coltec* and other similar cases were entered into prior to the enactment of section 358(h).

Several taxpayers litigated and challenged the disallowance of the capital losses generated from a contingent liability transaction. One such transaction was addressed by the District Court of Maryland and the Fourth Circuit in *Black & Decker v. United States*.⁹ Although the District Court of Maryland ruled in favor of the taxpayer, the Fourth Circuit reversed the decision and remanded the case for a determination of whether the contingent liability transaction at issue had economic substance.¹⁰

⁸ Under the fixed concession procedure, the taxpayer was allowed 25 percent of the capital loss and was not subject to any penalties. Under the dispute resolution procedure, the taxpayer was able to submit to a binding “baseball” arbitration and propose a settlement claiming up to 50 percent of the capital loss. Penalties were subject to negotiation in the arbitration. The settlement offer in Rev. Proc. 2002-67 expired on March 5, 2003.

⁹ 436 F.3d 431 (4th Cir. 2006)

¹⁰ There were two judgments of the District Court of Maryland in *Black & Decker*. First, the United States filed a motion for summary judgment in the District Court of Maryland and

B. History of Transaction in Coltec

In 1996, Coltec sold one of its businesses and recognized a capital gain of approximately \$240.9 million. In prior years, one of Coltec's subsidiaries, Garlock, Inc. ("Garlock") had manufactured or distributed asbestos products and in 1996 was facing numerous lawsuits and potential liabilities. As a result of a recommendation from Arthur Andersen LLP, Coltec entered into a contingent liability transaction that involved the following steps: (i) Coltec renamed a dormant subsidiary Garrison Litigation Management Group, Ltd. ("Garrison"); (ii) Coltec caused Garrison to issue 99,800 shares of common stock and 1,300,000 shares of Class A stock to Coltec in exchange for \$13,998,000 cash; (iii) Garlock transferred all the outstanding stock in one of its subsidiaries, Anchor Packing Company ("Anchor"), certain other property, and a \$375

argued that the basis of the stock in the subsidiary had to be reduced by the amount of the transferred contingent liabilities because section 357(c)(3) did not apply. The government argued (i) that section 357(c)(3) required that payment of the liabilities would give rise to a deduction by the *transferee*; (ii) that payment of the liabilities at issue would not give rise to a deduction by the subsidiary; (iii) and that therefore section 357(c)(3) did not apply and the basis should be reduced. The District Court of Maryland rejected the government's argument and stated, "[t]he legislative history to §357(c) lends no support to the United States' suggested interpretation." The taxpayer also filed a motion for summary judgment in the District Court of Maryland. The court granted that motion and declared, "[t]he BDHMI transaction...had very real economic implications for every beneficiary of B & D's employee benefits program, as well as for the parties to the transaction. The court may not ignore a transaction that has economic substance, even if the motive for the transaction is to avoid taxes."

The Fourth Circuit reversed the decision and remanded on the grounds that the District court misapplied the economic substance test. For purposes of the summary judgment motion, Black & Decker conceded that the motivation for the transaction was for tax purposes. However, as stated above, the District court held that the transaction satisfied the economic substance test because it had real economic consequences. The Fourth Circuit stated that the appropriate test was the one articulated in *Rice's Toyota World* and that "The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from *the transaction* existed apart from tax benefits." The Fourth Circuit remanded the case for a determination of whether a reasonable expectation of profit existed sufficient to satisfy the test. The emphasis on a reasonable expectation of profit by the Fourth Circuit raises questions about common transactions (e.g., restructurings, liquidations, incorporations, distributions, etc.) that are not done to earn a profit, but for other business reasons.

million note from one of its other subsidiaries, Stemco, Inc. to Garrison, in exchange for 100,000 shares of common stock of Garrison (approximately a 6% interest) and an agreement by Garrison to assume the liabilities incurred in connection with asbestos claims against Garlock. In addition, Garlock agreed to advance up to \$200 million to Garrison to cover Garrison's capital needs. Finally, Garlock sold all of its 100,000 shares of Garrison stock to two banks for \$500,000.

The above transaction resulted in a \$378.7 million capital loss to Garlock because the basis of the 100,000 shares was not reduced by the amount of the contingent liabilities resulting from the asbestos claims. Therefore Garlock's basis in the 100,000 shares was approximately \$379.2 million (the \$375 million note plus \$4.2 million in other property).

II. The Federal Circuit's Opinion

The Federal Circuit affirmed the Court of Federal Claims' opinion that the resulting capital loss was consistent with the technical operation of sections 351, 357, and 358 of the Internal Revenue Code. The court rejected the government's arguments that the basis should be reduced because (i) the liabilities would not give rise to a deduction under section 357(c)(3) and/or (ii) the principal purpose behind the assumption of liabilities was to avoid taxes under section 357(b)(1). The court found the government's section 357(c)(3) argument "to be inconsistent with the plain language" of the statute.¹¹ Thus the court declared that the position taken by the IRS in a series of rulings over the past few years to avoid the application of section

¹¹ 454 F.3d at 1349. ("Nothing in the plain language of § 357(c)(3) limits the liabilities excludable to only those that were transferred along with an underlying business.")

357(c)(3) was wrong.¹² The court also found that section 357(b)(1) did not preclude the application of section 357(c)(3) and cause the basis to be reduced. The court stated

We therefore conclude that the liabilities fall within § 357(c)(3); that § 357(b)(1) is not relevant here; and that § 358(d)(2) excludes the liabilities from “money received” treatment. The consequence is that under the literal terms of the statute the basis of Garlock’s Garrison stock is increased by the Stemco note and is not reduced by the assumed contingent asbestos liabilities.¹³

However, the court did not stop with the technical analysis. Despite the conclusions that the taxpayers treated the transaction correctly under the Code, the court disallowed the capital loss on the grounds that one step in the transaction—the assumption of the asbestos liabilities by Garrison—lacked economic substance. The court’s application of the economic substance doctrine in this manner is confused and expansive. Rather than rely on the two-prong test applied by past precedent to the entire transaction,¹⁴ the court appears to have invented a new test based on a series of principles and applies that test on a step-by-step basis. Moreover, the

¹² See e.g., TAM 2000060014 (Oct. 22, 1999); FSA 200122022 (June 1, 2001); FSA 200134008 (May 15, 2001); FSA 200121013 (Feb. 12, 2001); CCA 200117039 (Mar. 13, 2001); FSA 200217021 (Jan. 17, 2002); FSA 200218022 (Jan. 31, 2002); FSA 200224011 (Mar. 5, 2002). In light of the rulings by both the Fourth Circuit in *Black & Decker* and the Federal Circuit in *Coltec*, query whether the government will change its position with respect to the application of sections 357(c)(3), 358(d)(2), and 357(b).

¹³ *Coltec*, 454 F.3d at 1351.

¹⁴ See, e.g., *ACM Partnership*, 157 F.3d at 250 (“[e]xaming the sequence of ACM’s transactions as a whole as we must in assessing their economic substance,...we find that these transactions had only nominal, incidental effects on ACM’s net economic position.”); *American Electric Power*, 136 F.Supp.2d at 778 (“ [the] sham transaction doctrine requires the court to examine a challenged transaction as a whole and each element thereof to determine if the substance of the transaction is consistent with its form.”).

opinion ignores the Federal Circuit's prior standard for economic substance without reference or discussion.¹⁵

III. A New Conception of Economic Substance?

A. The Federal Circuit's Opinion in *Coltec*

The Federal Circuit's economic substance analysis in *Coltec* is difficult to decipher, but the court appears to reject the longstanding principle that transactions should be analyzed in their entirety and not step by step. In addition, it is difficult to determine what standard the Federal Circuit has adopted and applied.

The Supreme Court commented on the economic substance doctrine in *Frank Lyon v. United States*.¹⁶ In *Frank Lyon*, the Supreme Court stated

where...there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.”¹⁷

The Federal Circuit cites this language, but only in a parenthetical in a footnote. Moreover, the Federal Circuit omits that the Court in *Frank Lyon* also stated that the “fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.” *Id.* at 580. The test in *Frank Lyon* was further explained

¹⁵ 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). On November 8, 2006, Coltec filed a petition for a writ of certiorari with the U.S. Supreme Court.

¹⁶ 435 U.S. 561 (1978).

¹⁷ *Id.* at 583-584

by the Fourth Circuit in *Rice's Toyota World, Inc. v. Comm'r* as follows: "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."¹⁸ Prior to *Coltec*, the Federal Circuit had adopted the *Rice's Toyota World* standard as the applicable economic sham transaction test.¹⁹ In *Drobny v. United States*, the Federal Circuit quoted the *Rice's Toyota World* two-prong test as the applicable standard.²⁰ 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."²¹

However, in *Coltec*, the Federal Circuit does not cite *Rice's Toyota* or *Drobny* and only cites *Frank Lyon* in a parenthetical in a footnote. Instead, the court appears to rewrite the economic substance doctrine by relying on a series of cases, including *Gregory v. Helvering*²² and *Basic, Inc. v. United States*.²³ *Gregory* is frequently cited as the source of a business purpose requirement for all types of transaction. The Federal Circuit's application of *Gregory* in *Coltec* is overly expansive and erroneous. *Gregory* held that a transaction that had no business purpose whatsoever should be disregarded. *Gregory* did not evaluate a taxpayer's stated

¹⁸ 752 F.2d 89, 91 (4th Cir. 1985)

¹⁹ 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).

²⁰ *Drobny*, 86 F.3d at 1174.

²¹ *Id.*

²² 293 U.S. 465 (1935).

²³ 549 F.2d 740 (Ct. Cl. 1977).

business purpose or compare that purpose to the tax benefits of the transaction. If there was any business purpose at all in *Gregory*, the Supreme Court presumably would have decided the case differently. *Basic* is a more curious case for the Federal Circuit to cite. *Basic* has been cited affirmatively in only one other case, *Lareau v. United States*.²⁴ *Lareau* was an unreported case decided a year after *Basic* in the Court of Claims and dealt with the step transaction doctrine in the context of an excise tax issue. *Basic* is not generally cited because it has been widely criticized as wrongly decided.²⁵ It was distinguished by the Fifth Circuit in *TSN Liquidating Corp. v. United States*,²⁶ a case that also involved a dividend prior to a stock sale. *Basic* has not been cited by any court in a published decision for the proposition advanced by the Federal Circuit in *Coltec*—that the economic substance doctrine should be applied on a step-by-step basis.

The Federal Circuit in *Coltec* also ignores the circuit split on whether the economic substance test is a conjunctive or disjunctive test.²⁷ The Courts of Appeals for the Second

²⁴ 1978 WL 4215 (Ct. Cl. 1978)

²⁵ See, e.g., Bittker & Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 7th Ed. 8-67, fn. 289

²⁶ 624 F2d 1328 (5th Cir. 1980).

²⁷ This circuit split is one of the reasons that IRS Chief Counsel Donald L. Korb has made public comments suggesting that the Supreme Court may need to clarify the economic substance doctrine. See Alison Bennett, *Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance*, DAILY TAX REPORT, BNA, Inc., October 27, 2006. As stated above, *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

Circuit, Fourth Circuit, and D.C. Circuit have applied the test in a disjunctive fashion, requiring a transaction at issue to have objective economic substance *or* the taxpayer to have a subjective non-tax business purpose to prevent the transaction from being characterized as a sham.²⁸ In contrast, Seventh Circuit, Eighth Circuit, and Eleventh Circuit have applied the test in a conjunctive fashion, requiring a transaction at issue to have objective economic substance *and* the taxpayer to have a subjective non-tax business purpose..²⁹ The remaining Federal circuit courts (the First Circuit, Third Circuit, Fifth Circuit, Sixth Circuit, Ninth Circuit, and Tenth Circuit) have not applied a rigid two-part inquiry, but have instead collapsed the test and treated a transaction's objective economic substance and the taxpayer's subjective business purpose as relevant factors in determining whether the transaction was a sham.³⁰

Instead of the two-prong formulation, the Federal Circuit in *Coltec* defines the economic substance test as a series of principles derived from a variety of cases. These principles include: (i) the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality; (ii) it is the taxpayer that has the burden of proving economic substance; (iii)

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)?"

²⁸ See *DeMartino v. Commissioner*, 862 F.2d 400 (2d. Cir. 1988); *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992).

²⁹ See *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001).

³⁰ See *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d. Cir. 1998); *Merryman v. Commissioner*, 873 F.2d 879 (5th Cir. 1989); *Rose v. Commissioner*, 868 F.2d 851 (6th Cir. 1989); *Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990); *Keeler v. Commissioner*, 243 F.2d 1212 (10th Cir. 2001); *Deweese v. Commissioner*, 870 F.2d. 21 (1st Cir. 1989).

the economic substance of a transaction must be viewed objectively rather than subjectively; (iv) the transaction to be analyzed is the one that gave rise to the alleged tax benefit; and (v) arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.³¹

The above principles described by the court in *Coltec* apparently replace the Federal Circuit's previous disjunctive application of the two prong test in *Drobny*. The court makes use of the concepts of economic reality and business purpose, but it is difficult to ascertain whether the court views these concepts as distinct tests or different ways of characterizing the same test. In addition, the court does not directly explain the standards for either economic substance or business purpose.

To understand the court's approach in *Coltec* it is necessary to understand the taxpayer's arguments supporting the economic substance of the transaction. The taxpayer in *Coltec* made two arguments to support its claim that the transaction at issue had economic substance. First, that the transfer of the asbestos liabilities to a separate subsidiary would make the parent company more attractive to the investment community and second, that the transaction would create an additional barrier against potential veil piercing claims. Notably the taxpayer did not claim that the transaction would result in an economic profit. In fact, the structure of the transaction specifically prevented Garlock, the transferor of the liabilities, from earning an economic profit. Garlock agreed to advance up to \$200 million in additional funds to cover Garrison's (the transferee) capital needs and then immediately sold the stock in Garrison to banks. The agreement to advance additional funds caused Garlock to retain the downside risk and the sale to the banks caused Garlock to lose the upside potential. Thus the transaction placed

³¹ *Coltec*, 454 F.3d at 1355-57

Garlock in a position where it could only lose as a result of the subsequent liability experience.³² If the liabilities were greater than expected, Garlock was obligated to advance additional money. If the liabilities were less than expected, then the banks, as owners of the Garrison stock Garlock initially received, would reap the benefit of Garrison's increase in value.³³

To analyze the taxpayer's arguments, the court in *Coltec* does not focus on the economics of the transaction as a whole. Instead, the court focuses specifically on the transfer of the contingent liabilities to Garrison. The court does not dispute that the creation of a liability management subsidiary "may have had economic substance," but states

we must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale. That transaction is Garrison's assumption of Garlock's asbestos liabilities in exchange for the \$375 million note...It is this exchange that provided Garlock with the high basis in the Garrison stock, this exchange whose tax consequence is in dispute, and therefore it is this exchange on which we must focus.³⁴

In that regard, the court does not appear to dispute that the presence of such a subsidiary may indeed have made Coltec a more attractive company. The court cites testimony from John Guffey, Coltec's CEO, stating that a separate subsidiary "was a real plus to us," and does not dispute the conclusion.³⁵ However, the court does dispute the claim that transferring the

³² It is interesting that Coltec itself maintained ownership of approximately 93.4 percent in Garrison. To the extent Garrison increased in value, Coltec retained this upside.

³³ Although the Fourth Circuit in *Black & Decker* considered whether the taxpayers had a "reasonable expectation of profit" to be critical to its economic substance analysis, it is not clear why this is necessarily the best approach. Many transactions are done with no real expectation of profit. Distributions, liquidations, and restructurings are commonly done for reasons other than earning a profit. If the taxpayers in *Black & Decker* and *Coltec* had simply transferred assets and liabilities to a subsidiary and not sold stock in that subsidiary, thereby not generating a capital loss, would the transaction have been challenged as lacking economic substance?

³⁴ *Coltec*, 454 F.3d at 1358.

³⁵ *Id.*

liabilities was necessary to accomplish the benefits intended by creating the subsidiary. In the court's view, the same benefits could have been obtained without transferring the liabilities and therefore such transfer should be disregarded. The court stated

The transfer of the liabilities in exchange for the note is separate and distinct from the fact that Garrison took a managerial role in administering the asbestos liabilities, as demonstrated by the fact that Garrison managed another entity's asbestos liabilities (Anchor's liabilities) without actually assuming Anchor's liabilities. The taxpayer has not demonstrated any business purpose to be served by linking Garrison's assumption of the liabilities to the centralization of litigation management.³⁶

This is an extremely narrow way to slice the transaction to define a step that has no business purpose. Further, the court's narrow view of the transaction raises the question whether the court is substituting its judgment for that of the taxpayer. Also, the narrow focus of the court excludes the step that ultimately resulted in a tax benefit—the stock sale. If there was no stock sale, then there would have been no capital loss. How, then, can the court's focus solely on the “transfer of the liabilities in exchange for the note” be justified? Even if it were true that there was not a business purpose for the assumption of the liabilities, isn't it also true that without the stock sale there is no tax purpose for the assumption of the liabilities either? The Federal Circuit's step-by-step principle is logically inconsistent because it separates the steps of a transaction and in the process separates the events being challenged as lacking substance from the beneficial tax consequences at issue.

The court also rejects Coltec's argument that the transaction created additional insulation from veil-piercing claims. The court stated that Coltec was not able to provide any legal authority for this claim. Coltec's veil piercing argument rested entirely on the testimony of executives who believed the transaction would make veil piercing more difficult. The court

³⁶ *Id.*

rejects this testimony as self-serving and unpersuasive and states, “[l]ooking at the transaction objectively there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary.”³⁷ In addition, the court cites the fact that the banks had sufficient doubts about the veil piercing claim to establish separate subsidiaries to own the Garrison stock and demand indemnification from Coltec for potential veil piercing claims.

The fact that no authority was cited to justify the assertion that the new subsidiary would strengthen any defenses to veil piercing claims and the fact that the parties’ actions were contrary to the belief that transferring the liabilities to the subsidiary was effective to preclude veil piercing both suggest that the veil piercing argument was weak. However, the court’s response to Coltec’s other argument that a subsidiary to manage asbestos liabilities would make the company more attractive is much more troubling. The court states only that in its judgment they didn’t *need* to be transferred. What the court is essentially arguing is that because the taxpayer could have accomplished an objective in a less tax beneficial way, the court is empowered to void the tax benefits.³⁸

³⁷ *Id.* at 1359

³⁸ Interestingly, the court does not consider whether the liabilities were actually transferred, despite the fact that Garlock remained liable and was obligated to advance additional funds to Garrison if such liabilities turned out to be greater than expected. The transfer of the liabilities occurred in 1996, before the enactment of new section 357(d) in 1999 (effective for transfers after October 18, 1998), which provides statutory standards for determining whether liabilities are actually transferred. Prior to the enactment of section 357(d), there was no statutory provision establishing standards and whether a liability was considered assumed was determined based on the facts and circumstances. Under current law, section 357(d)(1)(A) states, “a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability.” It is unclear whether the liabilities transferred in *Coltec* would satisfy the standards of current section 357(d).

B. Possible Interpretations of the Federal Circuit's New Test

The five principles stated in the Federal Circuit's opinion are difficult to characterize as a specific test and to fit into the more common two-prong economic reality and business purpose framework of the economic substance doctrine. Different statements in the court's opinion can be used to characterize the test as (i) a unitary test for economic reality (in which business purpose is irrelevant); (ii) a unitary test for business purpose (in which economic reality is not determinative); or (iii) a conjunctive test in which both economic reality and business purpose are required.

1. Alternative #1: Economic Substance Test is a Unitary Test for Economic Reality

It is possible to read the Federal Circuit's opinion as articulating a single test focused on economic reality and not on business purpose. The court states in the beginning of its economic substance discussion that, "[w]hile 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."³⁹ This sentence can be read as requiring a conjunctive test for both economic substance and business purpose. In other words, a transaction must have economic substance and a taxpayer must have a business purpose for the transaction in order for the tax consequences to be respected. Alternatively, the sentence can be read to suggest that the relevant test is economic substance because a transaction without economic substance, according to the court, will be disregarded in all cases. This characterization is further supported by the language of the court's conclusion. The court states, "[w]e therefore see nothing indicating that the transfer of liabilities in exchange for the note effected any real change in the 'flow of

³⁹ 454 F.3d at 1355.

economic benefits,' provided any real 'opportunity to make a profit,' or 'appreciably affected' Coltec's beneficial interests aside from creating a tax advantage." This conclusion uses language more commonly associated with the economic reality prong of the more commonly used two prong economic substance test.

2. Alternative #2: Economic Substance Test is a Unitary Test for Business Purpose

In contrast to the interpretation discussed above, the Federal Circuit's overall approach can also be characterized as focused exclusively on business purpose. In the introductory paragraph to the economic substance analysis, the court states, "[t]he 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." After this sentence, the opinion's discussion of economic substance is structured as a rebuttal to two business purpose theories offered by Coltec. The court states:

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."⁴⁰

As described above, the court responds to each of Coltec's business purpose arguments and declares why each is an insufficient motivation to explain the transaction. In addition, the court's reason for why the transfer of liabilities in exchange for the note does not have economic substance and should not be respected is "The taxpayer has not demonstrated any business purpose to be served by linking Garrison's assumption of the liabilities to the centralization of

⁴⁰ 454 F.3d 1357

litigation management.”⁴¹ The court appears to reason that because there is no purpose for the transaction other than obtaining tax benefits that therefore there the transaction should be disregarded. The court does not analyze whether the transfer of the liabilities and note had economic reality. For example, the court doesn’t argue that the liabilities weren’t actually transferred. Instead, the court argues that there was no purpose for transferring them other than tax purposes. This suggests that the court’s focus in the application of the economic substance doctrine was on business purpose.

In addition, the court cites *Black & Decker*,⁴² *Nicole Rose Corp.*⁴³ and *ACM Partnership*⁴⁴ and concludes, “[t]hese 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).”⁴⁵ 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. v. United States*⁴⁶ further suggests it is focused exclusively on business purpose. As discussed in more detail below, 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

⁴¹ *Id.* at 1358

⁴² 436 F.3d 431 (4th Cir. 2006)

⁴³ 320 F.3d 282 (2d Cir. 2002)

⁴⁴ 157 F.3d 231 (3d Cir 1998)

⁴⁵ 454 F.3d at 1357.

⁴⁶ 549 F.2d 740 (Ct. Cl. 1977).

finding “the inter-company transaction should be disregarded because it had no “valid business grounds”).⁴⁷

3. Alternative #3: Economic Substance Test is Conjunctive Test for Economic Reality and Business Purpose

The different and alternating focuses on economic reality and business purpose in the Federal Circuit’s opinion can also be interpreted as in effect a conjunctive application of the more common two prong economic reality and business purpose test. Although the court doesn’t state specifically that the test is a two prong conjunctive test, the implication from the court’s reasoning is that a transaction that lacks either economic reality or a business purpose may be disregarded because it lacks economic substance.

C. The Federal Circuit Curious Application of the Economic Substance Test on a Step-by-Step Basis

The Federal Circuit’s conjunctive conception of the economic substance test is troubling in and of itself—apparently allowing a real economic transaction to be voided if done for tax purposes. However, as discussed above, the Federal Circuit is not the only court to have applied this formulation.⁴⁸ What makes the Federal Circuit’s test untenable is its expansive interpretation combined with what the court defines as the fourth principle of economic substances –that the application of the test should be applied on a step by step basis. As described below, this notion of economic substance has the potential to allow courts to undo numerous common business transactions traditionally undertaken by taxpayers in a tax efficient manner.

⁴⁷ 454 F.3d at 1356, fn.16.

⁴⁸ See *Deweese v. Commissioner*, 870 F.2d. 21 (1st Cir. 1989); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988); *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001).

As stated above, the federal courts have generally analyzed transactions that involve multiple steps as a single whole rather than a series of component parts. The only court to break a transaction into pieces to apply the economic substance doctrine was the district court in *Boca Investering v. United States*⁴⁹. Ironically, the District Court in *Boca* broke the transaction down in order to reach a result that was taxpayer favorable. The court in *Boca* did not view each of the steps of the transaction at issue as interrelated and part of a larger, pre-planned transaction. Instead, the court viewed each of the steps as distinct transactions because: (1) the taxpayer thoroughly evaluated each transaction separately; and (2) the taxpayer made no commitment to complete the subsequent transactions prior to entering into the first transaction. However, the District Court's decision in *Boca* was reversed by the D.C. Circuit because the court failed to consider the sham entity theory espoused by the D.C. Circuit in *ASA Investering*.⁵⁰

The Federal Circuit does not cite *Boca*, but relies on four other cases to support its step-by-step principle of analysis: (i) *Basic, Inc. v. United States*;⁵¹ (ii) *Black & Decker v. United States*;⁵² (iii) *Nicole Rose Corp. v. Commissioner*;⁵³ and (iv) *ACM Partnership v. Commissioner*.⁵⁴ In *Basic*, the taxpayer's first tier subsidiary distributed the stock of a second tier subsidiary to the taxpayer immediately before the taxpayer sold the stock of both subsidiaries to a third party. The transaction was originally structured as an asset sale, but the third party

⁴⁹ 167 F.Supp.2d 298 (D. D.C. 2001)

⁵⁰ 201 F.3d 505 (D.C. Cir. 2000)

⁵¹ 549 F.2d 740 (Ct. Cl. 1977).

⁵² 436 F.3d 431 (4th Cir. 2006)

⁵³ 320 F.3d 282 (2d Cir. 2002)

⁵⁴ 157 F.3d 231 (3d Cir 1998)

refused to increase the purchase price to cover the increased tax and management costs that would result from such a sale. The taxpayer proposed a stock sale instead. The third party agreed to this structure, but only on the condition that the stock in both subsidiaries be purchased directly from the taxpayer. To accomplish this, the taxpayer had the first tier subsidiary distribute the stock of the lower tier subsidiary. This created a tax benefit because the taxpayer received basis in the stock of the lower tier subsidiary and did not recognize gain on the distribution as a result of the dividends received deduction. Therefore the capital gain on the stock sale was reduced by the amount of basis the taxpayer received in the lower tier subsidiary's stock. The Court of Claims disregarded the distribution in *Basic* and treated the taxpayer as a conduit for the lower tiered subsidiary's stock because the taxpayer could not show a reason for the distribution "aside from the tax consequences attributable to that move."⁵⁵ Therefore, the court treated the distribution as part of the sale proceeds. *Basic* is a strange case for the court to rely on because it has been widely criticized. Bittker & Eustice note in their treatise that the case seems inconsistent with Rev. Rul. 75-493, 1975-2 C.B. 108 and Rev. Rul. 69-60, 1969-2 C.B. 42.⁵⁶

The court's citation to *Black & Decker* is particularly curious because the Fourth Circuit was faced with a very similar transaction in that case and approached the economic substance question quite differently. The Fourth Circuit relied on the two-prong disjunctive test in *Rice's Toyota*. For purposes of the summary judgment motion, the taxpayer conceded that the subjective business purpose prong was satisfied (i.e., that the taxpayer entered the transaction

⁵⁵ *Basic*, 549 F.2d at 749. This analysis makes little sense. As noted above, the buyer agreed to a stock sale but only on the condition that it would be able to buy the stock of each subsidiary. Thus the distribution was required by the buyer.

⁵⁶ Bittker & Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 7th Ed. 8-67, fn. 289

solely for tax reasons). Therefore, the Fourth Circuit’s opinion with respect to economic substance focused entirely on the objective economic substance prong. If the Fourth Circuit had instead applied the apparent conjunctive analysis of the Federal Circuit in *Coltec*, no opinion would have been necessary because of the taxpayer’s concession for purposes of the motion. In applying the objective economic substance test, the Fourth Circuit stated that the test articulated in *Rice’s Toyota*

focuses not on the general business activities of a corporation, but on the specific transaction whose tax consequences are in dispute. ‘The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits.’⁵⁷

This is a far different proposition than that offered by the Federal Circuit in *Coltec*. The Fourth Circuit in *Black & Decker* analyzes the economic consequences of the contingent liability transaction as a whole. The distinction made in the excerpt above and cited by the Federal Circuit in *Coltec* is only between the contingent liability transaction and the other business activities of the taxpayer. It is not a distinction between one step and another step in the contingent liability transaction itself. If the relevant inquiry is profitability, it would be absurd to break a transaction into steps to perform that analysis. Such an analysis would lead to all steps that did not directly produce a profit being disregarded. That is a result that has not been suggested by any court before *Coltec*.

⁵⁷ *Id.*, citing *Rice’s Toyota*, 752 F.2d at 94. The “reasonable expectation of profit” standard articulated in *Rice’s Toyota* raises the question of how economic substance should be evaluated in a transaction that is not intended to produce a profit. For example, restructuring transactions are often undertaken to better group related businesses together. Liquidations are often undertaken to free up capital for other activities or to pay down debt. Neither of these types of transactions strictly speaking are intended to produce a profit.

In *Nicole Rose*, the Second Circuit upheld the Tax Court’s determination that a series of sale leaseback transactions did not have economic substance. The taxpayer claimed such transactions resulted in a \$22 million loss, which the taxpayer used in part to offset an \$11 million gain from the purchase of an unrelated corporation and the sale of that corporation’s assets. The Second Circuit stated that the profit from this unrelated purchase and sale should not be included to evaluate the profitability of the lease transaction because “[t]he relevant inquiry is whether the transaction that generated the claimed deductions—the lease transfer—had economic substance.”⁵⁸ The court did not break the lease transaction down to evaluate each step individually for economic substance. Rather, the court stated that the transaction as a whole lacked economic substance. The court’s statement that the “relevant inquiry” should be the transaction that generated the tax deductions was only to distinguish the series of steps that resulted in a loss from the unrelated transactions entered into by the taxpayer that resulted in a gain.

Finally, the Federal Circuit cites *ACM Partnership*. The Third Circuit in *ACM Partnership* applied a similar holistic conception of the economic substance doctrine, stating “these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences.”⁵⁹ However, the Third Circuit specifically states that this analysis should be applied to the transaction as a whole. The court states, “In applying these principles, we must view the transactions “as a

⁵⁸ *Nicole Rose*, 320 F.3d at 284

⁵⁹ *ACM Partnership*, 157 F.3d at 247, citing *Casebeer v. Comm’r*, 909 F.2d 1360, 1363 (9th Cir. 1990).

whole, and each step, from the commencement...to the consummation...is relevant.”⁶⁰ Similar to the Federal Circuit’s misleading citation of the cases above, this proposition—that all steps of the transaction are relevant—is quite different from the proposition advanced by the Federal Circuit—that the transaction should be broken into pieces and each piece evaluated on its own.

Accordingly, the conception of economic substance as a test that should be applied to individual steps in a transaction is new ground broken by the court in *Coltec* and represents a marked change from the application of the test 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, clearly should be entitled to respect. Narrowing the focus of the economic substance doctrine to individual steps in a transaction represents a troubling expansion of the court’s authority and, as described below, has the potential to undo the tax consequences in numerous legitimate transactions.

IV. Contingent Liabilities After *Coltec*

The Federal Circuit’s analysis leaves many questions unanswered for taxpayers dealing with contingent liabilities. What if Garlock never sold the stock of Garrison in the *Coltec* transaction? Does a taxpayer need a business purpose for the transfer even if no sale of stock is contemplated?⁶¹

⁶⁰ *Id.*, citing *Weller v. Comm’r*, 270 F.2d 294, 297 (3d Cir. 1959).

⁶¹ Certain authorities have held that there is a business purpose requirement for section 351 transactions. *See, e.g., Estate of Kluener v. Comm’r*, 154 F.3d 630 (6th Cir. 1998); *Caruth v. United States*, 688 F. Supp. 1129 (N.D. Tex. 1987), *aff’d*, 865 F.2d 644 (5th Cir. 1989); TAM 8045001 (Oct. 25, 1978); FSA 200001001 (Jul. 28, 1999); FSA 200023016 (March 1, 2000). This authority, however, suggests that the business purpose requirement is a relatively low

As stated above, the court in *Coltec* disregards both the transfer of the liabilities and the transfer of the note. 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? 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? The Federal Circuit's opinion in *Coltec* does not answer any of these questions.

In addition, it is unclear whether the analysis in *Coltec* will apply to transactions entered into after section 358(h) became effective. Assume a parent corporation transfers assets and liabilities to a subsidiary and sells the subsidiary's stock. Under section 358(h), if the assets or business that related to the liabilities are not also transferred, the transaction is respected, but the basis in the stock of the subsidiary is reduced by the amount of the contingent liabilities. However, if the assets or business that is related to the liabilities are transferred, the basis is not reduced. In contrast, the Federal Circuit in *Coltec* declared that the transfer of a note and the transfer of contingent liabilities must be ignored because it lacks economic substance. Does this analysis apply even if the assets and business to which the liabilities relate are also transferred? If the assets and business to which the liabilities relate are not transferred, is the basis reduced under section 358(h) or is the entire transaction ignored under *Coltec*? Lastly, if section 358(h) applies, query whether the government will follow Rev. Rul. 95-74 and allow the transferee subsidiary to claim a deduction on payment of the liabilities.

standard. It is unclear whether the Federal Circuit's analysis in *Coltec* will supersede this authority.

V. Other Transactions after the Economic Substance Analysis in *Coltec*

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.⁶² Below is a brief list of 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.

A. Sale to Recognize Built-in Loss

John Prusiecki recently responded to a comment from Professor George K. Yin on *Coltec* in *Tax Notes* and raised the question whether a sale of depreciated publicly traded stock to recognize a loss can survive the *Coltec* court's conception of the economic substance doctrine.⁶³ Under section 1091, losses from the sale of stock or securities will be disallowed as "wash sales" if a taxpayer repurchases the same stock or securities within 30 days. As Mr. Prusiecki described in his letter, counsel generally advise that taxpayers may sell stock or securities to recognize a loss provided they wait the statutory period of 30 days before reinvesting in such stock or securities. If a taxpayer follows such advice and sells his depreciated stock on the open market, only to repurchase it again 31 days later, does *Coltec* provide justification for a court to disallow

⁶² For an article that raises similar questions with respect to the application of the business purpose and economic substance tests to certain transactions prior to the Federal Circuit decision in *Coltec*, see Mark J. Silverman, Philip R. West, Aaron P. Nocjar, *Establishing Business Purpose in a Transparent World*, TAX NOTES TODAY, 2004 TNT 159-17 (Aug. 16, 2004)

⁶³ John F. Prusiecki, *Coltec: The Dialogue Continues*, TAX NOTES, 2006 TNT 162-26 (Aug. 22, 2006)

the loss? What non-tax motivation for such a sale could there be? If *Coltec* does provide such justification, then what is the purpose of section 1091?

Further, the Federal Circuit's decision in *Coltec* appears to ignore the Supreme Court opinion in *Cottage Savings v. United States*.⁶⁴ In *Cottage Savings*, the Supreme Court held that a taxpayer's exchange of mortgage securities for other similar securities resulted in a realized loss for tax purposes. The Court stated that the sale of the mortgage securities resulted in a bona fide loss, even though the exchange was disregarded for regulatory purposes. The transaction was done solely for tax purposes. However, the Court did not cite *Gregory* or *Frank Lyon* to challenge the economic substance of the transaction and did not evaluate the business purpose of the transaction. The fact that it was a bona fide sale and there was an economic loss was sufficient to sustain the capital losses realized in the transaction. If the Federal Circuit's standard is that a transaction must have both economic reality and a business purpose, how can this standard as applied in *Coltec* be reconciled with *Cottage Savings*?

B. Liquidations

1. Section 332 Liquidations

Assume a parent corporation (P) owns all of the stock of a subsidiary (S) with separate return limitation year (SRLY) tax attributes. P liquidates S or checks the box to treat S as a disregarded entity. P retains S's assets and continues to operate the liquidated business. The transaction is motivated solely to use S's attributes to offset P's income. Does this transaction, which clearly has real economics, have economic substance under the Federal Circuit's analysis in *Coltec*?

⁶⁴ 499 U.S. 554 (1991)

2. Avoiding Section 332

Assume P owns stock of S with a built-in-loss. If P liquidates S, under section 332 P does not recognize the stock loss and the stock basis disappears. Assume instead that P sells 25 percent of the S stock to a foreign affiliate (FS). One year later S is liquidated in a section 331 liquidation. Is the loss allowable to P? Case law and the Service's own guidance hold that a taxpayer may take steps to avoid the application of section 332. The Service has accepted the reasoning in *Granite Trust Co. v. United States*,⁶⁵ that so long as sales of stock prior to liquidation are bona fide, such sales will be respected and allow a taxpayer to avoid the application of section 332.⁶⁶ Therefore it is generally believed that a taxpayer may sell stock in a subsidiary sufficient to reduce its ownership below 80-percent and recognize gain or loss on a subsequent liquidation of that subsidiary. Does *Coltec* jeopardize this line of authority? If such a transaction is broken down step-by-step and only the sale of stock is examined, would a taxpayer have a legitimate business purpose for reducing its ownership below 80-percent?⁶⁷

3. Fitting Within Section 332

A taxpayer may take steps in order to satisfy the 80-percent test and apply section 332. Section 332(b)(1) requires 80-percent ownership "on the date of the adoption of the plan of liquidation." This provision has generally been interpreted to allow a taxpayer to acquire stock

⁶⁵ 238 F.2d 670 (1st Cir. 1956)

⁶⁶ See Rev. Rul. 78-285 (citing *Granite Trust* with approval); TAM 8428006 (Mar. 26, 1984) (applying *Granite Trust* and allowing a capital loss where stock was sold specifically to avoid nonrecognition under section 332). See also *Commissioner v. Day & Zimmermann, Inc.* 151 F.2d 517 (3rd Cir. 1945).

⁶⁷ Note the sale would be characterized as a redemption and distribution under section 304. See section V(H), *infra*.

sufficient to meet the 80-percent test.⁶⁸ If P acquires stock to increase its ownership of S to 80-percent in order to liquidate S and apply section 332, would this acquisition have a legitimate business purpose? Would a court following *Coltec* then seek to disregard the acquisition and refuse to apply section 332 in order to force P to recognize gain?

4. Check and Sell Transaction

In *Dover Corporation & Subsidiaries v. Comm'r*,⁶⁹ the taxpayer checked the box to treat a subsidiary as a disregarded entity and then sold the ownership interests in that entity. This “check and sell” transaction was done solely to allow the taxpayer to avoid subpart F income on the sale. *Dover* held that a taxpayer does not need a business purpose to check the box and treat a subsidiary as a disregarded entity. The court in *Dover* stated, “[n]or do the check-the-box regulations require that the taxpayer have a business purpose for such an election or, indeed, for any election under those regulations. Such elections are specifically authorized ‘for federal tax purposes.’”⁷⁰ Under the Federal Circuit’s analysis in *Coltec*, could a check-the-box transaction such as the one in *Dover* be subject to review because the check-the-box election was made for tax purposes?

⁶⁸ See Rev. Rul. 75-521, 1975-2 C.B. 120.

⁶⁹ 122 T.C. 324 (2004)

⁷⁰ A check-the-box election still must meet the requirements set forth in the Treasury regulations under section 7701. In addition, a transaction accomplished using a check-the-box election must meet the same standards that would apply to the transaction if the taxpayer actually did the transaction without a check-the-box election. See Treas. Reg. § 301.7701-3(g)(2) (“tax treatment of a change in classification . . . is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law”); see also 62 FR 55768 (1997) (preamble) (“This provision . . . is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations.”)

C. Section 351 Transactions

Assume that various partners in a number of LLCs/partnerships roll-up these LLCs/partnerships into a single corporation. Is this transaction subject to review under the Federal Circuit's analysis in *Coltec* if the roll-up was done to combine income and loss of the various LLCs/partnerships into a single entity?⁷¹

D. Purchase and Liquidation

Section 269(b) states that the Service may disallow a deduction, credit, or other allowance if (i) there is a qualified stock purchase by a corporation of another corporation; (ii) an election is not made under section 338 with respect to such purchase; (iii) the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than 2 years after the acquisition date, and (iv) the principal purpose for such liquidation is the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquiring corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

This section of the Code is generally read to say that a corporation may liquidate a target acquired in a qualified stock purchase so long as the acquirer waits two years after the qualified stock purchase. In addition, if section 269(b) applies, the consequences are that the secretary is permitted to disallow a deduction, credit, or other allowance. Section 269(b) does not provide that the purchase and/or liquidation will be disregarded. Do both of these authorities potentially apply to the same transaction? Can the *Coltec* decision be interpreted to effectively read section 269(b) out of the Code and allow any deduction or credit in the above circumstance to be disallowed if the court feels there was a liquidation solely for tax purposes?

⁷¹ As stated above, certain authorities have held that there is a business purpose requirement for section 351 transactions. See footnote 60, *supra*.

E. Liquidation and Sale

In *Commissioner v. Court Holding*,⁷² 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.*,⁷³ 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 the Federal Circuit's analysis *Coltec*, could the IRS disregard the liquidation in each transaction?

F. Busted Section 351 Transaction to Make Section 338(h)(10) Election

The regulations under section 338 allow a taxpayer to "bust" a potential section 351 transaction in order to make a section 338(h)(10) election. Assume P transfers stock of S to a newly formed corporation (Newco) in exchange for stock of Newco (including some nonvoting stock) and P sells more than 50 percent of the Newco stock to the public.⁷⁴ The sale to the public causes the corporation to fail the "control" test in section 351 and the related party rule in section

⁷² 423 U.S. 331 (1945)

⁷³ 338 U.S. 451 (1950)

⁷⁴ The issuance of nonvoting stock avoids the characterization of the transaction as a "B" reorganization because Newco does not acquire the S stock solely in exchange for voting stock.

338(h)(3)(A)(iii). Accordingly, the transfer qualifies as a purchase under section 338.⁷⁵ As a result, the seller and purchaser may make a joint section 338(h)(10) election. Under the Federal Circuit's analysis in *Coltec*, could this transaction be subject to review because one step of the transaction is undertaken solely to step up the basis in the assets through the section 338(h)(10) election?

G. Reorganizations

The statutory requirements for reorganizations under section 368 require taxpayers to satisfy numerous requirements in order to qualify for the tax-free treatment afforded by those provisions. The Treasury regulations under section 368 and caselaw provide that a taxpayer needs a business purpose for the reorganization in order to qualify for tax-free treatment. Would the court in *Coltec* suggest that a taxpayer must also have a business purpose for each and every step in a 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?

Similarly, if P causes S1 to sell all of its assets to S2 and then liquidate, this transaction should qualify as an acquisitive "D" reorganization. Revenue Ruling 70-240, 1970-1 C.B. 81, states that an actual distribution of S2 stock to P is not required in these circumstances because it would be a meaningless gesture. This revenue ruling is supported by various cases and has been

⁷⁵ See Treas. Reg. § 1.338-3(b)(3)(iv), Ex. 1.

followed in numerous PLRs.⁷⁶ This transaction, the all cash “D” reorganization, results only in a restructuring of assets ultimately owned by a single taxpayer. Does the analysis in *Coltec* provide a basis to challenge the economic substance of the transaction? Specifically, would the Federal Circuit’s fifth principle of economic substance that “arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny” provide the needed authority?⁷⁷

⁷⁶ See, e.g., Rev. Rul. 2004-83 (treating the purchase of Sub2’s stock by Sub1, followed by the liquidation of Sub2, as a “D” reorganization); Rev. Rul. 75-383, 1975-2 C.B. 127; *American Manufacturing Co. v. Comm’r*, 55 T.C. 204 (1970); *Atlas Tool Co. v. Comm’r*, 614 F.2d 860 (3rd Cir. 1980); PLR 7950044; PLR 8108112; PLR 8305091; PLR 8334014; PLR 8339081; PLR 8529030; PLR 8530012; PLR 8624054; PLR 8635040; PLR 8645062; PLR 8751023; PLR 8806081; PLR 8830006; PLR 8909012; PLR 8924006; PLR 8924034; PLR 8945043; PLR 9014028; PLR 9023046; PLR 9045058; PLR 9105039; PLR 9112026; PLR 9124058; PLR 9127023; PLR 9132020; PLR 9220046; PLR 9223027; PLR 9320010; PLR 9331018; PLR 9335045; PLR 9441018; PLR 9541025; PLR 200011041. *But see* Preamble to Proposed Regulations on Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11,903 (March 10, 2005) (noting that the Service and Treasury intend to study the issues surrounding acquisitive “D” reorganizations, including “the continuing vitality” of the authorities discussed with respect to the first category transactions in this letter).

⁷⁷ 454 F.3d at 1355-57.

H. Section 304 Foreign Tax Credit Transaction

Assume P sells the stock of one foreign subsidiary (FS1) to another foreign subsidiary (FS2). This transaction generally is governed by section 304. Under section 304, the sale of stock of one controlled subsidiary to another acquiring controlled subsidiary is treated as a redemption of stock of the acquiring subsidiary. This treatment allows the U.S. parent to repatriate cash that bears foreign tax credits without paying foreign withholding taxes. Is this transaction subject to challenge under *Coltec* because it was done for tax purposes? Note that the transaction is among affiliates and that the cash remains in the same affiliated group.

VI. Conclusion: An Uncertain Future

It is not clear whether any of the above transactions may be reconciled with the opinion of the Federal Circuit in *Coltec*. Nevertheless, all of them should work under current law and should continue to work after *Coltec*. A sale to recognize a built-in loss should be recognized under the Supreme Court's opinion in *Cottage Savings*. Transactions to fit within, or avoid, the requirements of section 332 should be respected. Taxpayers should be allowed to take steps to be qualify under section 338(h)(10) and section 368 under the plain statutory language and Treasury regulations that contemplate these transactions. Section 269(b) establishes a clear rule for when the Service may disallow deductions or other tax benefits obtained from a purchase and liquidation. A purchase and subsequent liquidation that falls outside of those rules should be respected. Similarly, a liquidation and subsequent sale that is comparable to the facts in *U.S. v. Cumberland Public Service Co.*⁷⁸ should continue to be respected based on the Supreme Court's opinion in that case. A transaction that fits within section 304 should be respected, even though the transaction was done for tax purposes. The Federal Circuit's analysis in *Coltec* should not

⁷⁸ 338 U.S. 451 (1950)

upset any of these precedents. However, the difficulty of distinguishing the reasoning in *Coltec* from the above transactions should cause a serious evaluation of the potential scope of the ambiguous and broad doctrine the Federal Circuit articulated.

The potential expansive reach of the economic substance test articulated in *Coltec* combined with the application of that test on a step-by-step basis raises questions with respect to virtually all tax planning and the potential consequences of an “I know it when I see it” discretion given to the IRS and the judiciary. Although many practitioners and commentators have opposed legislative efforts to codify the economic substance doctrine, the Federal Circuit’s opinion in *Coltec* may cause those views to be reevaluated.⁷⁹ Unless *Coltec* is clarified and limited, the Federal Circuit risks becoming, in one decision, the most unfavorable venue for taxpayers to resolve their controversies with the IRS. Further, if *Coltec* is interpreted broadly, the Federal Circuit may cease to be a forum for taxpayer disputes altogether because taxpayers will rationally file their suits in Tax Court or the appropriate Federal district court. If other courts adopt the ambiguous and expansive test laid out in *Coltec*, the IRS may have the ability to challenge a whole new group of transactions. This may put the courts at risk to be flooded with economic substance review of business transactions the way the Supreme Court became flooded with obscenity cases in the late 1960s and early 1970s. Rather than increased faith in our revenue laws, this result would cause chaos, widespread uncertainty, and taxpayers to be subject to the whims of the IRS and an overburdened judiciary. Although “I know it when I see it” is an effective expression of frustration, it is not an effective way to enforce the tax law.

⁷⁹ See, e.g., “Steptoe & Johnson Attorneys Repeat Their Plea for Noncodification of Economic Substance Doctrine,” TAX NOTES TODAY, 2005 TNT 220-20 (November 15, 2005). The IRS and Treasury continue to oppose codification as well. See, e.g., Allen Kenney, *Korb Speculates on Codification of Economic Substance Doctrine*, 2004 TNT 217-2 (Nov. 9, 2004)