taxanalysts special report

DECONSTRUCTING BLACK & DECKER'S CONTINGENT LIABILITY SHELTER: A STATUTORY ANALYSIS

By Karen C. Burke

Karen C. Burke is a Warren Distinguished Professor of Law at the University of San Diego School of Law.

The Fourth Circuit will soon consider the government's appeal from the district court's decision in *Black & Decker Corp. v. United States*. This article presents two main arguments for reversing the district court's decision and awarding summary judgment to the government on its statutory claim under sections 357 and 358. The first argument, based on a close reading of the statute and legislative history, is that section 357(c) applies to assumed deductible liabilities that "relate to the transferred trade or business," not to liabilities that are stripped out and transferred separately from the underlying business. The second argument, based on a purposive inquiry, is that allowing the taxpayer an accelerated deduction for its contingent healthcare claims violates the policy of section 357(c)(3) premised on proper matching of income and deductions. In view of the widespread marketing of contingent liability shelters, this case affords the Fourth Circuit an opportunity to provide much-needed guidance. This article flows from the author's earlier commentary on the district court's decision (*Tax Notes*, Jan. 31, 2005, p. 577) and her discussion of the Supreme Court's *Hendler* decision in *Business Tax Stories* (Bank and Stark eds., Foundation Press 2005). The author acknowledges helpful comments from Ethan Yale on an earlier draft of this article.

Table of Contents

Introduction

The Fourth Circuit will soon decide the government's appeal of the district court's adverse decision in *Black & Decker Corp. v. United States*.[1] On appeal, the government argues that the district court's October 2004 decision should be reversed and that the case should be remanded with instructions to enter judgment for the government on its counterclaim, except for penalties.[2] As argued elsewhere, the district court's decision should be summarily reversed for failing to state essential conclusions of law and for ignoring genuine issues of fact.[3] In the interest of judicial economy and sound administration of the tax law, this article argues that the Fourth Circuit should direct the district court to enter summary judgment for the government on its statutory claim under sections 357 and 358.

Black & Decker's contingent liability shelter has been described as a "thing of grace and beauty."[4] In exchange for stock, Black & Decker (B&D) transferred to a dormant subsidiary, Black & Decker Healthcare Management Inc. (BDHMI), $561 million cash along with $560 million

[1]The district court's two previous opinions are exceedingly short. *Black & Decker Corp. v. United States*, 340 F. Supp.2d 621, *Doc 2005-20637, 2004 TNT 205-6* (D. Md. Oct. 22, 2004) (Quarles, J.) (granting taxpayer's motion for summary judgment); *Black & Decker Corp. v. United States*, 2004 U.S. Dist. LEXIS 17351, *Doc 2004-15893, 2004 TNT 150-10* (D. Md. Aug. 3, 2004) (Quarles, J.) (denying government's motion for summary judgment).

[2]Brief for the Appellant 64-65 (March 2005) (hereinafter Br. App.). The government's counterclaim seeks more than $200 million in taxes, interest, and penalties. In the alternative, the government requests that the case be remanded for trial on the issues of economic substance and the taxpayer's principal purpose for assumption of liabilities. This article was completed before submission of the taxpayer's appellate brief.

[3]*See* Karen C. Burke, "Black & Decker's Contingent Liability Shelter: 'A Thing of Grace and Beauty'?", *Tax Notes*, Jan. 31, 2005, p. 577 at 590.

[4]Transcript of Motions Hearing Before the Honorable William D. Quarles 28-29 (July 30, 2004) ("Whether I uphold it or not, this transaction is one of the few things I've seen in a tax setting that could be described as a thing of grace and beauty, because it is a wonderful transaction.") (Quarles, J.) (hereinafter Transcript).

worth of contingent liabilities relating to B&D's self-insured healthcare benefits for current and retired workers.[5] One month later, B&D sold the BDHMI stock (worth $1 million net of contingent liabilities) to a grantor trust created by a former B&D executive and claimed a $560 million loss, which B&D used to offset gains from the 1998 sale of three of its businesses.[6] As a result of the section 351 exchange and subsequent stock sale (the BDHMI transaction), B&D thus obtained the equivalent of an immediate deduction for healthcare expenses that would not accrue until 1999-2007. BDHMI may stand to obtain a second deduction when (and if) the future healthcare claims are eventually paid on behalf of B&D's employees, even though BDHMI acquired neither the employees nor the underlying assets of the business that gave rise to the contingent liability.[7]

The statutory issue posed on appeal is whether B&D's basis in the stock received in the section 351 exchange should be $561 million (as claimed by B&D) or $1 million (as claimed by the government). Under the government's view, B&D recognized no loss on the stock sale, because the sales price was equal to its basis of $1 million ($561 million cash transferred in the section 351 exchange less $560 million liabilities assumed).[8] B&D claims that the stock basis was $561 million because the assumed contingent liabilities were liabilities described in section 357(c)(3) and, therefore, under section 358(d)(2), B&D's basis in the stock was not reduced by the amount of the assumed liabilities. The outcome in *Black & Decker* is of considerable practical interest because contingent liability shelters were marketed to numerous taxpayers and cost hundreds of millions of dollars in lost revenue.[9] As the first contingent liability shelter case to reach the appellate level, *Black & Decker* affords an opportunity for the Fourth Circuit to provide much-needed judicial guidance.[10]

As the first contingent liability shelter case to reach the appellate level, Black & Decker affords an opportunity for the Fourth Circuit to provide much-needed judicial guidance.

Main Arguments Presented

At the outset, it may be helpful to outline the two main arguments set forth in this article. First, the pivotal statutory provision — section 357(c)(3) — should be read as excluding only those assumed deductible liabilities which "relate to the transferred trade or business." That proposition is derived directly from the relevant legislative history, which makes it clear that Congress never contemplated that section 357(c)(3) would apply to a transfer of liabilities apart from the underlying business. Because the BDHMI transaction segregated the assumed liabilities from the trade or business giving rise to the liabilities, the assumed liabilities are not deductible liabilities described in section 357(c)(3).[11] Accordingly, section 358(d)(2) does not apply and, under sections 358(d)(1) and 358(a)(1)(A)(ii), B&D's basis in the stock must be reduced by the amount of liabilities assumed. Second, the statute should not be construed to permit an acceleration of B&D's deduction for contingent healthcare liabilities because that acceleration contravenes the policy of section 357(c)(3) based on proper matching of income and deductions. Those arguments, which are properly raised in the government's brief on appeal, were never fully considered in the proceeding below. Therefore, the Fourth Circuit should decide the government's statutory claim that B&D was required to reduce its basis in the stock received in the section 351 exchange, eliminating its claimed loss on the subsequent sale.

District Court Opinion

In the district court, the government moved for summary judgment on the grounds that B&D's purported loss on the sale of the BDHMI stock was improper. The

[5]The actual facts surrounding the BDHMI transaction, including the circular financing arrangement for capitalizing BDHMI, are somewhat more complicated than described here. *See* Burke, *supra* note 3, at 578 (describing the transaction in greater detail). The reference to "B&D" includes all of the corporations that sold and received the BDHMI stock. *See* Br. App., *supra* note 2, at 1 n.1.

[6]BDHMI issued or sold sufficient stock to nonaffiliated parties to cause BDHMI not to be considered part of B&D's affiliated group, thereby sidestepping restrictions on duplicated losses under the then current consolidated return regulations.

[7]Although grant of the government's counterclaim would not directly decide the issue of BDHMI's ability to deduct the healthcare claims when paid, it may resolve this issue as a practical matter. *See infra* notes 19-21 and accompanying text.

[8]The government claims that B&D's stock basis was reduced, under sections 358(d)(1) and 358(a)(1)(A)(ii), by the amount of the liabilities assumed. *See* sections 358(d)(1) 358(a)(1)(A)(ii). Section references are to the Internal Revenue Code of 1986, as amended, except as otherwise noted.

[9]Contingent liability shelters were actively marketed by large accounting firms such as Deloitte & Touche (B&D) and Arthur Andersen (Enron). For a description of Enron's contingent liability shelters, see I Joint Committee on Taxation, "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," 118-35 (JCX-10-03) (Feb. 13, 2003) (hereinafter JCT Report).

[10]In another contingent liability shelter, the court ruled in favor of the taxpayer. *See Coltec Indus. Inc. v. United States* 62 Fed. Cl. 716, *Doc 2004-21316*, *2004 TNT 214-16*. The government filed its appeal in *Coltec* in April 2005. Yet another case, *Quanex Corp. v. Comm'r*, Docket No. 12642-01, is currently pending in the Tax Court.

[11]This article refers to liabilities "described in" section 357(c)(3) to avoid a semantic argument concerning the meaning of "excluded" for purposes of section 358(d)(2). *See* section 358(d)(2) (referring to liabilities "excluded" under section 357(c)(3)). If liabilities are not "described in" section 357(c)(3), they are presumptively neither "excluded" nor "excludable." *See* Burke, *supra* note 3, at 587 n.68 (noting semantic argument); *id.* at 584 (suggesting that section 357(c)(3) is functionally "an exclusionary provision that should be construed narrowly").

government raised a novel statutory claim — namely, that the transferor (B&D) was required to reduce its basis in stock received in a section 351 transfer for liabilities assumed unless the transferee (BDHMI) was entitled to deduct payment of those liabilities following the transfer. The government's statutory argument linking the transferor-transferee treatment was convoluted: If BDHMI was barred from deducting the payments when made (as the government claimed on various grounds open to dispute), section 357(c)(3) did not permit B&D to exclude the liability. Finding that the statute itself was ambiguous, the court turned to the legislative history. It noted that section 357(c)(3) was not intended to affect the tax treatment of the transferee's accounting for assumed liabilities. Indeed, the legislative history focused primarily on whether payment of deductible liabilities would have given rise to a deduction to the transferor. Accordingly, the court dismissed the government's motion for summary judgment.

With the benefit of hindsight, the government's framing of its summary judgment motion appears to have been unnecessarily confusing. Nevertheless, the government's ''tactical error'' is not a sufficient explanation of what went wrong in the district court proceedings. In fact, neither side properly apprised the court concerning the state of the law before enactment of section 357(c)(3). Indeed, before 1978 it was unsettled whether the transferee in a section 351 exchange should be allowed to deduct assumed liabilities. The case law directly on point, *Holdcroft Transp. Co. v. Commissioner*,[12] disallowed a deduction to the transferee on the grounds that those liabilities were incurred in the transferor's business (not the transferee's business). *Holdcroft* put the transferee in a tax-free exchange on the same footing as a purchaser in a taxable transaction who is required to capitalize assumed liabilities as part of the purchase price of a business.[13] Nevertheless, the IRS's pre-1978 administrative policy permitted corporate transferees, in section 351 nonrecognition transactions, to deduct certain assumed liabilities based on concerns about proper matching of income and deduction.[14] At least one court evinced willingness to accept the IRS's broad policy-oriented goal of facilitating section 351 transfers.[15]

In amending sections 357 and 358 in 1978, Congress made as few changes to the statute as possible to address the paramount issue — namely, whether a cash-basis taxpayer who transferred accounts payable to a corporation in a section 351 transfer should be required to recognize gain, under section 357(c)(1), on account of relief of liabilities. In effect, section 357(c)(1) turns a nontaxable section 351 transaction into a partially taxable exchange if the transferor is relieved of liabilities in excess of basis. To avoid harsh results to taxpayers under section 357(c)(1), Congress in 1978 adopted the result in *Focht v. Commissioner*,[16] which treated the transferor as having discharged its own deductible obligation in an amount equal to the transferred liability. For purposes of determining the transferor's recognized gain and basis adjustments, sections 357(c)(3) and 358(d)(2) ignore deductible liabilities in a section 351 exchange. The net result is a ''wash'' to the transferor, because the immediate deduction offsets the amount realized attributable to the liability assumption.

Based on the arguments presented, the district court's dismissal of the government's summary judgment motion was ''quite unremarkable.''[17] Congress declined to address the treatment of the transferee and left it to the courts and the IRS to resolve the *Holdcroft* issue. Whatever the rationale for the IRS's administrative policy of allowing a deduction to the transferee, it is apparent that the transferee's claim to a deduction did not rest on explicit judicial or legislative sanction. For that reason, however, B&D may have been understandably reluctant to call the court's attention to the continuing vitality of the *Holdcroft* precedent and its implications. In fact, the viability of the contingent liability shelter depended precisely on the government's ''largesse'' in declining to apply *Holdcroft.*[18]

While BDHMI was not a party in the district court proceedings, the government has consistently maintained that (1) the BDHMI transaction failed to satisfy the conditions of Rev. Rul. 95-74[19] and (2) B&D (not BDHMI) is the proper party to deduct the healthcare expenses when paid. Thus, the government should not be precluded by reason of its administrative policy from arguing that *Holdcroft* applies with respect to BDHMI. Indeed, the government's appellate brief explicitly cites *Holdcroft* as authority for disallowing BDHMI's deduction.[20] While BDHMI will almost certainly claim that the requirements

[12]153 F.2d 323 (8th Cir. 1946).

[13]*See* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 10.40[4][a], at 10-94 (7th ed. 2000); *Illinois Tool Works Inc. v. Comm'r*, 355 F.3d 997, 1003 (7th Cir. 2004) (assumption of contingent liability).

[14]*See* GCM 34118 (May 2, 1969); Glenn E. Coven, ''Liabilities in Excess of Basis: *Focht*, Section 357(c)(3) and the Assignment of Income,'' 58 *Or. L. Rev.* 61, 79 (1979) (attributing government's willingness to allow the transferee to deduct assumed liabilities to its ''correlative decision to abandon application of the assignment of income doctrine to incorporation exchanges'').

[15]*See Hempt Bros. Inc. v. U.S.*, 490 F.2d 1172, 1176-78 (3d Cir.), *cert. denied* 419 U.S. 826 (1974).

[16]68 T.C. 223 (1977); *see* S. Rep. No. 1263, 95th Cong. (1978), *reprinted in* 1978-3 C.B. Vol. 1, 315, 482-483 (describing various judicial approaches to deductible liabilities under pre-1978 law) (hereinafter S. Rep. No. 1263).

[17]Burke, *supra* note 3, at 581; *see id.* (noting that the government's interpretation might have rendered section 357(c)(3) inoperative because, under *Holdcroft*, the transferee would never be entitled to a deduction).

[18]*Id.* at 582.

[19]1995-2 C.B. 36, *Doc 95-9854, 95 TNT 212-35*; *see* Rev. Rul. 80-198, 1980-2 C.B. 113 (IRS will not follow *Holdcroft* when substantially all of the business assets associated with accounts payable are transferred in a section 351 exchange).

[20]*See* Br. App., *supra* note 2, at 62-63. The government also maintains that BDHMI is acting as a mere conduit for B&D in paying healthcare expenses on behalf of B&D's current and retired employees; B&D remains liable for any ''excess'' payments and is obligated to provide funds to BDHMI that are expected to be sufficient to meet the obligations as they mature. *See infra* notes 46-47 and accompanying text; *see also infra* note 36.

of Rev. Rul. 95-74 are satisfied, a court may well find otherwise if it ever reaches that issue.[21] Denying a deduction to BDHMI would leave undisturbed the broad policy of facilitating section 351 transfers in routine situations. Moreover, the corporate-level deduction for the healthcare expenses would not be ''lost'' entirely, because the government is apparently willing to permit B&D to deduct healthcare payments as they accrue, provided that (1) B&D is not allowed a loss on the stock sale and (2) BDHMI is not allowed any deduction.

Even if BDHMI is eventually disallowed any deduction on payment of the healthcare expenses, however, it remains necessary to determine the proper treatment of B&D. To resolve that dispute, the Fourth Circuit should address the technical issue of whether the assumed liabilities are described in section 357(c)(3). If the assumed liabilities are not described in section 357(c)(3), the Fourth Circuit should direct the district court to enter summary judgment for the government.

Liabilities Described In Section 357(c)(3)

At the outset, it may be helpful to clarify an obvious gap in the statutory language. Section 357(c)(3) states that ''a liability the payment of which . . . would give rise to a deduction'' shall be ignored in determining the amount of liabilities assumed.[22] The provision implies a condition contrary to fact but fails to supply the counterfactual predicate required to render the clause syntactically complete.[23] Despite that linguistic infelicity, contemporary understanding was that a deductible liability was a liability that would give rise to a deduction ''if paid'' by the transferor.[24] Thus, the focus was not necessarily on the party to whom the deduction would be allowed but rather on the nature of the hypothetical payment of the transferor's assumed liability as an event that would give rise to a deduction. In amending the statute in 1978, Congress focused only on the treatment of the transferor who was the logical party to receive a deduction (or, more precisely, an offset against the amount realized) on the hypothetical payment of its liability. If a transferee assumes a liability with a present value of $100, the transferor has effectively paid $100 at the time of the transfer because the liability assumption reduces the cash (or other consideration) received by the transferor. Thus, the assumption itself is the event that gives rise to the deemed payment by the transferor, thereby freeing up the transferor's deduction.

Section 357(c)(3) is an exception to the general rule of section 357(c)(1) that relief of liabilities in excess of the transferor's basis triggers taxable gain. In turn, section 357(c)(1) is an exception to the general rule of section 357(a) that assumption of liabilities in a section 351 transaction is not equivalent to receipt of cash. For convenience, the general rule of section 357(a) may be referred to as the anti-*Hendler* rule, because its predecessor was hastily adopted in 1939 to override the Supreme Court's decision in *Hendler v. United States*.[25] Section 357(c)(1) essentially reinstates the *Hendler* rule (treating assumption of liabilities as equivalent to receipt of cash by the transferor) for assumed liabilities in excess of basis. If the assumed liability is a deductible liability, however, section 357(c)(3) then blocks the partial reinstatement of the *Hendler* rule.[26] In determining the transferor's amount realized, deductible liabilities are ignored; those liabilities do not trigger gain recognition and do not reduce the transferor's basis in the stock received.[27]

Because section 357(c)(1) embeds a ''partial sale'' within a nonrecognition transaction when excess liabilities are assumed, the drafters of the 1978 relief provision presumably looked to the analogy of a taxable sale of a business.[28] On a sale of a business, the seller should generally be indifferent whether it withholds sufficient cash to pay its own retained liabilities or receives less cash from the seller who agrees to assume the liabilities. If the seller retains a deductible liability, there is no problem: The seller will be entitled to a deduction when the liability is paid. If the buyer instead expressly assumes the liability, the seller generally offsets the liability against the amount realized.[29] Thus, a seller should generally be indifferent whether liabilities are assumed or retained.

That background is helpful in understanding precisely which liabilities are described in section 357(c)(3). Fortunately, the legislative history is not silent on this matter, even though neither party directed the district court's attention to the relevant passages. The government's

[21]The government maintains that the BDHMI transaction falls outside Rev. Rul. 95-74 because (1) the contingent liabilities were severed from the underlying assets, (2) the transaction had a tax-avoidance purpose, and (3) the sale of the stock received in the section 351 exchanged was prearranged.

[22]Section 357(c)(3).

[23]The government makes a slightly different argument based on the legislative history, which refers to payment of a liability that ''would have given rise to a deduction'' to the transferor; the government argues that the subjunctive language implies ''a condition contrary to fact'' in the sense that a deduction would no longer be available to the transferor following the transfer. *See* Br. App., *supra* note 2, at 58.

[24]*See supra* note 16; *see also* JCT, *General Explanation of the Revenue Act of 1978*, 219 (1979) (hereinafter *1978 General Explanation*).

[25]303 U.S. 564 (1938); *see generally* Stanley Surrey, ''Assumption of Indebtedness in Tax-Free Exchanges,'' 50 *Yale L.J.* 1 (1940).

[26]This result is consistent with the principles enunciated in *Crane v. Comm'r*, 331 U.S. 1 (1947), and arguably already implicit in *Hendler*. *See* Douglas A. Kahn and Dale A. Oesterle, ''A Definition of 'Liabilities' in Internal Revenue Code Sections 357 and 358(d),'' 73 *Mich. L. Rev.* 461, 472 (1975).

[27]*See* sections 357(c)(3), 358(d)(2).

[28]*See Pierce v. Comm'r*, 326 F.2d 67, 72 (1964); *Thatcher v. Comm'r*, 61 T.C. 28, 43 (1973) (Hall, J., dissenting), *rev'd on this issue* 533 F.2d 114 (9th Cir. 1976); *see also* S. Rep. No. 1263, *supra* note 16 (discussing both cases precisely on this point).

[29]*See* Bittker and Eustice, *supra* note 13, para. 10.40[4][a], at 10-94 (noting that ''the seller may be able to deduct [the] liability as an offset [to] the amount realized from the assumption''). Similarly, an accrual-method seller may receive an offsetting deduction for assumed liabilities that would otherwise be deductible. *But see* sections 404(a)(5), 461(h) (limiting deduction).

appellate brief rectifies this omission and provides clear guidance to the Fourth Circuit concerning how to resolve this issue. In arriving at its ultimate conclusion, the Fourth Circuit should critically examine the following three propositions:

One: Liabilities are described in section 357(c)(3) only if they are ''deductible liabilities.''

Two: For that purpose, the term ''deductible liabilities'' refers only to those assumed liabilities ''which relate to the transferred trade or business'' and would give rise to a deduction.

Three: Because the BDHMI transaction segregated the assumed liabilities from the underlying trade or business, the assumed liabilities are not described in section 357(c)(3) and B&D's stock basis must accordingly be reduced, under sections 358(d)(1) and 358(a)(1)(A)(ii), by the amount of those liabilities.

The first proposition, derived from the statute, is essentially tautological. The second proposition is taken directly from the relevant legislative history, which makes it clear that Congress never contemplated that section 357(c)(3) would apply to a transfer of liabilities separate from an existing business. In 1978, statutory relief was extended only to accounts payable of a cash-basis transferor. The general explanation to the 1978 act states that ''for purposes of this provision, *accounts payable mean*, in general, those trade accounts payable and other liabilities . . . *which relate to the transferred trade or business* and which constitute cash method items.''[30] When Congress amended section 357(c)(3) in 1979, it extended statutory relief to accrual-basis transferors and to liabilities other than accounts payable. It continued, however, to limit application of the statutory relief provision to assumed liabilities ''which relate to the transferred trade or business.''[31]

Consistent with the district court's findings below, it is appropriate to look to the legislative history to determine the scope of section 357(c)(3).[32] As indicated above, the operative phrase in section 357(c)(3) implies a counterfactual predicate — namely, that an assumed liability would give rise to a deduction ''if paid'' by the transferor. The legislative history makes it clear that Congress also imported the requirement that the assumed liability relate to the transferred business. That requirement is not satisfied if there is no transfer of an underlying business, that is, if the assumed liability is segregated from the business itself. Thus, the Fourth Circuit should give considerable weight to the original understanding of assumed deductible liabilities for purposes of section 357(c)(3) as reflected in the legislative history.

The third proposition requires a determination that B&D segregated future liabilities from the business that gave rise to those liabilities. On appeal, the government has argued that it would be inappropriate to apply section 357(c)(3) because B&D did not ''transfer the related assets with the liabilities.''[33] While the healthcare liabilities relate to B&D's current employees and retirees, the government has asserted that ''the employees were not transferred along with the related liabilities.''[34] In fact, BDHMI has only three employees.[35] Although the legislative history does not purport to define the term ''trade or business'' for purposes of section 357(c)(3), a transfer exclusively of cash or other liquid assets should present a relatively easy case.[36] Section 357(c)(3) was never intended to reach an assumption of a ''naked'' liability stripped from the underlying business. Accordingly, the Fourth Circuit should find that the assumed liabilities are not described in section 357(c)(3) and therefore B&D's basis in the stock received must be reduced, under sections 358(d)(1) and 358(a)(1)(A)(ii), by the amount of liabilities assumed. As a result, B&D is not entitled to any loss on sale of the stock, because B&D's reduced basis did not exceed the amount realized.

---

[30] *See 1978 General Explanation, supra* note 24 (emphasis added). Thus, the legislative history purports to define the term ''accounts payable'' as used in the 1978 amendment. *See also* S. Rep. No. 1263, *supra* note 16 (noting that provision was not intended to affect the definition of liabilities for purposes of section 357(a) and (b)).

[31] S. Rep. No. 498, 96th Cong. at 62 (1979), *reprinted in* 1980-1 C.B. 517, 546. Specifically, the 1979 legislative history states that ''[i]n general, liabilities the payment of which would give rise to a deduction include accounts payable and other liabilities (e.g., interest and taxes) which relate to the transferred trade or business.'' *Id*. The legislative history then refers to two ''exceptions'' to this general description, that is, liabilities that have previously been deducted or given rise to basis. *Id*. By contrast, B&D apparently maintains that 357(c)(3) applies whether or not liabilities are transferred together with an existing business — as long as B&D would have been entitled to deduct the liabilities in the ordinary course of its business had no section 351 transfer occurred (even though the liabilities represent unaccrued expenses for future healthcare claims that may never actually be paid). *See* Burke, *supra* note 3, at 583. If B&D's position is that section 357(c)(3) reaches an assumption of contingent liabilities in an isolated transaction (that is, not in connection with a transfer of assets and activities constituting all or part of a business), a scrupulous perusal of the 1978 and 1979 legislative

(Footnote continued in next column.)

history should easily dispel that untenable and pernicious notion. In providing guidance to lower courts in similar cases, the Fourth Circuit should expressly reject B&D's apparent statutory reading as fundamentally at odds with Congress's intent to provide limited relief for bona fide business transfers involving liability assumptions. *See infra* note 50.

[32] *Black & Decker Corp. v. United States*, 2004 U.S. Dist. LEXIS 17351 (D. Md. Aug. 3, 2004) (Quarles, J.); *see also United States v. Iverson*, 162 F.3d 1015, 1022 (9th Cir. 1998).

[33] Br. App., *supra* note 2, at 60.

[34] *Id*. at 19.

[35] In 1996 B&D had 21,000 employees worldwide and 6,000 retired employees to whom it provided healthcare benefits. *Id.* at 7. One of BDHMI's three employees is Raymond Brusca, formerly B&D's vice-president of benefits and then president of BDHMI; Brusca remained with B&D in a dual capacity. *See id.* at 18.

[36] Alternatively, the Fourth Circuit could request that the parties stipulate facts concerning what (if any) business was transferred to BDHMI. The taxpayer may seek to argue that BDHMI functions similarly to an insurance company; the analogy is flawed, however, because BDHMI does not bear the risk for excess claims. *See* Burke, *supra* note 3, at 583 n.38.

Granting the government's counterclaim (except for penalties) would not directly resolve the issue of whether BDHMI may deduct the healthcare expenses when paid. BDHMI's claim to a deduction may be barred because (1) *Holdcroft* applies when the conditions of Rev. Rul. 95-74 are not satisfied or (2) BDHMI is acting merely as a conduit for B&D. So far, B&D has staunchly resisted the government's argument that BDHMI is a mere conduit. Nevertheless, there does not seem to be any compelling reason not to permit B&D to change its stance and claim a deduction when the healthcare expenses are eventually paid. Under section 482, the IRS has broad authority to reallocate income and deductions to the transferor or transferee to ensure that income and expenses are properly matched. To the extent that *Holdcroft* disallows the transferee's deduction, the goal of proper matching of income and deductions suggests that the transferor should be permitted to claim the deduction upon actual payment.[37] The transferor is not deprived of any tax benefit as a result of the section 351 exchange, since the timing of the transferor's deduction is the same as if the transfer had not occurred.

If the conditions of Rev. Rul. 95-74 are satisfied, the transferee essentially steps into the transferor's shoes and the assumed liabilities are treated as deductible (or capitalized) expenses of the transferee when paid. Sections 357(c)(3) and 358(d)(2) eliminate any ''overstatement'' of the transferor's income on assumption of deductible liabilities by preventing a reduction in the transferor's stock basis, thereby preserving basis to generate a future tax benefit. If the transferor is instead allowed to claim the deduction on payment of the liability — because the requirements of Rev. Rul. 95-74 are not satisfied and *Holdcroft* applies to the transferee — such basis preservation is wholly inappropriate. The statutory relief provisions have no role to play when a liability has previously been deducted, or will subsequently be deductible, by the transferor.[38]

Claimed Deduction Violates Policy

The argument above suggests that the Fourth Circuit need not concern itself with a purposive interpretation of section 357(c)(3) to resolve the government's statutory claim that B&D was required to reduce the basis of the BDHMI stock. If a purposive inquiry is appropriate, however, the Fourth Circuit must consider two related, but analytically distinct, policy arguments set forth in the government's appellate brief: (1) Section 357(c)(3) should not be construed in a manner that would permit the equivalent of a ''double deduction'' to the same taxpayer (B&D);[39] and (2) section 357(c)(3) should not be construed in a manner that would accelerate B&D's deduction for assumed contingent liabilities.

In the district court, the government's argument focused on the impropriety of allowing a double deduction to B&D if it were permitted to recognize its loss on the stock sale and to deduct the healthcare expenses when paid. The argument is straightforward: If B&D is entitled to a future deduction for the healthcare expenses, B&D should not be entitled to the equivalent of a deduction for the assumed liabilities under section 357(c)(3). When the transferor is entitled to a future deduction on actual payment of contingent claims, the transferor has not been deprived of any tax benefit as a result of the section 357 transfer. Allowing B&D to deduct the loss on the stock sale and to deduct the healthcare expenses when paid would provide a windfall to B&D.

While the double-deduction argument is theoretically unassailable, the district court appears not to have grasped its significance.[40] Perhaps the district court was confused, because B&D had not actually sought to deduct the healthcare expenses and indeed claimed that it would not be entitled to deduct them on payment. Moreover, under *Skelly Oil v. United States*,[41] the government could presumably disallow a second deduction to B&D on payment of the healthcare claims. Therefore, the issue of whether B&D could be allowed to claim two deductions for a single economic loss may be considered too speculative for grant of summary judgment.

On appeal, the government again raises the double-deduction argument but also maintains that allowance of a loss on the stock sale would improperly ''accelerate'' B&D's deduction for the future healthcare claims. As the government's appellate brief points out, ''[i]n the normal course of things, [B&D] would not have been entitled to any deduction for the assumed healthcare claims until they accrued over the next seven years.''[42] Thus, the government now argues that B&D has ''accelerated the deduction of the next seven years' worth of healthcare claims in the form of the artificial $560 million capital loss it claimed on the sale of the stock.''[43] Under that view, acceleration of B&D's deduction for the contingent healthcare claims will work mischief even if B&D is denied any deduction when the actual claims are paid.

[37]*See* Glenn E. Coven, ''What Corporate Tax Shelters Can Teach Us About the Structure of Subchapter C,'' *Tax Notes*, Nov. 8, 2004, p. 831 at 836 n.26 (''When liabilities are assumed in an isolated transaction, not a part of the transfer of all of the assets of a business, the Service may be able to challenge [a] deduction by the transferee [under *Holdcroft*] but only if the transferor is allowed to claim the deduction.'')

[38]The requirements of section 357(c)(3) are obviously not perfectly congruent with the conditions of Rev. Rul. 95-74, because some combinations of assumed liabilities and transferred assets constituting a ''trade or business'' (however narrowly or broadly defined) may be sufficient to satisfy the former but not the latter. These discontinuities are unlikely to pose problems in routine section 351 transfers when the transferee acquires a business (or portion of a business) together with the associated liabilities.

[39]Technically, the government's argument is that B&D would receive a double benefit, that is, the artificial loss on the sale of the BDHMI stock and a potential deduction on payment of the healthcare claims (either directly or, if BDHMI were subsequently brought within B&D's affiliated group, through the use of a net operating loss attributable to BDHMI). If the minority interest in BDHMI were eliminated, B&D could include BDHMI in its affiliated group.

[40]*See* Burke, *supra* note 3, at 583-584.

[41]394 U.S. 678 (1969).

[42]Br. App., *supra* note 2, at 61.

[43]*Id.*

When liabilities are segregated from the underlying business, such acceleration contravenes the policy of section 357(c)(3) based on proper matching of income and deductions. It may also violate other judicial and statutory restrictions on deductibility of estimated future costs.[44]

One way to understand the acceleration issue is to consider a familiar arrangement involving deferred employee compensation. Suppose that Employer and Employee agree to defer Employee's salary for one year. Both parties earn a 10 percent pretax rate of return on investments and are taxed at a 40 percent rate. Rather than receiving $100 at the end of Year 1, Employee will receive $106 at the end of Year 2. Employee's income inclusion and Employer's compensation deduction are both deferred until the end of Year 2. Nevertheless, deferral of both the inclusion and deduction should not alter the economic position of the parties.[45] As long as the employer is not allowed an interest deduction, the deferred deduction is economically equivalent to an immediate deduction. Denial of an interest deduction to the employer for the deferred compensation offsets the tax advantage achieved by the employee through deferral of the $106 until the end of Year 2. In general, Employer should be willing to pay $100 at the end of Year 1 in exchange for a third party's agreement to discharge Employer's obligation to pay $106 to Employee at the end of Year 2.

If certain conditions are satisfied, the tax law may thus be indifferent between allowing a smaller, earlier deduction and a larger, deferred deduction. B&D may argue that accelerating its deduction for the contingent healthcare claims does not provide any advantage to B&D: B&D is merely deducting the expected present value of the future expenses rather than the larger amount that B&D would be entitled to deduct on actual payment of the claims. That argument ignores the fact that B&D is actually seeking to deduct interest payments under its promissory note to BDHMI.[46] The promissory note obligates B&D to make payments of principal and interest that are intended to closely approximate BDHMI's obligation to pay the contingent claims as they accrue during 1999-2007. If B&D can deduct interest on the contingent obligation, an immediate deduction of the expected present value of the healthcare claims is not economically equivalent to deferral of the deduction until the expenses are paid.[47]

In this instance, the expected present value of the future healthcare claims is merely an estimate of future costs that matters principally for purposes of generating an artificial loss on the subsequent stock sale. In effect, the parties have insulated themselves against the economic consequences of an erroneous valuation. If the estimate of future costs proves too low, the minority stockholders in BDHMI can look to B&D to fund any ''excess'' costs; that protection was necessary to ensure the participation of the minority stockholders. If the estimate of future costs proves too high, BDHMI will apparently receive a windfall because the eventual payments will be less than the amount of B&D's obligation under the promissory note. Given its ability to buy out BDHMI's minority investors under prearranged terms, however, B&D has capped any shift of value to those ''outside'' investors whose participation was essential to facilitate delivery of the tax benefit to B&D.[48] Under those circumstances, it would be naive to accept uncritically the expected present value assigned by B&D to the contingent healthcare claims.

The purported business purpose of the BDHMI transaction was to allow B&D to control its employee healthcare costs more aggressively. If BDHMI succeeds in

[44]*See, e.g., United States v. General Dynamics Corp.*, 481 U.S. 239, 243-246 (1987) (disallowing a current deduction for anticipated employee health claims by an employer who had self-insured its workforce because the ''all-events'' test was not satisfied); *see also* Burke, *supra* note 3, at 583 (noting that ''the BDHMI transaction could be viewed as a blatant end run around *General Dynamics*''). Other statutory provisions (for example, sections 404(a)(5) and 267) require inclusion of income by the payee before allowance of a deduction.

[45]*See* Daniel Halperin, ''Assumption of Contingent Liabilities on Sale of a Business,'' 2 *Fla. Tax Rev.* 673, 679 (1996) (noting that deferral of the employer's deduction is ''equivalent to an immediate deduction for the compensation and the denial of any deduction for the interest.'') While the $106 may appear to include a deduction for interest, it merely compensates for the delay at the 6 percent after-tax rate. *See id.* at 694 (maintaining that denial of interest deduction should apply to contingent liabilities even if potential payees may not be deferring inclusion); *cf.* Charlotte Crane, ''More on Accounting for the Assumption of Contingent Liabilities on the Sale of a Business,'' 3 *Fla. Tax Rev.* 615, 622 (1997) (applying ''surrogate'' taxation only when values have been omitted from the tax base).

[46]The parties engaged in a circular financing arrangement involving the following three steps: (1) B&D borrowed $560 million from banks to contribute to BDHMI; (2) BDHMI ''funneled'' the funds back to B&D which repaid the bank loans within one month after the section 351 transaction; and (3) B&D substituted its own obligation for the original cash contribution. If B&D had contributed its own note at the outset, the note would arguably have had a zero basis (rather than a basis of $560 million). *See* Br. App., *supra* note 2, at 12-13; Burke, *supra* note 3, at 578. The government raised step transaction issues below that were never ruled on.

[47]Thus, B&D stands to deduct immediately the expected present value of the healthcare claims and to deduct interest on the $560 million as it accrues under the promissory note. Of course, it might be argued that the net result is a wash if BDHMI must include any interest paid by B&D (and is taxed at the same rate as B&D). Even if an interest deduction is disallowed, however, deferral of a deduction until actual payment may be preferable to an immediate deduction because of uncertainty concerning the appropriate discount rate, the payment date, and the amount of the eventual payment to third-party beneficiaries (that is, the current and retired workers under B&D's healthcare plan). *See* Daniel I. Halperin, ''Interest in Disguise: Taxing the 'Time Value of Money,''' 95 *Yale L.J.* 506, 531 (1986).

[48]*See* JCT Report, *supra* note 9, at 25-26 (recommending that the tax law not ''permit the use of accommodation parties such as employees, consultants, or advisors, to serve as a party in a transaction or arrangement'' intended to provide delivery of tax benefits to a taxpayer).

containing costs, the amounts actually paid on future healthcare claims may be reduced and the estimated cost (and B&D's loss on the stock sale) may be overstated. Significantly, B&D has retained complete control over the amount of the future costs. As many other employers have recently done, B&D could drastically reduce or even terminate its employee healthcare benefits.[49] Nevertheless, B&D maintains that it is entitled to lock in the loss on the stock sale attributable to liabilities that may never be paid (or may be paid in a much smaller amount). Permitting such a windfall to B&D would subvert Congress's desire to provide limited statutory relief, in the form of section 357(c)(3), when deductible liabilities are assumed in connection with the transferred business.

Fortunately, that windfall to B&D can be easily averted by interpreting section 357(c)(3) consistently with Congress's intent.[50] Under general tax principles, a taxpayer's deduction is normally deferred until a claim is actually paid or ''economic performance'' occurs.[51] The statutory requirement of economic performance, adopted in 1984, reflects heightened awareness of time-value-of-money issues.[52] Nevertheless, it may be viewed as a codification of earlier nonstatutory rules deferring deductions in specific situations to mitigate the problems caused by erroneous estimates of future obligations. When liabilities are assumed on a taxable transfer of a business, the section 461 regulations deem economic performance to occur as the amount of the liability is included in the seller's amount realized on the transaction.[53] Moreover, it is unlikely that the transaction will have been undertaken mainly to avoid the economic performance requirement.[54] Thus, there may be little reason to be concerned that shifting of the liabilities will accelerate the seller's deduction.[55]

The issue of when economic performance should be treated as occurring in a taxable transaction is closely analogous to that raised in a section 351 nonrecognition transaction. In 1978 Congress sought to resolve that issue by importing the requirement — similar to section 461(h) — that relief be allowed only when the assumed liabilities are related to the transferred business. The same policy judgment is reflected in the IRS's longstanding administrative policy of allowing two deductions — one to the transferor and the other to the transferee — when a section 351 transfer and assumption of liabilities satisfies the requirements of Rev. Rul. 80-198.[56] Rev. Rul. 95-74 did not alter that policy, but rather allowed the same potential double deduction when contingent liabilities are assumed and the underlying expense would otherwise be capitalized. The IRS continues to believe that a double deduction (to the transferor and the transferee) is warranted when the strictures of its administrative policy are satisfied.

In hindsight, Congress's statutory response to the *Focht* decision may be viewed as providing an excessive subsidy to section 351 transfers.[57] However, Congress may reasonably have viewed the alternatives — denying any deduction to the transferor or rigorously applying assignment of income principles — as too draconian and fundamentally inconsistent with the policy of facilitating section 351 transfers.[58] While admittedly lacking in theoretical purity, the statutory compromise embodied in sections 357(c)(3) and 358(d)(2) achieves ''rough justice'' for both taxpayers and the government. It avoids nearly intractable valuation issues when liabilities are assumed in a bona fide section 351 transfer of an ongoing business, while protecting the fisc against acceleration of deductions when liabilities are assumed in isolation.

That practical balancing of competing policy goals would be upset if section 357(c)(3) were read as applying to assumed liabilities that have been intentionally segregated from the underlying business. As the BDHMI transaction amply demonstrates, segregation of liabilities and assets invites the creation of artificial deductions.

---

[49] *See, e.g.*, *McGann v. H&H Music Co.*, 946 F.2d 401 (5th Cir. 1991), *cert. denied* 506 U.S. 981 (1992) (altering healthcare plan for current workers); *UAW v. Yard-Man Inc.*, 716 F.2d 1476 (6th Cir. 1983), *cert. denied* 465 U.S. 1007 (1984) (seeking to terminate healthcare benefits for retired workers).

[50] Despite the language in the legislative history, B&D may maintain that Congress never expressly considered whether section 357(c)(3) should apply to a transfer of liabilities in isolation, and therefore the taxpayer's reading of the statute is just as plausible as the government's reading. In fact, the dissent in *Focht* warned that the majority's decision allowing an immediate deduction to the transferor might prove too advantageous in some situations; thus, it might be preferable to defer the transferor's deduction until the transferee's actual payment of the liability. *See Focht v. Comm'r*, 68 T.C. at 245-46 (Hall, J., dissenting). By defining deductible liabilities narrowly, Congress treated the transfer of the underlying business as a ''proxy'' for when the transferor should be allowed an immediate deduction, without waiting for ultimate payment by the transferee. *See* Surrey, *supra* note 25, at 30 (noting that ''the fact of payment . . . does finally measure the value of the transferee's promise to pay the liability'').

[51] *See* section 461(h).

[52] Halperin, *supra* note 47, at 507-508.

[53] *See* reg. section 1.461-4(d)(5), (g)(1)(ii)(C). Thus, the seller is allowed to offset the deduction against the amount realized; the buyer's basis in the acquired assets is increased by the expected present value of the contingent liability assumed.

[54] *See* Robert R. Wooton, ''Mrs. Logan's Ghost: The Open Transaction Today,'' 71 *Taxes* 725, 739 (1993) (noting that ''it is unlikely that sellers will systematically be in higher brackets than buyers'').

[55] A sale of a business is thus an exception to the general rule that, even if no interest deduction is allowed, a seller should normally not be allowed to accelerate its deduction for a contingent liability. *See* Halperin, *supra* note 45, at 683.

[56] 1980-2 C.B. 113.

[57] *See* Coven, *supra* note 14, at 94-95 (arguing that section 357(c)(3) relief is overbroad because it deviates from assignment of income principles that would accelerate the transferor's income and deductions).

[58] *See supra* note 14.

Consider again the example of deferred employee compensation. It would be strange to view the employer as having sustained an economic ''loss'' equivalent to the amount of the deferred compensation obligation. Presumably, the employee has already generated or will generate value that more than offsets the deferred compensation. But, under B&D's statutory interpretation, the employer could arguably generate an artificial deduction of $100 by ''paying'' a third party (BDHMI) to assume its obligation in a section 351 transaction followed by a prompt sale of the stock received in the exchange.[59] Such a noneconomic loss arises solely from splitting off a future obligation from the business that gives rise to the liability.

Alternatively, assume that B&D desired a larger artificial loss on the stock sale to offset larger capital gain from the sale of its three businesses in 1998. Under B&D's interpretation of sections 357(c)(3) and 358(d)(2), it would be possible to manufacture a larger loss merely by requiring BDHMI to assume the healthcare claims further into the future (say until 2012 rather than 2007). The assumed liability would be larger than $560 million merely because the healthcare expenses relate to a longer period (1999-2012 rather than 1999-2007), increasing commensurately B&D's artificial loss on the stock sale. The lesson derived from Enron's machinations was that contingent liability shelters, if left unchecked, could generate virtually unlimited artificial losses.[60] While the requirement that assumed deductible liabilities be related to the transferred business does not eliminate all potential abuses, it does impose significant economic constraints that may be sufficient often to discourage those tax shelter transactions.

An obligation to pay deferred compensation is economically quite similar to the contingent liability for future healthcare claims of B&D's workforce. As a policy matter, it might well be preferable to have a bright-line rule that would treat liabilities for wages and fringe benefits as not assumed upon a transfer of business unless ''the expense clearly relates exclusively to pre-transaction events.''[61] At this late stage, however, B&D should be held to its position that the assumed future obligations were ''liabilities'' as a matter of law.[62] It would be ironic to permit B&D to claim that the liabilities were too indefinite to be taken into account under section 357, yet sufficiently definite to allow B&D to recognize a $560 million loss on a prompt sale of the BDHMI stock. Thus, these future obligations should be treated as liabilities cognizable under section 357 that were expressly assumed by BDHMI. Because section 357(c)(3) was never intended to apply to assumption of liability in an isolated transaction, however, the assumed liabilities do not constitute deductible liabilities described in section 357(c)(3). Therefore, under sections 358(d)(1) and 358(a)(1)(A)(ii), B&D should be required to reduce its basis in the stock, eliminating any loss on the subsequent sale.

Fortunately, as discussed more fully elsewhere, the Fourth Circuit may ''address the BDHMI transaction on its own terms without becoming unduly entangled in deciphering section 358(h) or how it fits with the rest of the statute.''[63] Section 358(h) is a complex provision designed to deter various ''loss-cloning'' techniques. Aware that taxpayers were selectively transferring assets and liabilities in a manner designed to duplicate and accelerate losses, Congress sought to fix the basis adjustment provisions to prevent further abuses. Solely for purposes of section 358(h), Congress defined the term ''liability'' to include essentially any ''obligation'' that could reasonably be taken into account by the parties in an arm's-length transaction, even if such a liability would not be cognizable under other provisions of the code. Congress provided an exception from the application of section 358(h) if, as part of a tax-free exchange, the transferee acquires an entire business with which the assumed liability is associated (or substantially all of the assets with which the assumed liability is associated).[64]

B&D may seek to use the subsequent enactment of section 358(h) as a ''sword'' against the government.[65] Such a litigation strategy should not suffice, however, to

---

[59]In the case of deferred compensation, section 404(a)(5) would defer the payor's deduction until the amount is included in the payee's income. *See* section 404(a)(5); reg. section 1.461-4(d)(2)(iii) (economic performance deemed to occur when the amount is otherwise deductible under section 404).

[60]In 2000 Congress enacted section 358(h) to remedy those abuses; the provision is a substitute for an earlier proposed fix to the tax-avoidance rule of section 357(b). *See generally* Coven, *supra* note 37; *see infra* nn.63-68 and accompanying text.

[61]*See* Halperin, *supra* note 45, at 709. Such a bright-line rule might require bifurcation of the assumed liabilities between those relating to B&D's retired employees and those relating to its current workforce. Of course, even payments to retired employees may be intended, in part, ''to impart a sense of security to the current workforce and, thus, provide future value.'' *Id.* at 709 n.13.

[62]*See* Burke, *supra* note 3, at 589; *id.* at 589 (''B&D's prompt sale of the preferred stock may be viewed as having adequately 'fixed' the amount of the assumed liabilities so that the assumption may properly be taken into account for purposes of reducing B&D's basis in the preferred stock.'').

[63]*See id.* at 589.

[64]Consistent with Rev. Rul. 95-74, that exception prevents a basis reduction when the statutory requirements are met. Section 358(h) is intended, in part, to eliminate the need to determine case-by-case whether the transferor has transferred liabilities together with a sufficient portion of an existing business to avoid a basis reduction. *See* note 38 *supra* (explaining that the section 357(c)(3) requirement, under prior law, was not ''perfectly congruent'' with Rev. Rul. 95-74). To the extent that a pre-section 358(h) transaction resulted in a mandatory basis reduction, section 358(h) has no effect and the law remains unchanged. *See infra* note 66 and accompanying text.

[65]Section 358(h) clearly represents a change in existing law to the extent that it extends to obligations not otherwise cognizable under section 351 and therefore generally outside the basis reduction rules of section 358 under prior law. The legislative history provides an example involving an assumed deductible liability in which a basis reduction would be required under post-section 358 law but not under pre-section 358(h). *See* H.R. Conf. Rep. No. 1033, at 1019 (2000). If, in the example, the liability was too contingent to be treated as a liability for purposes of section 351 (without regard to section 358(h)), it logically follows that the liability would not have reduced basis

(Footnote continued on next page.)

divert attention from whether the liability assumed by BDHMI properly constituted a deductible liability for purposes of section 357(c)(3) under prior law. Indeed, under the intricate statutory ordering rules, section 358(h) has no application when a basis reduction is required under the other provisions of section 358, without regard to section 358(h).[66] Thus, the sole issue here is whether pre-section 358(h) law may be fairly interpreted to deprive B&D of the protection of sections 357(c)(3) and 358(d)(2). Other pre-section 358(h) transactions similar to the BDHMI transaction, but involving different combinations of assets and assumed liabilities, may be vulnerable to challenge only if the IRS can demonstrate a tax avoidance motive under section 357(b). The tax avoidance provision of section 357(b) potentially offers an alternate route for reducing the transferor's basis to reflect assumed contingent liabilities.[67] Indeed, should the Fourth Circuit remand this case, the government will at last have an opportunity to present its section 357(b) argument that was properly raised but never addressed by the district court.[68]

Conclusion

This article argues that the Fourth Circuit should direct the district court to enter summary judgment on the government's statutory claim under sections 357 and 358. The language of section 357(c)(3) is not especially complicated, but it is incomplete because it fails to specify to whom a deduction is allowed or what events precisely should be treated as freeing up the deduction.[69] The government's articulation of its double-deduction theory may have contributed to the lower court's confusion, since Congress in 1978 failed to clarify the proper treatment of the transferee. Moreover, the IRS's longstanding administrative policy of permitting a deduction to the transferee seemed to fly in the face of existing case law, as articulated in *Holdcroft*.[70]

> ***There is no indication that the district court grasped the significance of Holdcroft.***

There is no indication in the proceedings below that the district court grasped the significance of *Holdcroft* or was aware of the language in the legislative history defining assumed deductible liabilities as liabilities that relate to the transferred business. Even if the government had framed its statutory argument more adroitly, however, the outcome in the district court would still have been uncertain. In tax shelter cases, the government runs a risk of being ''outgunned'' because tax shelter clients are able to retain leading law firms with formidable transactional expertise. Moreover, district court judges not conversant with the tax law often must rely on the parties to present technical arguments concerning difficult statutory material in a manner that illuminates rather than obscures the issues. Under those circumstances, even a perceptive and impartial district court[71] might have encountered difficulty in piercing the statutory misconstruction that underlies B&D's claimed loss.

At first glance, it may seem puzzling that a major accounting firm was apparently willing to issue a favorable opinion on a contingent liability shelter that effectively reads out of the statute any requirement that assumed liabilities be related to the transferred business.[72] One obvious (but unsatisfactory) answer might be

---

under prior law but would reduce basis under current law; unfortunately, the example does not contain sufficient facts to make that assessment.

[66]Section 358(h) applies only ''after application of the other provisions of this section'' when the basis of the transferor's stock would otherwise exceed its fair market value. Section 358(h).

[67]*See* Bittker and Eustice, *supra* note 13, at par. 3.10[3] at 3-60 (''If a borderline liability is sufficiently fixed for [section] 357(b) or [section] 357(c) purposes, then it would seem that the transferor should be required to reduce (or adjust) his basis in the stock received for the property under 358(a)(1)(A)(ii).'' *See also* Burke, *supra* note 3, at 586-588 (explaining that B&D's contrary position concerning the basis effects of section 357(b) would create a ''disjunction between the gain recognition and basis provisions,'' contrary to the clear intent of the anti-*Hendler* amendments). The Senate report accompanying proposed 1999 legislation also specifically states that (without regard to the proposal) relief of a section 357(b) liability is treaty as ''money'' for section 358 purposes, thereby reducing basis. *See id*. at 587 and 587 n.67 (discussing the 1999 proposed amendment to section 357(b)).

[68]Even though B&D conceded, for purposes of summary judgment, that its sole motivation was tax avoidance, the district court granted B&D's motion without even mentioning the [section] 357(b) issue. *Black & Decker*, 340 F. Supp.2d at 623. The government's alternative tax avoidance argument is that, because section 357(b) negates operation of sections 357(c)(3) and 358(d)(2), B&D must reduce its basis in the BDHMI stock by $560 million. *See* Burke, *supra* note 3, at 586-588. On appeal, the government has requested, in the alternative, that the district court be directed to try the matter of B&D's principal motivation for the liability assumption. *See supra* note 2.

[69]As contemporaries observed, the ''drafting [of section 357(c)(3)] leaves much to be resolved.'' Coven, *supra* note 14, at 71.

[70]*Hendler v. United States*, 303 U.S. 564 (1938), was another case involving a longstanding administrative policy — one quite favorable to taxpayers in tax-free reorganizations — that was arguably in conflict with judicial precedent. When Congress overturned the Supreme Court's *Hendler* decision, it essentially reinstated the Service's pre-*Hendler* administrative policy. *See* Surrey, *supra* note 25, at 26-27.

[71]The transcript of the July 30, 2004, conference is revealing concerning Judge Quarles's view of tax shelters: ''You have to admire the transaction, though, don't you? . . . I now [understand] why my former tax partners got paid so much.'' Transcript, *supra* note 4, at 7 (Quarles, J.).

[72]*See* Burke, *supra* note 3, at 578-579 (summarizing conclusions from Deloitte & Touche's 15-page tax opinion letter to Harry Pogash, B&D's vice president of taxes). Although the 100-page tax opinion is a matter of public record in this trial, repeated requests to obtain the document from the district court proved unavailing. The Deloitte & Touche tax opinion may well be subject to judicial scrutiny as part of B&D's defense to penalties asserted by the government.

that the statute is simply silent concerning that requirement and the relevant legislative history (even if properly presented to a court) is not determinative. Under that view, any reading that tracks the literal words of the statute might suffice to persuade a court that the sought-after tax shelter benefits should be allowed. In interpreting tax statutes, it has been suggested that there is an ''absolute chasm between lawyers and accountants'' and that the two professions' differing views on statutory interpretation ''have an economic basis,'' or at least are plausibly ''supported by the economics of the two practices.''[73] Yet purveying of tax shelters is not exclusively the province of large accounting firms. Prestigious law firms have also rendered tax shelter opinions that have been strongly criticized in the courts.[74]

Black & Decker suggests that an overly formalistic approach to statutory interpretation may prove particularly treacherous in dealing with tax shelters, which are often designed to exploit ambiguous statutory language that even the most careful reader may be unable to fully decipher without resort to legislative history. To avoid overworking the economic substance doctrine, it is essential that the government seek to resolve tax disputes based on technical arguments derived from the statutory language whenever possible. Yet the dynamics of the *Black & Decker* litigation suggest that even strong technical and policy-oriented arguments may be unavailing if generalist judges lack the ability or willingness to master complex statutory material.[75] Ironically, many modern tax statutes are considerably less well-drafted than section 357(c)(3) and therefore even more susceptible to willful misconstruction. Moreover, the statutory compromise embodied in section 357(c)(3), which functioned undisturbed for nearly 20 years until the emergence of contingent liability shelters, reflected a coherent pattern of taxation that made sense based on a common understanding that the assumed liabilities must be related to the transferred business.

One might well ask whether tax shelter promoters and their clients realistically expected that contingent liability shelters, once brought to light, could withstand thorough judicial scrutiny.[76] If the Fourth Circuit directs the district court to enter judgment on the government's counterclaim, a trial will still be necessary to assess penalties, one of the central issues in this case. Thus, it may be necessary to determine whether B&D reasonably relied on advice rendered by Deloitte & Touche concerning the likely consequences of the contingent liability shelter. Even if the BDHMI transaction does not rank as the most egregious of recent tax shelters,[77] numerous taxpayers have used contingent liability shelters to generate artificial losses. Only if courts are willing to sustain penalties in appropriate cases will tax shelter promoters and their clients be encouraged to respect the crucial distinction between sophisticated business planning and unlawful tax avoidance.[78]

---

[73]Joseph Bankman, ''The Business Purpose Doctrine and the Sociology of Tax,'' 54 *SMU L. Rev.* 149, 152-153 (2001).

[74]*See* Alvin C. Warren Jr., ''Understanding *Long Term Capital*,'' *Tax Notes*, Feb. 7, 2005, p. 681 at 695.

[75]Burke, *supra* note 3, at 589 (describing *Black & Decker* as tax shelter litigation ''run amok''); *see* Marvin Chirelstein and Lawrence Zelenak, ''A Note on Tax Shelters,'' *Colum. L. Rev.* (forthcoming 2005) (''The decision is of course preposterous.'').

[76]Obviously, differences in facts matter; in some instances, taxpayers may be able to argue successfully that contingent liabilities were not stripped from the underlying business.

[77]*See* Warren, *supra* note 74, at 695. One of the issues to be decided in the penalty phase is whether B&D sought improperly to delay the IRS's discovery of its participation in the BDHMI transaction by the timing of its capital loss carryback. *See* Plaintiff's Reply to Defendant's Opposition to Plaintiff's Cross-Motion for Summary Judgment at 23 (Sept. 23, 2004).

[78]The district court initially believed that B&D had admitted a motive of ''tax evasion'' but later substituted the phrase ''tax avoidance'' in its revised opinion. *See* Burke, *supra* note 3, at 586.