Coltec Industries, Inc. v. United States

454 F.3d 1340 (Fed. Cir. 2006), cert. denied, 549 U.S. 1206 (2007), rev'g 62 Fed. Cl. 716 (2004)

DYK, Circuit Judge.

In 1996, Coltec Industries, Inc. ("Coltec") reported a capital loss of approximately $378.7 million on its consolidated tax return. This loss was generated by Coltec's selling of high-basis stock for a relatively low price.…We conclude that, although Coltec's claimed capital loss fell within the literal terms of the statute, the transaction that created the high basis in the stock lacked economic substance and therefore must be disregarded for tax purposes.…

In 1996 Coltec was a publicly traded company with numerous subsidiaries. In that year, Coltec sold one of its businesses, Holley Automotive, Inc., for a gain of approximately $240.9 million. Coltec then met with its tax advisors at Arthur Andersen LLP to discuss, among other things, strategies to offset this gain. Arthur Andersen proposed a transaction that had been used in the past to generate capital losses. The transaction essentially involved three steps. First, the parent company would reorganize a dormant subsidiary into a special purpose entity. Second, the parent would transfer property and contingent liabilities to the newly reorganized subsidiary in exchange for stock in that subsidiary. Finally, the parent would sell the stock to a third-party for a nominal sum. The parent would treat its basis in the stock as equal to the property it transferred to the subsidiary but not reduced by the liabilities the subsidiary assumed. The parent would then suffer a significant loss from the sale of the stock because the sale price of the stock would be drastically lower than its basis.

Coltec found Arthur Andersen's proposal appealing. For one thing, Coltec had contingent liabilities, namely asbestos liabilities, which were a prerequisite for this type of transaction.…Coltec was at risk from the asbestos problem, as one of its subsidiaries, "Garlock," and one of Garlock's subsidiaries, "Anchor," had both previously manufactured or distributed asbestos products.…

Coltec decided to implement the Arthur Andersen proposal, and has admitted that tax avoidance was one of its reasons for doing so. Coltec's first step was to rename one of its dormant subsidiaries, "Garrison." 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 a payment of $13,998,000. In a separate transaction, Garrison issued

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100,000 shares of common stock to Garlock (representing approximately a 6.6% interest in Garrison), and assumed all the managerial responsibilities for handling the asbestos related claims against Garlock. Garrison also assumed, and agreed to indemnify Garlock against, all losses and liabilities incurred in connection with asbestos-related claims against Garlock. Garlock transferred to Garrison all outstanding Anchor stock, certain records and insurance policies relating to asbestos liabilities, and furniture. Garlock also transferred to Garrison a promissory note from one of its other subsidiaries, Stemco, Inc., in the amount of $375 million.[7]… [T]he $375 million amount was calculated to cover the estimated future asbestos liabilities of Garlock, including the Anchor liabilities.…Thus, Garrison assumed responsibility for Garlock's potential asbestos liabilities in exchange for a promissory note in the amount of approximately $375 million.

The third and final step involved Garlock's sale of its newly-acquired Garrison stock. On December 20, 1996, as previously contemplated, Garlock sold all of its 100,000 shares of Garrison stock to two banks for $500,000. The amount received was only slightly greater than half the transaction costs for establishing Garrison. As a condition of this sale, Coltec agreed to indemnify the banks against any veil-piercing claims for asbestos liabilities. Coltec, after this transaction, continued to own 93% of Garrison.

In its consolidated tax return for 1996, Coltec asserted that Garlock's basis in the Garrison stock was $379.2 million (representing the $375 million Stemco note plus the other property given to Garrison valued at approximately $4 million, but not reduced by the liabilities assumed by Garrison). Thus Garlock claimed to suffer a $378.7 million loss when it sold the stock for only $500,000. This $378.7 million loss more than offset Coltec's gains for that tax year. The unused loss was carried forward to offset gain in future tax years. Significantly, the loss was recognized only for tax purposes and not for book purposes, and the loss was not reported on the taxpayer's public financial reports.

…The government contended that the loss should be disallowed because Garlock was not entitled to the claimed basis for the Garrison stock. The government offered three separate theories. First, the government argued that the contingent asbestos liabilities were not excluded from "money received" treatment by §358(d)(2), because §357(c)(3) was inapplicable, as it refers to liabilities which would "give rise to a deduction" and the contingent liabilities here would not "give rise to a deduction." Second, the government argued that the transaction in which Garlock transferred a $375 million note to Garrison in exchange for the assumption of the asbestos liabilities had an improper purpose and should thus result in "money received" treatment under the statutory anti-abuse provision. Finally, the

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government argued that the transaction in which the note was exchanged for the liability assumption should be disregarded under the general economic substance doctrine with the result that the basis would not be increased by the amount of the Stemco note.

The Court of Federal Claims, after a bench trial, rejected the government's three arguments. The court held that the liabilities would "give rise to a deduction" under §357(c)(3). The court also determined that that transaction should not result in "money received" treatment under §357(b)(1), the statutory anti-abuse provision, because the principal purpose of the transaction was not tax avoidance; rather, it was a bona fide business purpose. The Court of Federal Claims finally rejected the government's alternative argument under the general economic substance doctrine, concluding that the doctrine was unconstitutional as a violation of separation of powers. The court went on to hold alternatively that the doctrine did not apply to the present case because the transaction had a bona fide business purpose.…

DISCUSSION

We find nothing in the literal terms of the statute that required Garlock to reduce its basis in the stock by the amount of liabilities assumed by Garrison. However, we conclude that the Court of Federal Claims erred in rejecting the long-standing economic substance doctrine and in its application of that doctrine. The underlying transaction between Garlock and Garrison, in which a $375 million note was transferred to Garrison in exchange for the assumption of the contingent asbestos liabilities, had no meaningful economic purpose, save the tax benefits to Coltec. As such, that transaction must be ignored for tax purposes.

[The court's explanation that "contingent liabilities" are included within the term "liability" as used in section 358(d), is omitted.]

Consequently, under the general rule, the liabilities assumed by Garrison would be treated as "money received" by Garlock. Thus under the general rule [of section 358(d)(1)], Garlock's basis in its newly acquired Garrison stock would be decreased by the amount of the contingent liabilities assumed by Garrison.

However, there is an exception to this general rule for calculating basis. Section 358(d)(2) provides that §358(d)(1) "shall not apply to the amount of any liability excluded under section 357(c)(3)."…The government asserts that the liabilities at issue do not fall under §358(d)(2)'s exception. The government's argument requires that we consider the interaction of four code provisions: sections 358(d)(2), 357(c)(3), 357(c)(1), and 357(b)(1).

i. Application of §357(c)(3)

…The parties first dispute whether the liabilities here "would give rise to a deduction" as §357(c)(3) requires. The government contends that the liability is not the kind that "would give rise to a deduction" under §357(c)(3) because §357(c)(3)

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only applies where the transferor (here Garlock) transferred *both* a liability and the underlying business that generated that liability. Because Garlock transferred its asbestos liabilities but kept its core business, the government urges that the liabilities do not fall within the scope of §357(c)(3). It is true that the central purpose of §357(c)(3) was to protect taxpayers who transferred the assets of their business along with liabilities of their business (such as accounts payable) from having to recognize gain if the liabilities exceeded the assets. The theory was that the transferor corporation should not have to recognize gain when it had lost the tax deduction that would flow from payment of the liabilities. However, we find the government's interpretation to be inconsistent with the plain language of §357(c)(3). Nothing in the plain language of §357(c)(3) limits the liabilities excludable to only those that were transferred along with an underlying business.

Accordingly, we conclude that §357(c)(3) does not limit excludable liabilities to only those that were transferred with an underlying business, and that the liabilities here satisfy the "would give rise to a deduction" requirement. In so holding, we join the only other court of appeals to have considered this exact issue. *See* Black & Decker Corp. v. U.S., 436 F.3d 431, 437 (4th Cir. 2006).…

ii. Applicability of §357(b)(1)'s Anti-Abuse Provision

…Basically, §357(c)(1) sets forth a gain-recognition calculation where one of the variables is the "amount of liabilities assumed." Section 357(c)(3) excludes certain liabilities from this gain-recognition calculus.

However, §357(c)(1) does not apply when an exchange triggers §357(b)(1)'s anti-abuse provision. 26 U.S.C. §357(c)(2). Section 357(b)(1)'s anti-abuse provision applies where liabilities are assumed principally for tax avoidance purposes or lack a bona fide business purpose.…

When it applies, the effect of §357(b)(1) is two-fold. First, it supplants §357(c)(1) and requires that assumed liabilities be treated as "money received" for purposes of §351(b), so that the full amount of gain must be recognized to the extent of liabilities assumed rather than merely (as (c)(1) requires) the amount that liabilities exceed basis. Second, it eliminates the §357(c)(3) exclusion. In other words, §357(c)(3)'s exclusion may be rendered inapplicable by (b)(1) if there is a principal tax avoidance purpose or an absence of bona fide business purpose.

The government argues that the transaction here falls within §357(b)(1) because the principal purpose behind the assumption of liabilities by Garrison was to avoid taxes or was otherwise not a bona fide business purpose. Although neither §358(d)(2) nor §357(c)(3) (the sections directly involved here) makes a direct reference to §357(b)(1) (the anti-abuse provision), the government argues that: §357(c)(3) refers to §357(c)(1); §357(c)(1) can only apply when §357(b)(1) does not apply; and that therefore, §357(c)(3) cannot apply where §357(b)(1) applies.

We disagree with the government's construction of these code provisions. These code provisions are not a model of statutory draftsmanship. The real question is what

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is meant by §358(d)(2) when it refers to a "liability excluded under section 357(c)(3)." This could have two possible meanings. It could mean that a liability is excluded "under section 357(c)(3)" if—looking at §357(c)(3) in a vacuum—the liability is of the type excluded from the §357(c)(1) calculation. On the other hand, it could mean that the liability is "excluded" only if it is actually excluded from gain recognition under §357(c)(1) by operation of §357(c)(3)—that is, if the (c)(3) exclusion is meaningful because §357(c)(1) is operative and not overridden by §357(b)(1). In essence, the taxpayer urges the former interpretation, and the government urges the latter interpretation. We think the taxpayer's interpretation is the better of the two.

In construing statutory provisions, we appropriately consult dictionaries in use at the time the statute was enacted. The use of the term "under" in §358(d)(2) suggests limiting consideration to (c)(3) itself since the dictionary definition of "under" in this context is "required by" or "in accordance with." In other words, the dictionary definition of the term "under" suggests looking only to the operation of §357(c)(3) itself. The section says nothing about excluding liabilities from gain recognition. It deals only with excluding liabilities from the §357(c)(1) computation. Moreover, we think that Congress likely would have done one of the following if it wished §357(b)(1) to apply in this situation. On the one hand, it could have made explicit reference to the basis provision of §358 in §357(b)(1); instead that section refers only to treating an assumption of liabilities as "money received" for "purposes of section 351 or 361" (which deal only with gain recognition and not basis reduction). Alternatively, Congress could have made explicit reference to §357(b)(1) in §358(d)(2) if it intended to require that §358(d)(2) apply only if §357(c)(3)'s exclusion was not rendered inoperative by §357(b)(1). In other words, if Congress wanted the operation of §357(b)(1) to preclude the benefit of §358(d)(2), it could have said in §358(d)(2) something like, "§358(d)(1) shall not apply to the amount of any assumed liability excluded under §357(c)(3) *unless the assumption involved a prohibited purpose described in §357(b)(1)*." (The added underscored language would achieve the supposedly desired result.)

We thus conclude that if the liability is excluded by §357(c)(3) standing alone, then §358(d)(2)'s exception may be invoked. It does not matter whether the anti-abuse provision of §357(b)(1) applies and overrides the actual operation of §357(c)(1). The interpretation we adopt in this respect is identical to the interpretation adopted by the Fourth Circuit in *Black & Decker*, though we reach this result by a somewhat different interpretive path. 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. Ultimately, the taxpayer would not be disqualified from claiming the capital loss.

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II

Having concluded that Garlock's loss from the sale of its Garrison stock falls within the literal terms of the statute, we now turn to the government's argument under the general economic substance doctrine. We must first consider the Court of Federal Claims' holding that "the use of the economic substance doctrine to trump mere compliance with the Code would violate the separation of powers." That holding is untenable. In rejecting the economic substance doctrine, the court failed to follow binding precedent of the Supreme Court and this court and its predecessor court, the Court of Claims.

Over the last seventy years, the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality. This principle has its roots in several Supreme Court cases.…The economic substance doctrine has also been repeatedly applied by our predecessor court.…There can be no question that the Court of Federal Claims is required to follow the precedent of the Supreme Court, our court, and our predecessor court, the Court of Claims.

Despite acknowledging that "the [Supreme] Court has decided tax cases invoking [the economic substance] doctrine," the Court of Federal Claims chose not to follow this precedent because "[a] careful reading of *other* cases cited by the Government[]…reveals that the Court resolved the tax question at issue first by looking to the Code and utilized doctrinal language only to further support its conclusion." We fail to see how the existence of other Supreme Court cases that do not rely on the doctrine undermine the authority of those that do.…

Even if we were to assume that the decisions of the Supreme Court and our predecessor court recognizing the economic substance doctrine are not binding, we cannot agree that the doctrine is somehow unconstitutional. Even Coltec makes no effort to defend this proposition on appeal. The Court of Federal Claims has cited no authority supporting its determination that the doctrine is unconstitutional.…

The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute. The Supreme Court has explicitly held that when the judiciary goes beyond the literal language of a statute in order to give effect to its purpose, the separation of powers is not violated.…Here, the economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance. We conclude that there is no basis for holding the economic substance doctrine unconstitutional.

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III

Although the Court of Federal Claims found the economic substance doctrine unconstitutional, it went on to hold that the doctrine was inapplicable in any event, relying on the findings that it made in connection with the statutory tax avoidance test. A review of that determination requires us to consider the basic principles of the economic substance doctrine, as well as its applicability to this case.…

B. APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

Under these principles, Coltec had the burden of proving that this transaction, which admittedly had a tax avoidance purpose, had an economic reality. The Court of Federal Claims held that Coltec had met this burden. 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.

In urging that the transaction had economic substance, Coltec focused particularly on its objective to make the company as a whole a more attractive acquisition target as well as on its objective to make other potential target companies view Coltec as a desirable acquirer. 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 first asserted business purpose focuses on the wrong transaction—the creation of Garrison as a separate subsidiary to manage asbestos liabilities. Coltec contends that the transaction had an economic purpose because, by having a separate corporation like Garrison manage Garlock's asbestos liabilities, Coltec became more attractive.…The Court of Federal Claims also found that "[T]he management and minimization of [the asbestos] liabilities were essential to the continued viability of Anchor and potentially Garlock. *Therefore, the conversion of these businesses into corporate form* was clearly to serve a *bona fide* business purpose."

The government does not dispute that the transfer of management activities may have had economic substance. The transfer of management activities, however, is not the transaction at issue. Here…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. Coltec admits that "Garrison received the Stemco note in exchange for assuming Garlock's asbestos liabilities." 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.

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

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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.

Coltec's second argument for why the transaction has economic substance—that the transaction was designed to strengthen Coltec's position against potential veil-piercing claims—focuses on the appropriate transaction but is also unavailing. Coltec argues, and the Court of Federal Claims agreed, that the transfer of the liabilities for the note was designed to strengthen Coltec's core business from veil-piercing claims, because Garrison would serve as another corporate layer between asbestos claimants and Coltec. Coltec correctly points out that the asbestos liabilities of subsidiary companies such as Garlock frequently exceeded the assets of those companies, and that plaintiffs in asbestos liability cases routinely sought to pierce the corporate veil to reach the assets of parent companies. Understandably, this was a matter of considerable concern to parent companies such as Coltec. The problem is that there is no objective basis for suggesting that the assumption of these liabilities by another subsidiary (in this case Garrison) would in any way ameliorate this veil-piercing problem.

In this respect, Coltec relied entirely on the testimony of various Coltec executives about the veil-piercing benefits that they perceived from the Garlock-Garrison transaction.…These subjective views of Coltec's executives, even if credited, as they were by the Court of Federal

Claims, are insufficient to establish economic substance. As we have discussed, economic substance is measured from an objective, reasonable viewpoint, not by the subjective views of the taxpayer's corporate officers. Looking 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.

The transfer of the liabilities for the note could only strengthen Coltec's defense against veil-piercing if third parties would be obligated to pursue Garrison instead of Garlock. It is perfectly clear that the transaction had no such result. We are not aware of, nor has Coltec brought to our attention, any authority suggesting otherwise. Nor has Coltec pointed to testimony from any third party that there could be such a benefit. The Court of Federal Claims made no such finding, and even Coltec concedes that Garrison's assumption of Garlock's asbestos liabilities did not actually shield Garlock or Coltec from direct liability, conceding that "Coltec could not, of course, effect a release of Garlock's liabilities to third parties."

Thus the transaction here could only affect relations among Coltec and its own subsidiaries—it has absolutely no affect on third party asbestos claimants.…We therefore see 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. Garrison's assumption of Garlock's liabilities in exchange for the Stemco note served no purpose other than to artificially inflate Garlock's basis in its Garrison stock. That transaction must be disregarded for tax purposes. When that transaction is disregarded, the basis in the Garrison stock is unaffected by the Stemco note/assumed liability exchange.…

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NOTES AND QUESTIONS

1. *When is the economic substance doctrine relevant?* The *Coltec* decisions present two opposing views concerning the role of the economic substance doctrine and its "relevance" to future transactions potentially subject to section 7701(o). The trial court urged that the doctrine be invoked very sparingly because

> [t]he public must be able to rely on clear and understandable rules established by Congress to ascertain their federal tax obligations. If federal tax laws are applied in an unpredictable and arbitrary manner, albeit by federal judges for the "right" reasons in the "right case," public confidence in the Code and tax enforcement system will be further eroded. [62 Fed. Cl. 716, 755 (2004).]

Balanced against the trial court's concern, however, is the effect on public confidence if taxpayers are allowed to reduce their tax liabilities through use of egregious tax shelters.

In contrast to the trial court, the Federal Circuit explained that

> [t]he economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.…Here, the economic substance doctrine

is merely a judicial tool for effectuating the underlying Congressional purpose.…[454 F.3d at 1353-54.]

In characterizing the doctrine as merely a tool of statutory interpretation, the Federal Circuit unfortunately provides little guidance on when and how frequently it should be raised. Was it necessary to invoke the doctrine in *Coltec*? Did the Federal Circuit perhaps feel obligated to address the economic-substance issue once the government raised it and the trial court made its novel assertion that use of the doctrine violated separation of powers?

2. *Deduction of asbestos liabilities?* If Garrison satisfied the asbestos liabilities assumed in the transaction, would it be entitled to deduct those expenses? What is the answer based on the discussion of issue 2 in Rev. Rul. 95-74?

3. Black & Decker *and subsequent cases*. As mentioned in *Coltec*, another contingent liability case decided about the same time is Black & Decker v. U.S., 436 F.3d 431 (4th Cir. 2006), aff'g in part and rev'g in part 340 F. Supp. 2d 621 (D. Md. 2004). In that case, the taxpayer transferred to its controlled subsidiary $561 million in cash and also had the subsidiary assume the taxpayer's contingent liability to provide health care benefits for the taxpayer's employees. The contingent liability was valued at $560 million so that when the taxpayer subsequently sold the stock of the subsidiary for $1 million, it claimed a $560 million capital loss. The trial judge

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was apparently quite taken by the transaction, referring to it at a bench conference as "a thing of grace and beauty…a wonderful transaction," and stating, "I now [understand] why my former tax partners got paid so much." The judge denied the government's summary judgment motion that the statute precluded the claimed capital loss, and granted the taxpayer's summary judgment motion that as a matter of law, the transaction was not a sham and should be respected for tax purposes. Like the Federal Circuit in *Coltec*, the Fourth Circuit affirmed the trial judge's conclusion that the statute did not bar the capital loss. The court, however, found that there remained genuine issues of material fact to be resolved regarding whether the transaction was a sham, and therefore reversed that portion of the trial court opinion and remanded the case for trial. In December 2007, the parties announced that they had settled their dispute. According to news reports, the settlement required Black & Decker to pay the government about $50 million in 2008, or less than 30 percent of the amount the company had apparently reserved for the contingent additional tax liability (plus interest) if the company's position were not respected.

Subsequent cases have not been as favorable to taxpayers. In both WFC Holdings Corp. v. U.S., 728 F.3d 736 (8th Cir. 2013), cert. denied, 134 S. Ct. 2724 (2014), and Gerdau MacSteel, Inc. v. Comm'r, 139 T.C. 67 (2012), the court applied the common-law economic substance doctrine to deny the taxpayer's claimed tax benefits from engaging in a contingent liability tax shelter. In *Gerdau*, the court also ruled against the taxpayer on technical grounds, finding that the taxpayer only received NQPS in a purported section 351 exchange and, therefore, that provision was not applicable. In addition to denying the taxpayer's claimed tax loss, the Tax Court in *Gerdau* disallowed the taxpayer's deduction for fees incurred to engage in the transaction, and imposed a 20 percent negligence penalty.

4. *Some collateral consequences of a failed tax shelter*. Both the contingent liability tax shelter in *Coltec* and the basis-shifting tax shelter in *Heinz* (see p. 240) result in a taxpayer obtaining an overstated basis in property. In U.S. v. Home Concrete & Supply, LLC, 132 S. Ct. 1836 (2012), the Court relied on Colony, Inc. v. Comm'r, 357 U.S. 28 (1958), to conclude that an overstated basis (from a contingent liability tax shelter using a partnership) did not constitute a substantial omission of gross income that triggered the extended six-year statute of limitations for assessing a deficiency. I.R.C. §6501(a) and (e)(1)(A). According to the majority, to inflate basis

is not to "omit" income in the sense of leaving out an actual item of income or profits. 132 S. Ct. at 1840. In U.S. v. Woods, 134 S. Ct. 557, 565-68 (2013), however, the Court held that a basis overstatement (from the same type of shelter), if sufficiently excessive, may be a "gross valuation misstatement" that potentially allows imposition of a 40 percent penalty on top of any underpayment of tax attributable to that error. I.R.C. §6662(a) and (h)(1). In 2015, Congress reversed the holding in *Home Concrete* and provided that an overstated basis is an omission of gross income for purposes of the extended statute of limitations. P.L. 114-41 (2015), §2005(a).

In another collateral consequence, Paul Daugerdas, a tax lawyer and CPA who aggressively marketed the contingent liability and other tax shelters, was sentenced in 2014 to serve 15 years in prison and required to forfeit over $164 million and pay

$371 million in restitution to the government. According to the Department of Justice, Daugerdas's efforts over a 20-year period generated over $7 billion in fraudulent tax losses and $95 million in fees for himself. After the tax shelters began to unravel, the three professional firms in which Daugerdas worked all dissolved. Another lawyer who worked with Daugerdas was sentenced in 2013 to eight years in prison and ordered to pay $190 million in restitution.

5. *Legislative fixes*. The contingent liability shelter illustrates the importance of matching as closely as possible the tax consequences of a transaction with its economic effect. This objective has been particularly difficult to achieve when liabilities are involved in a transaction because the economic effect of a liability transfer—that is, the amount of the economic obligation actually transferred from one party to another—may be hard to determine. In the contingent liability shelter, the entire liability transferred apparently became an obligation of the corporate transferee because the value of the transferee's stock was reduced by the full amount of the liability. Yet, at least as found by the courts in *Black & Decker* and *Coltec*, sections 357(c)(3) and 358(d)(2) permitted the liability to be disregarded for tax purposes, so that there was no required matching reduction in the transferor's basis in the stock of the transferee. The result of the mismatch was the huge claimed capital loss upon disposition of the stock.

Read I.R.C. §358(h). This provision was enacted in direct response to the contingent liability shelter. If, after application of the rest of section 358 (including section 358(a)(1) and (d)), the transferor's basis in the transferee stock exceeds its fair market value, such basis must be reduced (but not below fair market value) by the amount of any liability assumed by the transferee in the transaction. For this purpose, the term "liability" is defined broadly to include any fixed or contingent obligation to make a payment. Subject to regulatory override, no basis reduction is required if the liability assumption occurs in connection with a transfer of the trade or business, or substantially all of the assets, with which the liability is associated. The regulations have since removed the second exception contained in section 358(h)(2)(B) relating to liability assumptions in connection with a transfer of substantially all the assets. Reg. §1.358-5.

In contrast to the contingent liability cases, certain earlier shelters were built upon the opposite claim that the liability amount to be taken into account for tax purposes exceeded the economic effect of transferring the liability. For example, under prior law, section 357 also applied to transfers of property "subject to" a liability (even though the liability was not expressly assumed by the transferee). Certain taxpayers transferred property subject to a liability and claimed that the full amount of the liability had to be taken into account for tax purposes even though less than the full amount was actually assumed by the transferee. An example is a section 351 transfer of an asset (with basis and value of $60,000) encumbered by a $100,000 nonrecourse liability (with the remaining security for the debt retained by the transferor). If the asset transferred was treated as "subject to" the full $100,000 liability, then that full amount arguably had to be taken into account under section 357 even though it exceeded the economic burden actually assumed by the transferee

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(the $60,000 value of the only asset received by the transferee that was encumbered by the liability). Under that interpretation, the transferor arguably had to recognize $40,000 gain under section 357(c); if the transferor was not subject to U.S. tax, however, there was no resulting U.S. tax liability. At the same time, the corporate transferee arguably obtained a basis of $100,000 in the transferred asset (still only worth $60,000), allowing the transferee to claim a large tax loss upon subsequent disposition of the asset.

Read I.R.C. §§357(a) and (d), 362(d). The statute has also been amended to try to stop these shelters and more closely match the tax and economic consequences of a liability transfer. Congress amended section 357(a) to limit that provision to liabilities expressly assumed (or treated as assumed) by the corporate transferee. Section 357(d) defines the amount of a liability that is treated as assumed for purposes of sections 357, 358(d) and (h), 362(d), and certain other provisions dealing with reorganizations. For recourse liabilities, the amount is generally the portion of the liability the transferee has agreed to and is expected to satisfy, whether or not the transferor's liability is relieved. Nonrecourse liabilities are generally treated as assumed if an asset subject to the liability is also transferred. If there are, however, additional nontransferred assets subject to the same nonrecourse liability, the amount treated as assumed must be reduced by the lesser of (1) the amount the owner of such nontransferred assets has agreed to and is expected to satisfy, or (2) the fair market value of such nontransferred assets. These same rules apply in determining how much of a liability should be taken into account in a corporate distribution where the distributee assumes a liability or takes property subject to a liability. See I.R.C. §301(b)(2); Reg. §1.301-1(g).

Section 362(d)(1) bars the corporate transferee from receiving a basis in any property transferred greater than its fair market value by reason of gain recognized to the transferor under section 357. Further, section 362(d)(2) limits the transferee's basis in any property received where the transferor is not subject to U.S. tax and the transferee assumes a nonrecourse liability that is also secured by assets not transferred to the transferee. In that case, for purposes of determining the transferee's basis, the gain recognized by the transferor is determined as if the transferee assumed only a ratable share of the nonrecourse liability (determined by relative fair market values of the transferred and nontransferred properties).

Application of these new rules will depend upon the facts and circumstances of the transactions. Since incorrect tax results may arise if the amount of a liability taken into account for tax purposes is *either* too much *or* too little relative to the economic effect of the liability transfer, transactions involving liabilities will likely remain a perilous area for the tax system.