UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

Coltec Industries, Inc. v. United States

454 F.3d 1340 (Fed. Cir. 2006) · No. 05-5111 · Decided July 12, 2006

SUMMARY

The Federal Circuit held that Coltec Industries' transaction involving the transfer of a promissory note and contingent asbestos liabilities lacked economic substance and must be disregarded for tax purposes. Although the claimed capital loss fell within the literal terms of the tax code, the court vacated the Court of Federal Claims' judgment and remanded for recomputation of the allowable deduction.

CASE DETAILS

COURT	United States Court of Appeals for the Federal Circuit
WRITING FOR THE COURT	Dyk, Circuit Judge; Bryson, Circuit Judge; Gajarsa, Circuit Judge
JURISDICTION	Federal
DECIDED	July 12, 2006
DOCKET	05-5111
DISPOSITION	vacated_and_remanded
PROCEDURAL POSTURE	The United States appealed from a judgment of the United States Court of Federal Claims awarding Coltec a full refund of taxes paid after the IRS disallowed a claimed capital loss.
STANDARD OF REVIEW	The ultimate conclusion concerning business purpose and economic substance was reviewed without deference; underlying relevant facts were largely undisputed. The Federal Circuit also reviewed the Court of Federal Claims' legal conclusions concerning statutory interpretation and the economic substance doctrine de novo.
PRECEDENTIAL VALUE	Published precedential Federal Circuit opinion
PARTIES	United States v. Coltec Industries, Inc.

TOPICS

income tax · capital gains tax · tax basis · statutory interpretation · appellate procedure

PRACTICE AREAS

Federal income taxation | Corporate taxation | Tax litigation | Appellate procedure

QUESTIONS PRESENTED

1. Whether contingent asbestos liabilities assumed in a transaction governed by Internal Revenue Code sections 351 and 358 are liabilities for purposes of the basis-adjustment rules.
2. Whether the liabilities qualified for the section 358(d)(2) exception because they were liabilities described in section 357(c)(3), even though Garlock transferred the liabilities without transferring the underlying business that generated them.
3. Whether section 357(b)(1)'s anti-abuse provision made the section 358(d)(2) exception unavailable.
4. Whether the economic substance doctrine is valid and may be applied to disregard a transaction that literally complies with the Internal Revenue Code but lacks economic reality.
5. Whether the Garlock-Garrison transfer of the Stemco note in exchange for assumed asbestos liabilities had economic substance.
6. Whether Coltec was entitled to any partial capital-loss refund after disregarding the note-for-liabilities transaction.

HOLDINGS

1. Contingent liabilities are liabilities under section 358(d); their contingent nature does not prevent them from being treated as liabilities for purposes of the basis-adjustment rules.
2. Section 357(c)(3) does not limit excludable liabilities to liabilities transferred along with the underlying business that generated them. The asbestos liabilities satisfied the statutory requirement that payment would give rise to a deduction.
3. Section 357(b)(1) is not relevant to whether a liability is excluded under section 358(d)(2). If a liability is excluded by section 357(c)(3) standing alone, the section 358(d)(2) exception may be invoked even if section 357(b)(1) would override the actual operation of section 357(c)(1).
4. The economic substance doctrine is a valid judicial doctrine and is not unconstitutional under the separation-of-powers principle. Courts may disregard transactions that comply with the literal terms of the tax code but lack economic reality.
5. The transfer of the $375 million Stemco note to Garrison in exchange for Garrison's assumption of Garlock's contingent asbestos liabilities lacked economic substance and must be disregarded for tax purposes.

KEY QUOTATIONS

> *"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."*

> *"The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code."*

> *“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.”*

FACTUAL BACKGROUND

Coltec implemented a transaction in which its subsidiary, Garlock, transferred a $375 million promissory note and other property to a newly organized subsidiary, Garrison, in exchange for Garrison stock. Garrison assumed Garlock's contingent asbestos liabilities, and Garlock then sold the Garrison stock to two banks for $500,000 while claiming a basis of approximately $379.2 million. The resulting claimed capital loss was recognized only for tax purposes and was designed to offset Coltec's taxable gain. The Federal Circuit found that the note-for-liabilities exchange had no meaningful economic purpose apart from creating an inflated basis and a tax loss.

PROCEDURAL HISTORY

Coltec reported a 1996 capital loss of approximately $378.7 million arising from the sale of Garrison stock. After the IRS disallowed the loss and assessed additional tax, Coltec paid the assessment and brought a refund action in the Court of Federal Claims. Following a bench trial, that court rejected the government's statutory, anti-abuse, and economic-substance arguments, awarded Coltec a full refund, and held the economic substance doctrine unconstitutional. The Federal Circuit vacated and remanded for determination of whether Coltec was entitled to a partial refund based on the approximately $4 million basis attributable to property other than the Stemco note.

DISPOSITION

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vacated_and_remanded
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REMAND INSTRUCTIONS

The Court of Federal Claims must recompute the allowable capital loss and determine whether Coltec is entitled to a partial refund based on the sale of Garrison stock with a basis of approximately $4 million, representing the value of property other than the disregarded Stemco note.

CASES CITED

- Gregory v. Helvering, 293 U.S. 465 (1935)
- Commissioner v. Court Holding Co., 324 U.S. 331 (1945)
- Knetsch v. United States, 364 U.S. 361 (1960)
- Frank Lyon Co. v. United States, 435 U.S. 561 (1978)
- Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006)
- Ill. Tool Works, Inc. v. Commissioner, 355 F.3d 997 (7th Cir. 2004)
- Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946)
- United States v. Smith, 418 F.2d 589 (5th Cir. 1969)
- Ballagh v. United States, 331 F.2d 874 (Ct. Cl. 1964)
- Rothschild v. United States, 407 F.2d 404 (Ct. Cl. 1969)

- Falconwood Corp. v. United States, 422 F.3d 1339 (Fed. Cir. 2005)
- First Hartford Corp. Pension Plan & Trust v. United States, 194 F.3d 1279 (Fed. Cir. 1999)
- Wisc. Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992)
- Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982)