

REEXAMINING BLACK & DECKER'S CONTINGENT LIABILITY TAX SHELTER

By Ethan Yale

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In this article, Prof. Yale reviews the contingent liability tax shelter employed by Black & Decker, and critiques the arguments the government has made in its appeal to the Fourth Circuit. He concludes that the government's technical arguments are unpersuasive and demonstrates that if the Fourth Circuit accepts them, it might result in unintended consequences in run-of-the-mill transactions. Yale suggests a different strategy the government should pursue when challenging contingent liability tax shelters, a strategy that would prevent taxpayers from enjoying an undeserved tax windfall in abusive cases without distorting the language of the code.

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I. Introduction

Black & Decker engaged in a transaction the IRS has dubbed the "contingent liability tax shelter."¹ The transaction is designed to duplicate the tax benefit derived from contingent liabilities generated in the ordinary course of the taxpayer's business. It was marketed by most of the major accounting firms² and is surprisingly simple.

Here's how it worked.³ Black & Decker together with certain controlled subsidiaries (collectively referred to as Black & Decker) were anticipating future healthcare claims by current and former employees with an estimated present value of \$560 million. Black & Decker dropped \$561 million cash and those contingent claims into a subsidiary, Black & Decker Health Management Inc. (BDHMI), in exchange for preferred stock in BDHMI (Black & Decker already owned all of BDHMI's common stock). Black & Decker reported the transaction as a section 351 exchange and concluded that its basis in the BDHMI preferred stock received in the exchange was \$561 million even though the value of the preferred stock was approximately \$1 million (\$561 million of cash less \$560 of liabilities). One month later, Black & Decker sold the BDHMI preferred stock for \$1 million to a trust controlled by a former Black & Decker executive. Black & Decker claimed a \$560 million loss on the sale, equal to the excess of its claimed basis over the sales proceeds. Black & Decker used the loss to set off gain recognized on the sale of unrelated businesses.

Black & Decker has been and plans to continue to cause BDHMI to deduct the claims as they are paid. Because BDHMI has no business other than paying the claims, the deductions will amass into a significant net operating loss. Later, several years after BDHMI's preferred stock was sold, Black & Decker will repurchase the

¹Notice 2001-17, 2001-1 C.B. 730 *Doc 2001-2017, 2001 TNT 13-4* (classifying this shelter as a listed transaction).

²E.g., Lee A. Sheppard, "Enron's Contingent Liability Shelter," *Tax Notes*, Mar. 3, 2003, p. 1302.

³I say "worked," because it does not work any longer. In 2000 Congress added to the code section 358(h), which effectively shut down the shelter. Community Renewal Tax Relief Act of 2000, P.L. 106-554, section 309(c) (2000). For an insightful critique of the approach taken in section 358(h), see Glenn Coven, "What Corporate Tax Shelters Can Teach Us About the Structure of Subchapter C," *Tax Notes*, Nov. 8, 2004, p. 831.

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stock, causing BDHMI to rejoin Black & Decker's consolidated group. That will allow Black & Decker to use BDHMI's NOL to set off income from Black & Decker's business — providing Black & Decker with the possibility of a second tax benefit from the contingent healthcare liabilities.⁴

The IRS claimed Black & Decker did not realize a loss on the sale of the subsidiary stock. Black & Decker paid the resulting deficiency and sued for a refund in the U.S. District Court for the District of Maryland. The parties engaged in pretrial squabbles over discovery,⁵ the possible application of accuracy-related penalties, and other issues. In December 2003 the government moved for summary judgment,⁶ and in August 2004 the motion was denied.⁷ Following the denial of the government's summary judgment motion, Black & Decker moved for summary judgment,⁸ and in October 2004 Black & Decker's motion was granted.⁹ The government appealed and

the case is currently pending before the Fourth Circuit.¹⁰ The pivotal question in the appeal is whether Black & Decker's basis is really \$560 million, as it claims and as the district court held, or rather \$1 million, as the government claims.

If the government's arguments are rejected on appeal, Black & Decker will have saved \$57.4 million in taxes.¹¹ Conceivably, however, the Fourth Circuit could either reverse the district court's judgment and render judgment in favor of the government, or vacate and remand the case for trial. The government filed a counterclaim asserting a liability, including taxes, interest, and penalties, of \$214.8 million.¹² This is high-stakes litigation to be sure. It also presents a crucial opportunity for the government to develop a favorable precedent to be used as a sword in disputes with other taxpayers that engaged in the contingent liability shelter at issue in the case.¹³

The government's first argument on appeal, an argument it raised repeatedly in its filings with the district court, is that the transaction lacked economic substance and that Black & Decker should be denied the tax benefits it seeks on that basis. I will not address the government's economic substance argument in detail, but pause here to make two brief points.

First, the district court was wrong to grant summary judgment to Black & Decker in the face of the government's economic substance argument. In the Fourth Circuit the controlling standard is the one set forth in *Rice's Toyota World*: to disallow the claimed tax benefit "the court must find [1] that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering into the transaction, and [2] that the transaction has no economic substance because no reasonable possibility of a pretax profit exists."¹⁴ The first prong of the test is met, given that Black & Decker admitted that "tax avoidance was the sole motivation underlying Black & Decker's decision to outsource its healthcare management function to BDHMI."¹⁵ Whether the second prong

⁴The actual facts of the transaction are more complicated. Briefly, Black & Decker sold BDHMI stock to Hansen, an affiliate of Black & Decker's healthcare consultant, and Black & Decker caused BDHMI to issue shares to Black & Decker Canada, a foreign affiliate of Black & Decker. Enough BDHMI stock was held by each nonaffiliate so that BDHMI became ineligible to remain in Black & Decker's consolidated group. That step allowed Black & Decker to circumvent the consolidated return duplicated loss disallowance rule then in effect (reg. section 1.1502-20(c)).

Given that the stock sale to Black & Decker Canada and the stock sale to Hansen were each large enough to break consolidation, an alternative explanation for the sale to Hansen is to give a patina of legitimacy to the claimed business purpose of providing an incentive for the owners of the minority stakes in BDHMI to exercise their rights as shareholders to minimize the cost of providing healthcare benefits, to the mutual benefit of the minority shareholders and Black & Decker.

It is clear from documents prepared when the transaction was being implemented that Black & Decker planned from the start to reconsolidate with BDHMI and enjoy a duplicated tax benefit. For instance, a memo to file drafted by an employee in Black & Decker's Controller's Department provides that "BDHMI will generate net operating losses. . . . Since BDHMI is not consolidated for U.S. tax purposes . . . the realizability of those NOLs is delayed. Upon wind-down B&D re-acquires 100% of BDHMI and therefore would have access to BDHMI's NOL's." U.S. Motion for Summary Judgment, at Exhibit 3, filed Dec. 30, 2003 (hereinafter US MSJ). US MSJ (but not the exhibits thereto) is available at *Doc 2004-17470* or *2004 TNT 173-20*.

⁵During the discovery phase of the litigation, the IRS inadvertently supplied the taxpayer an unredacted copy of a field service advice (FSA) memorandum that had previously only been made available in redacted form, and then tried (unsuccessfully) to force Black & Decker to return the unredacted copy. See Sheryl Stratton, "FOIA Request Seeks Redacted Legal Analysis," *Tax Notes*, May 3, 2004, p. 512.

⁶US MSJ, *supra* note 4.

⁷*Black & Decker Corp. v. United States*, No. WDQ-02-2070, 2004 WL 2051215, *Doc 2004-15893*, 2004 TNT 150-10 (D. Md. Aug. 3, 2004).

⁸Black & Decker Motion for Summary Judgment, filed Aug. 30, 2004 (hereinafter B&D MSJ), *Doc 2004-17594*, 2004 TNT 173-22.

⁹*Black & Decker Corp. v. United States*, 340 F. Supp.2d 621, *Doc 2005-20866*, 2004 TNT 207-13 (D. Md. 2004).

¹⁰The government's appellate brief is available at *Doc 2005-7305* or *2005 TNT 68-52* (hereinafter US App. Br.). I did not have the benefit of the taxpayer's appellate brief when I drafted this article. I understand the taxpayer's brief was due in late May 2005.

¹¹US App. Br. at 2.

¹²*Id.*

¹³News reports indicate that this shelter was widespread. See Sheppard, *supra* note 2. The government has appealed an adverse decision in another refund suit involving the same shelter. See *Coltec Industries Inc. v. United States*, 62 Fed. Cl. 716, *Doc 2004-2136*, 2005 TNT 214-16 (2004). The commissioner settled a deficiency suit involving the shelter with Hercules Inc. See IRS News Release IR-2004-151, *Doc 2004-23844*, 2004 TNT 243-4, Dec. 16, 2004. Yet another case involving this shelter, *Quanex Corp. v. Commissioner*, Docket No. 12642-01, is pending in the Tax Court.

¹⁴*Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985) (emphasis added). Compare *Kirchman v. Commissioner*, 862 F.2d 1486, 1491 (11th Cir. 1989). ("It is clear that transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer.")

¹⁵Black & Decker's Reply to U.S.'s Opposition to Black & Decker's Motion for Summary Judgment, Oct. 8, 2004, at 2.

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of the test is met is a question of fact.¹⁶ The government submitted expert analysis and opinion demonstrating that the transaction could not reasonably have been expected to produce a pretax profit. The district court simply failed to address the second prong of the *Rice's Toyota World* test or to consider the evidence proffered by the government tending to show that no pretax profit was possible. The court focused instead on the irrelevant question whether BDHMI engaged in sufficient business activity to be considered a bona fide corporation.¹⁷ That is reversible error given the procedural posture of the case.¹⁸

Second, the sentiment George Yin expressed in response to similar arguments the government raised in earlier cases is equally relevant here: "Tools such as 'economic substance' and 'business purpose' should be reserved to combat transaction that are more unambiguously objectionable than the ones involved in those cases."¹⁹ The government's indiscriminate use of those judicial doctrines "has backfired and left [the] doctrines in shambles [W]e have less understanding of when these doctrines should apply and what they mean when they do. Taxpayers may now feel emboldened to try more and more creative tax-reduction strategies."²⁰ Given the multitude of alternative arguments at its disposal, and the fact that the government itself is not completely convinced that the economic substance doctrine applies to the contingent liability shelters,²¹ it is a mistake for the government to raise the argument in this case.

Black & Decker made that concession to advance its argument that even if all disputed fact issues are resolved against Black & Decker, it does not preclude summary judgment. Black & Decker has *not* conceded the issue for all purposes.

¹⁶*Rice's Toyota World*, 752 F.2d at 92.

¹⁷340 F. Supp.2d 621, 623-624.

¹⁸Because the district court was reviewing Black & Decker's motion for summary judgment, its role was to determine if there was a genuine issue of material fact. Fed. R. Civ. P. 56(c). "[T]he judge's function is not . . . to weigh the evidence and determine the truth of the matter but to determine whether there is a material issue for trial." *Anderson v. Liberty Lobby Inc.*, 477 U.S. 242, 249 (1986). If "a fair-minded jury could return a verdict for the [nonmoving party] on the evidence presented," then summary judgment is improper. *Id.* at 252. Conceivably the district could have found that a fair-minded jury could not have believed that there was no possibility of a pretax profit from the transaction, but if it did (1) it did so without any discussion and (2) its determination is highly questionable. The government's key expert on this point, a former chair of Harvard University's economics department, opined that the transaction entailed significant transaction costs and failed to yield any incremental value. U.S. Response in Opposition to B&D MSJ, filed Sept. 24, 2004, at 35.

¹⁹George K. Yin, "The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches," 55 *Tax L. Rev.* 405, 407 (2002).

²⁰*Id.* at 426.

²¹The government's uncertainty can be gleaned from a couple of different sources. First, in an August 16, 1999, internal IRS memorandum released as part of the Enron Report, District counsel refused to allow the field agent to issue a notice of deficiency disallowing Enron's loss on the sale of a subsidiary's stock attributable to a contingent liability shelter. The proposed

(Footnote continued in next column.)

The balance of this article evaluates the government's arguments other than its economic substance argument. In Part II, I sketch out the statutory scheme. In Part III, I lay out the argument the government made in its motion for summary judgment (rejected by the district court), which it has reiterated on appeal. In Part III, I also suggest an alternative approach to denying Black & Decker the tax benefit it seeks. In Part IV, I describe another argument that the government raised before the district court in response to Black & Decker's motion for summary judgment, an argument the district court overlooked, and which the government has raised again on appeal. In Part V, I offer some brief concluding remarks.

II. A Brief Primer on Sections 357 and 358

Suppose P contributes \$561 million cash and \$560 million of contingent liabilities to newly formed S corporation in exchange for all of S's common stock. If P had not caused S to assume the contingent liabilities, and if the contingency were resolved against P, P's payment of the liabilities would have been deductible (or alternatively a capital expenditure). The pivotal question the Fourth Circuit must answer in this case is what is P's basis in its S stock.

The transaction — an exchange of property (here cash)²² for stock when the transferor controls the transferee immediately after the transfer — qualifies for

notice of deficiency relied on lack of economic substance or, in the alternative, absence of a business purpose. The memo states that "after discussing the issue with the Corporate Division of Chief Counsel, we determined . . . against applying the lack of economic substance argument. . . . [Corporate Division of Chief Counsel] will not support your alternative position [lack of business purpose] either." Enron Report, Appendix B, at B-171.

Second, in FSA 199905008, *Doc 1999-5118*, 1999 *TNT* 25-64, the IRS advised against applying the economic substance argument to a contingent liability shelter. Although the version of that FSA that has been released does not mention economic substance, the IRS undoubtedly rendered this advice. The Enron Report memorandum, *supra*, states that the IRS Office of Chief Counsel (Corporate) "determined that our case was covered by the recently issued Field Service Advice 199905008, which advised against applying the lack of economic substance argument."

²²Black & Decker actually borrowed the cash from a consortium of banks, contributed it to BDHMI, which held the cash for one month and then distributed the cash to Black & Decker in exchange for a series of notes. Black & Decker used the cash distribution to repay the banks. US MSJ, *supra* note 4, at 5. If the step transaction doctrine were to apply so that the cash contribution and distribution are disregarded, and Black & Decker is considered to have contributed its own notes for BDHMI stock, a thorny question arises — what is Black & Decker's basis in its own note? If the note has a zero basis, Black & Decker should have reported \$560 million of section 357(c) gain.

The IRS's official position is that a taxpayer has a zero basis in its own note, Rev. Ruls. 68-629, 1968-2 C.B. 154, and 81-178, 1981-2 C.B. 167, although the IRS has had a difficult time convincing the courts of appeals that its official position is correct. See *Peracchi v. Commissioner*, 143 F.3d 487, *Doc 98-14167*, 98 *TNT* 86-11 (9th Cir. 1998); *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989); Jasper L. Cummings Jr., "Zero Basis Hoax or Contingent Debt and Failure of Proof — Sorting Out the Issues in the *Lessinger* Case," 2 *Fla. Tax Rev.* 283 (1994). The government

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nonrecognition under section 351.²³ Application of section 351 is not important in its own right — P has not *realized* any gain on the exchange, so the *nonrecognition* afforded by section 351(a) is not important to P — but application of section 351 has collateral consequences that are extremely significant.

First, the application of section 351 triggers application of section 357. Section 357(a) provides that liability assumptions by the transferee will not be treated as boot for purposes of section 351(b), the rule requiring the transferor in a section 351 exchange to recognize realized gain to the extent of any boot received. In the preceding example, it is not apparent that section 357 is relevant to P, given that characterization of the liability assumption as boot only triggers gain recognition to the extent gain has been realized, and P has not realized any gain. Nevertheless, determining which of the exceptions to section 357(a) apply (if any) could have important basis consequences for P, as described below.

Section 357(a) is qualified by two exceptions, section 357(b) and (c)(1). Section 357(b) provides that if the liability assumption has a tax avoidance purpose,²⁴ the transferee's (S's) assumption of the liability will be treated as payment of boot to the transferor (P) in the section 351 transaction. Section 357(c)(1) provides that if (i) the liabilities assumed by the transferee (S) exceed (ii) the adjusted basis of the property transferred, the excess of (i) over (ii) shall be treated as gain of the transferor (P). Section 357(c)(3) excepts certain liabilities from section

357(c)(1): If payment of a liability "would give rise to a deduction . . . then, for purposes of [section 357(c)(1)], the amount of such liability shall be excluded in determining the amount of liabilities assumed."²⁵ When both section 357(b) and (c)(1) apply by their terms, section 357(b) takes precedence.²⁶

The second collateral consequence of the application of section 351 is that it triggers application of section 358, which provides that the transferor in a section 351 exchange takes a substituted basis in the shares received in the exchange, *decreased* by the amount of money received by the taxpayer.²⁷ Section 358(d)(1) provides that liabilities assumed by the transferee (S) are "treated as money received by the taxpayer on the exchange." If section 358(d)(1) applies, P's basis in the S stock received in the exchange is \$1 million, or a substituted basis computed by reference to the basis of the contributed cash (\$561 million) and reduced by the liabilities assumed (\$560 million). Section 358(d)(2) provides that section 358(d)(1) "shall not apply to the amount of any liability excluded under section 357(c)(3)"; application of section 358(d)(2) therefore depends on application of section 357(c)(3). If section 358(d)(2) applies, P's basis in the S preferred stock received in the exchange is \$561 million, that is, the cash contribution undiminished by the liabilities assumed by S. The determination whether to apply the general rule that liability assumptions reduce basis (section 358(d)(1)) or the exception to that rule

informed the district court of the circular cash flow preceding the contribution of the note but did not specifically argue for application of the step transaction doctrine to that aspect of the transaction, presumably because the argument is only effective if the government can convince the court to accept its zero basis argument, which would require the court to reject the analyses of both the *Lessinger* and *Peracchi* courts, the only two courts of appeals to have directly addressed the issue.

²³Qualification under section 351 is not beyond dispute. Before the district court, the government argued that "Black & Decker's compliance with the technical requirements of section 351 aside, [an exchange] that lacks a legitimate business purpose will not qualify for non-recognition treatment under section 351(a)." Whether a section 351 has a business purpose requirement is unclear. See Ginsburg and Levin, *Mergers, Acquisitions & Buyouts*, para. 901(3) (Dec. 2004 ed.) ("practitioners have not thought Code section 351 to contemplate . . . [a] business purpose requirement").

²⁴More specifically, section 357(b) is triggered when the principal purpose of the taxpayer with respect to the liability assumption "(A) was a purpose to avoid Federal income tax on the exchange, or (B) if not such a purpose, was not a bona fide business purpose."

Literally, section 357(b) requires that the tax avoidance purpose relate to the exchange, which is not the case in this transaction. The purpose of the exchange *coupled with the later sale of the preferred stock* was tax avoidance, rather than the exchange itself. Nevertheless, Black & Decker's concession (for summary judgment purposes) that tax avoidance was the sole motivation behind its decision to outsource its healthcare liability management function is broad enough so that it would be difficult for Black & Decker to successfully assert section 357(b) does not apply based on a hypertechnicality. See *supra* note 15 and accompanying text.

²⁵The nest of exceptions layered one atop the next is confusing because it is four layers deep. This list might help the uninitiated reader:

1. *General rule (the Crane rule)*. When a liability is assumed by another taxpayer, or property is taken subject to a liability, the taxpayer shedding the liability is treated as though they received consideration equal to the value of the liability. *Crane v. Commissioner*, 331 U.S. 1 (1947); *United States v. Hendler*, 303 U.S. 564, 566 (1938) (a taxpayer shedding a liability should be treated "as if the money had been paid to it and then paid over by it to its creditors").

2. *Exception*. Section 357(a) turns off the *Crane* rule when the liability assumption takes place in a section 351 transaction.

3a. *Exception's exception*. Section 357(b) turns the *Crane* rule back on — so liability assumption is treated as payment of boot in a section 351 transaction — when the assumption has a tax avoidance purpose. When section 357(b) applies it applies to the total amount of the liability assumed, even if the tax avoidance purpose does not taint the entire liability assumption. Section 351(b)(1) (note the parenthetical in the flush language); reg. section 1.357-1(c).

3b. *Exception's exception*. Section 357(c)(1) turns the *Crane* rule back on — so the liability assumption is treated as payment of boot in a section 351 transaction — to the extent that debt exceeds the basis of the assets transferred. When section 357(b) applies it displaces section 357(c)(1). Section 357(c)(2).

4. *Exception to exception's exception 3b*. Section 357(c)(3) turns the *Crane* rule back off — so section 357(a) applies, and the liability assumption is not boot — when the liability would give rise to a deduction, provided that the liability did not result in the creation of or an increase in basis.

²⁶Section 357(c)(2).

²⁷Section 358(a)(1). The text describes only the basis adjustment relevant to this case; other adjustments are called for by section 358(a)(1) in different circumstances.

(section 358(d)(2)) will control the amount of loss realized on any subsequent sale of the S preferred stock.

Naturally, all of Black & Decker's arguments lead to the conclusion that the exception under section 358(d)(2) applies, and consequently the liabilities *do not* reduce Black & Decker's basis in its BDHMI stock. All of the government's arguments, on the other hand, lead to the conclusion that the general rule under section 358(d)(1) applies, so that Black & Decker's basis in its BDHMI stock is the net amount of the cash and liabilities transferred — that is, \$1 million, or \$561 million reduced by the \$560 million of assumed liabilities. If the government is correct, Black & Decker was in error when it claimed a \$560 million loss on the sale of its BDHMI stock.

III. Government's Summary Judgment Argument

A. Overview: The Government's Argument

The government moved for summary judgment based on a novel argument regarding the interrelationship between sections 357 and 358. That was a tactical blunder, given that its motion was denied and, framing the analysis as it did, the government apparently confused the district court about the significance of other arguments that it had yet to raise. (Admittedly, tactical blunders are always easier to see with the benefit of 20-20 hindsight.) The government's argument, which it has reiterated on appeal, has three steps:

1. The contingent liabilities Black & Decker transferred to BDHMI in the section 351 exchange are deductible by Black & Decker and not by BDHMI after the exchange.
2. Section 357(c)(3) refers to liabilities that, after the transfer, are deductible by the transferee corporation — BDHMI (and not to liabilities that continue to be deductible by the transferor — Black & Decker).
3. Because section 357(c)(3) does not apply (given Steps 1 and 2), neither does section 358(d)(2). Thus Black & Decker's basis is reduced under section 358(d)(1) for the liabilities assumed by BDHMI.

If Steps 1 and 2 in the argument are sound, Step 3 follows, leading to the conclusion that Black & Decker's basis in its BDHMI preferred stock was \$1 million following the transfer rather than \$561 million.

As explained below, Step 1 in the government's argument is misguided and Step 2 is without support in the code or legislative history. Step 2 makes sense at a policy level, but the right policy result could be achieved more simply by an argument the government has yet to raise — that *neither* Black & Decker *nor* BDHMI may deduct the contingent healthcare claims.

B. Which Taxpayer Deducts the Liabilities?

1. Overview. The first part of the government's argument — that Black & Decker, and not BDHMI, is entitled to claim a deduction for payment of the contingent healthcare claims after the exchange — is misguided. In brief, the relevant cases hold that liabilities assumed by the transferee in a section 351 exchange are *not* deductible by the transferee. Rev. Rul. 95-74 repudiated those precedents, but the ruling is easily distinguishable from Black & Decker's transaction, suggesting that case law predat-

ing the ruling should control which taxpayer is allowed to deduct the assumed liabilities. The case law does not supply a complete answer to that question, though, because the cases merely hold that the transferee in a section 351 exchange may not deduct assumed liabilities without passing on the question whether the absence of a deduction for the transferee implies the transferor should be allowed a deduction.²⁸ The government's argument, therefore, is not foreclosed by precedent. A better approach, however, would be to deny a deduction to *both* the transferor *and* the transferee following the exchange — a solution also not foreclosed by precedent. That would produce a sensible policy result and would spare the court from having to choose between either granting Black & Decker a tax windfall or distorting the language of section 357(c)(3).²⁹

After describing the relevant authorities, I explain why a deduction should be denied to both Black & Decker and BDHMI.

2. The relevant authorities do not resolve which taxpayer (if any) should get a deduction. The two most significant authorities addressing the question of which taxpayer should deduct liabilities assumed in a section 351 exchange are *Holdcroft Transportation Co. v. Commissioner*³⁰ and Rev. Rul. 95-74.³¹ *Holdcroft* holds that the transferee in a section 351 exchange may not deduct payment of a liability assumed from the contributing shareholder. *Holdcroft* was a partnership engaged in the trucking business. The partnership contributed its assets and liabilities to an eponymous corporation. Among the liabilities transferred was a pending lawsuit against the

²⁸There is *dicta* from at least one case suggesting that the deduction that existed before the exchange must survive the exchange, so that if a deduction is denied to the transferee, the transferor must be entitled to it (or vice versa). There is no case squarely holding as much, and application of the principle in this case that some taxpayer must be allowed a deduction does not survive careful analysis. That point is discussed further below. See *infra* notes 55-57 and accompanying text.

²⁹BDHMI is not a party to the litigation, so judicial implementation of this solution in this case would be impossible. That does not mean, however, that either the Fourth Circuit or the government's counsel should be indifferent to my proposed solution, given that it prevents the abuse the government is concerned with — at least for the most part, see *infra* note 61 and accompanying text for discussion of one potential difficulty — and spares the court the difficult task of balancing the various policy and statutory arguments that have been presented.

It is possible that the statute of limitations has run on the government for at least some of the years in question, although that would not preclude the IRS from denying use of the NOL to BDHMI, or to Black & Decker's consolidated group on reconsolidation with BDHMI. *E.g.*, Rev. Rul. 56-285, 1956-1 C.B. 134 (expiration of statute of limitations for year when loss was sustained does not preclude the IRS from making such adjustments as are necessary to correct the amount of a subsequent NOL deduction).

³⁰153 F.2d 323 (8th Cir. 1946).

³¹1995-2 C.B. 36, Doc 95-9854, 95 TNT 212-35 (holding (2)). As discussed below, Rev. Rul. 95-74 reconfirmed the IRS's longstanding administrative practice of allowing transferee corporations to deduct liabilities assumed in section 351 exchanges. See *infra* note 33.

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business arising from an accident before the section 351 exchange. After the exchange, the transferee corporation claimed a deduction for a sum paid to resolve the lawsuit. The IRS disallowed the deduction.

The Eighth Circuit, affirming the Tax Court, held that because “[t]he claims did not arise out of the operation of the business of” the corporation — but rather arose out of the business of the predecessor partnership — payment of the claim was not deductible.³² The Eighth Circuit found that the taxpayer corporation’s assumption of the claim “was a part of the purchase price of its assets, [and thus] the payments were capital expenditures, and not current expenses or losses of the business of” the corporation.³³ That conclusion is undoubtedly correct in principle.³⁴

Black & Decker would be hard pressed to distinguish its case from *Holdcroft* and the case will — I expect — undermine BDHMI’s claimed deduction on payment of the claims if that issue is ever litigated. Although the government mentioned *Holdcroft* only in passing in its motion for summary judgment, it stressed the importance of the case in its appellate brief.³⁵ *Holdcroft*, however, is utterly silent on the question whether the transferor shareholder may deduct the liability when it accrues in the hands of the transferee corporation. As discussed below, some commentators have suggested that nondeductibility by BDHMI implies deductibility by

Black & Decker as a logical imperative, but neither *Holdcroft* nor any other case cited by the government stands for that principle.³⁶

Rev. Rul. 95-74 concludes that the transferee in a section 351 exchange may deduct contingent liabilities assumed in the exchange.³⁷ In the ruling, P contributes to S all of the assets and all of the liabilities related to one of its businesses “for bona fide business reasons.” Rev. Rul. 95-74 confirmed the IRS’s long-standing practice of allowing transferees to deduct assumed liabilities. That practice is not a wholesale rejection of the holding of *Holdcroft* and similar cases; the IRS has consistently limited the practice to cases in which unrealized income items (paradigmatically, unrealized receivables) are transferred at the same time liabilities are assumed. In those cases, to deny the transferee a deduction for the assumed liabilities would be antithetical to the clear reflection of income.³⁸

Although Rev. Rul. 95-74 would undermine the government’s claim that Black & Decker is entitled to deduct payment of the liabilities were it to apply, Black & Decker’s transaction is clearly beyond the scope of Rev. Rul. 95-74 for two reasons. First, Black & Decker has conceded (for purposes of its summary judgment motion) that its transaction was undertaken to avoid taxes.³⁹ That is the antithesis of the bona fide business reason for the exchange posited in the ruling, and the ruling expressly does not apply to transactions that have a tax avoidance purpose.

Second, Black & Decker, unlike the transferor in the ruling, reported and continues to report on its consolidated income tax return all of the income from the business that generated the contingent liabilities, but has transferred to BDHMI the liabilities that (if the ruling were to apply) would give rise to substantial deductions. The ruling expressly does not apply to transactions in which income is split from liabilities in that fashion. Accordingly, any reliance by the taxpayer on Rev. Rul. 95-74 to support a claim that BDHMI is entitled to deduct the contingent healthcare claims would be misplaced,⁴⁰ as would any suggestion that the government is bound by its ruling.⁴¹

³²*Id.* at 324.

³³*Id.* See also *Stone Motor Co. v. Commissioner*, T.C. Memo. 1956-179 (holding that the sales taxes at issue in the case “are deductible . . . only by the person on whom they are imposed. Here the taxes in dispute were imposed on the partnership and not petitioner [the successor corporation]. The fact that petitioner is a successor to the partnership is of no consequence in this respect.”); cf. *Magruder v. Supplee*, 316 U.S. 394 (1942), discussed at *infra* note 46; *Athol Mfg. Co. v. Commissioner*, 54 F.2d 230 (1st Cir. 1931).

Despite its victories in *Holdcroft* and *Stone Motor*, the IRS has by long-standing administrative practice often allowed transferee corporations to deduct liabilities transferred in a section 351 transaction when the liabilities would have been deductible by the transferor. See, e.g., GCM 34118 (May 2, 1969) (explaining that clear reflection of income principles dictate the nonapplication of *Holdcroft* in incorporation transactions *provided liabilities are not separated from unrealized income*); 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, 474 & n.66 (1975) (“while the Code is silent about whether a section 351 transferee can deduct its subsequent payment of liabilities that were deductible in the hands of the transferor, the [IRS] has permitted such deductions in most cases”). That administrative practice was made official by Rev. Rul. 95-74.

³⁴Stanley S. Surrey, “Assumption of Indebtedness in Tax Free Exchanges,” 50 *Yale L. J.* 1, 21-22 (1940); Glenn E. Coven, “Liabilities in Excess of Basis: *Focht*, Section 357(c)(3), and the Assignment of Income,” 58 *Or. L. Rev.* 61, 76-77 (1979) (“under the decided case law, supported by principle and by the legislative history of the reorganization provisions, the transferee is not entitled to a deduction for its discharge of assumed accounts payable”).

³⁵U.S. App. Br., *supra* note 10, at 62.

³⁶See *infra* notes 55-57 and accompanying text.

³⁷1995-2 C.B. 36 (holding (2)).

³⁸See GCM 34118 (May 2, 1969); Coven, *supra* note 34, at 79 (explaining that the IRS’s decision to allow the transferee to deduct assumed liabilities is a corollary to its decision not to tax the transferor — under assignment of income principles — on unrealized income shifted to the transferee).

³⁹See *supra* note 15.

⁴⁰The taxpayer did not rely on Rev. Rul. 95-74 before the district court to support its assertion that BDHMI is entitled to deduct the healthcare claims, presumably because it recognizes that the ruling is easily distinguishable.

⁴¹Generally, the government is bound to follow its published guidance. E.g., *McLendon v. Commissioner*, 135 F.2d 1017 (5th Cir. 1998). Indeed, the very reason that revenue rulings are published is so that taxpayers may rely on them “in determining the tax treatment of their own transaction” without having to “request specific rulings applying the principles of a published revenue ruling to the facts of their particular cases.” Rev. Proc.

(Footnote continued on next page.)

Given the dearth of authority on the question whether the transferor should be allowed to deduct the payment of a contingent liability when a deduction has been disallowed to the transferee, the question should be resolved by asking whether allowing the transferor to take the deduction makes sense as a matter of policy.

3. The correct policy result is achieved by denying a deduction to both the transferor and the transferee. Consider the following example:

Example 1. P contributes undeveloped land encumbered by a contingent environmental liability to newly formed S corporation in exchange for all of S's stock. The value of the land and liability are as follows:

Assets	FV	Liabilities	FV
Land (basis: \$100)	\$100	Environmental damage	\$75*
		Net Worth	\$25
* \$75 is the expected cost of remediating the environmental damage, expressed as a present value.			

Under the basis rules applicable in section 351 exchanges, P's basis in its S stock (worth \$25) is \$100 and S's basis in the land is \$100.⁴² The question is whether P or S should be allowed a deduction for remediating the environmental damage.⁴³ The government argues that P should, Black & Decker argues that S should, and I am suggesting that neither party should get a deduction.

To see why my suggestion is correct, consider first P's precontribution position. P has an asset worth \$100 and a future deduction with an expected present value of \$75. If P sold the land in a taxable sale to buyer B (rather than contributing it in a section 351 exchange to subsidiary S) without first remediating the environmental damage, P would have an amount realized of \$100 comprising of \$25 of cash proceeds plus B's assumption of the \$75 liability. Because the amount realized equals P's basis, P realizes no gain or loss on the sale. Yet P should get a \$75

deduction. As the Supreme Court reasoned in *Hendler*, P should be treated as though \$100 "had been paid [to P] and then [\$75 is] paid over by [P] to its creditors," or in this case, paid out to remediate the environmental damage.⁴⁴

Turn now to the buyer. B's cost, and hence B's basis, is \$100.⁴⁵ When B subsequently remediates the damage, B is not entitled to a deduction. The liability assumption was part of the consideration B paid to acquire the land, and the cost of acquiring a capital asset is nondeductible. If B were allowed a deduction for remediating the environmental damage, B would enjoy a windfall: For a \$100 out-of-pocket cost, B would get both a basis of \$100 and a \$75 deduction. Indeed, the Supreme Court has held the buyer is not entitled to a deduction for assumed liabilities attributable to the presale period.⁴⁶

Returning to the facts of Example 1, when P contributes the land to S in a section 351 exchange the timing and character of P's deduction may change, but the tax rules should preserve for P the \$75 tax benefit attributable to the economic cost of the environmental damage. The tax rules should *not* create for P two \$75 tax benefits, which is the result that would follow if either P or S is allowed to deduct the cost of remediating the environmental damage. Under section 358, P takes a \$100 substituted basis in S stock worth \$25.⁴⁷ That is the correct result since P gave up property with a net value of \$25 and a \$75 built-in loss, and in the section 351 exchange receives S stock with a net value of \$25 and a \$75 built-in loss. The substituted basis rule of section 358 preserves P's preexchange tax position, provided that section 358(d)(2) applies to carve the deductible liabilities out of the general rule that transferring a liability reduces the transferor's stock basis.⁴⁸ Turn now to S. S takes a \$100 transferred basis in the land.⁴⁹ That basis includes both the value of the stock S transferred to P — \$25 — and the value of the liability assumed by S — \$75. To allow S an

89-14, 1989-1 C.B. 814, at section 7.01(5). Nonetheless, taxpayers are on notice that "[e]ach revenue ruling represents the conclusion of the Service as to the application of the law to the entire statement of facts involved. Therefore, taxpayers... are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same." *Id.* at section 7.01(6).

⁴²Sections 358(a), 362(a). The determination that P's basis in its S stock is \$100 assumes that the liabilities assumed by S are described in section 357(c)(3), which invokes section 358(d)(2). If so, section 358(d)(2) displaces section 358(d)(1), the general rule that liability assumptions by the transferee reduce the transferor's stock basis. Whether application of section 357(c)(3) is appropriate in this circumstance is discussed below. See parts III.C.5 and IV *infra*.

⁴³Throughout this example I assume the costs of remediation are deductible rather than subject to capitalization. Rev. Rul. 94-38, 1994-1 C.B. 35, *Doc 94-5264*, 94 *TNT* 107-12 (permitting taxpayer to deduct cost incurred to clean up hazardous waste attributable to manufacturing operations).

⁴⁴*United States v. Hendler*, 303 U.S. 655, 656 (1938); see also Daniel Halperin, "Assumption of Contingent Liabilities on Sale of a Business," 2 *Fla. Tax Rev.* 673, 677, 683-684 (1996) (explaining why the seller should get a deduction in such a circumstance).

⁴⁵Halperin, *supra* note 44, at 683; see also *id.* at 685 n.28 (noting that B might be granted basis, to the extent attributable to the assumed liability, when the liability accrues, rather than at the time of the exchange).

⁴⁶*Magruder v. Supplee*, 316 U.S. 394 (1942). In *Magruder*, a property tax liability was due and payable before the sale. The buyer assumed liability for the taxes. The Supreme Court held that the buyer was not entitled to a deduction given that "[p]ayment by [the] purchaser is not the discharge of a burden which the law placed on him, but is actually as well as theoretically a payment of the purchase price" (internal quotation and citation omitted). See also *Merchant's Bank Bldg v. Helvering*, 84 F.2d 478 (8th Cir. 1936).

⁴⁷See *supra* note 42.

⁴⁸P's preexchange tax position would also be preserved if P were given a basis of \$25 and allowed to retain the deduction for the transferred liability. That is the outcome the government is seeking. Although that result makes sense as a policy matter, it does not square with the language of the code. See *infra* Part III.C.5.

⁴⁹Section 362(a).

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additional deduction when it actually remediates the damage would be unduly generous.⁵⁰

P's and S's postexchange tax positions fully account for the consideration that each of them transferred in the exchange. Allowing either one to deduct the liability would permit P to enjoy a double tax benefit for a single economic cost. If, as the taxpayer argues, S (BDHMI) is allowed a deduction, that deduction will ultimately redound to P's (Black & Decker's) benefit (in the form of an NOL) when P reacquires a sufficient stake in S so that S rejoins P's consolidated group. (Black & Decker has planned from the outset to reconsolidate with BDHMI.)⁵¹ If, as the government argues, P is allowed a deduction, then the deduction P is allowed when S remediates the environmental damage will duplicate P's \$75 stock loss on the sale of its S stock. Either way P will get two tax benefits for a single economic cost. In Black & Decker's case, as in Example 1, precluding both the transferor and the transferee from taking a deduction would prevent the double tax benefit.

Despite the anomalous result caused by allowing a postexchange deduction to either party to the exchange, there are at least two arguments that *some* taxpayer is entitled to a deduction. Both of those arguments merit discussion, although neither is persuasive. First, it could be that BDHMI (or S in Example 1) is acting as Black & Decker's (P's) agent for purposes of paying the liabilities, so Black & Decker (the principal) is entitled to a deduction. That argument is foreclosed to Black & Decker at this point in the litigation. Black & Decker has strenuously argued that payment of the liabilities was an ordinary and necessary feature of BDHMI's business, not an activity undertaken by BDHMI as an agent for Black & Decker,⁵² and that "there is no legal basis for [Black & Decker] to claim deduction for the healthcare liabilities assumed by BDHMI."⁵³ Allowing Black & Decker to change its tune now would create tension with the Supreme Court's reluctance to entertain after-the-fact arguments that a corporation is a mere agent of its shareholders for tax purposes.⁵⁴

Second, various courts and commentators have intimated (but none have held squarely) that a conservation principle governs the treatment of deductions in section

351 exchanges — that is, no deductions are ever destroyed in an exchange; whatever deductions existed before an exchange must exist after that exchange.⁵⁵ Black & Decker has advanced that argument directly (without the benefit of citation to authority);⁵⁶ and the government has apparently accepted the argument.⁵⁷ That conservation principle makes sense in many (perhaps most) section 351 transactions: Some taxpayer is going to bear the economic cost of the liability, so some taxpayer should get a tax benefit. In Example 1, as in Black and Decker's transaction, assuming section 358(d)(2) applies, the contributing shareholder is getting a tax benefit for bearing the economic cost of the liabilities in the form of a capital loss on the sale of the transferee corporation's stock, so disallowing a deduction to both parties to the exchange would thwart the double tax benefit that is objectionable as a policy matter. Compare a case in which unrealized income items such as accounts receivable of a cash method taxpayer or built-in gain property is contributed together with contingent liabilities. In such a case, loss duplication makes sense since it mitigates the harshness of the gain duplication inherent in a two-tier corporate income tax, and facilitates rather than frustrates a clear reflection of income.⁵⁸ This explains why the IRS ruled, in Rev. Rul. 95-74, that the transferee is entitled to deduct assumed contingent liabilities. It further explains, however, why the IRS explicitly declined to extend this treatment to cases when the incorporation improperly separates income from related expenses — such as Black & Decker's transaction, in which only deductions and not gains or income items would be duplicated.

⁵⁵E.g., *Doggett v. Commissioner*, 275 F.2d 823 (4th Cir. 1960) (stating in *dicta* that when a shareholder transfers a liability to his wholly owned corporation, "one or the other should be allowed to claim the deduction"); Coven, *supra* note 2, at 836 n.26 ("When liabilities are assumed in an isolated transaction, not a part of the transfer of all the assets of a business, the Service may be able to challenge this deduction by the transferee under the authority of such cases as *Holdcroft* . . . but only if the transferor is allowed to claim the deduction.") (Emphasis added.)

⁵⁶B&D Opposition to US MSJ, filed Feb. 25, 2004, at 32. Theoretically one could argue that the conservation principle stems from the continuity between the transferor and transferee. For instance, the transferee steps into the transferor's shoes for basis purposes; why not for other purposes, like deducting assumed liabilities, too? Unfortunately for the taxpayer, that argument has been specifically considered and rejected. *Holdcroft*, 153 F.2d 323, 324-25 (8th Cir. 1946). It has been firmly established for several decades that there is insufficient continuity between or among parties to a section 351 exchange to serve as a basis for allowing the transferee to deduct liabilities assumed from a transferor. Coven, *supra* note 34, at 75-76.

⁵⁷Both before the district court and in its appellate brief, Black & Decker has argued that no deduction is allowed to BDHMI because the liabilities were not incurred in its business, and that the deduction is allowed to Black & Decker. The government has not explicitly stated that the deduction must belong to someone after the exchange, but neither has the government objected to the taxpayer's clear statement to that effect.

⁵⁸See *supra* note 38 and accompanying text.

⁵⁰Surrey, *supra* note 34, at 21 ("The transferee's basis is not affected by its later action in regard to the liability. Its assumption of the liability is part of its cost."); Coven, *supra* note 34, at 74-78.

⁵¹The trial record includes a file memo by Black & Decker indicating that it plans to reacquire a sufficient stake in BDHMI to reconsolidate at some point in the future. This will allow Black & Decker to capture the benefit of BDHMI's deduction of the healthcare expenses, which will have amassed into a significant NOL. See *supra* note 4 and accompanying text.

⁵²B&D Opposition to US MSJ, filed Feb. 25, 2004, at 29-33.

⁵³*Id.* at 32 n.29.

⁵⁴See *Commissioner v. Bollinger*, 485 U.S. 340 (1988) (holding that a claim that controlled corporation was acting as agent for its shareholders must be supported by "unequivocal evidence of genuineness"); *Citizens National Trust & Savings Bank v. Welch*, 119 F.2d 717, 719 (9th Cir. 1941) (rejecting claim that transferor was entitled to deduct liabilities paid by transferee on the theory that transferee was transferor's agent).

The bottom line is that if the government were to disallow a deduction to both Black & Decker and BDHMI it would successfully block Black & Decker from enjoying a tax windfall. The argument for disallowing a deduction to both parties is straightforward, produces a correct policy result (as demonstrated by Example 1), and does no damage to either the language of the code or to future application of sections 357 and 358 in run-of-the-mill section 351 exchanges. That is in contrast to the arguments the government is pursuing, as discussed below.

The bottom line is that if the government were to disallow a deduction to both Black & Decker and BDHMI it would successfully block Black & Decker from enjoying a tax windfall.

A loose end: One could argue that denying a deduction to both Black & Decker and BDHMI is an inadequate solution because it allows the taxpayer to accelerate the deduction for the contingent liabilities. But for the section 351 exchange the deduction would accrue in the (perhaps distant) future, whereas the exchange generates stock with a built-in loss that can be recognized immediately. If that is right, the loophole Black & Decker is seeking to exploit would not be completely closed.⁵⁹ But that argument overlooks an important fact — the value assigned to the contingent healthcare claims is the *present value* of the future obligations.⁶⁰ So while the deduction would in effect be accelerated, allowing Black & Decker to currently capture its loss on the sale of BDHMI's stock, Black

& Decker would reap no advantage given that the value of the deduction would be reduced to account for the time value of money.⁶¹

C. Does Section 357(c)(3) Apply?

1. Overview. Step 2 of the government's argument — that section 357(c)(3) refers to liabilities that, after the transfer, are deductible by the transferee, not the transferor — is based on the "tax policy behind the statute."⁶² That is not surprising because, as the government itself admits, section 357(c)(3) does not specify by whom the liabilities in question must be deductible.⁶³ Specifically, the government is arguing that applying section 357(c)(3) in this case would frustrate the policy against allowing two deductions for one economic loss.⁶⁴ If, as I suggest

⁶¹It is entirely possible — if not likely — that the \$560 million value assigned to the contingent liabilities is artificially high either because the actuarial estimates are too high, or because the discount rate is too low, or a combination of the two. It would have been to Black & Decker's advantage to come up with a high estimate, since the estimated present value of the future liabilities was the limiting factor in setting the size of the built-in loss on Black & Decker's BDHMI preferred stock. High-balling the value of the liabilities would also disadvantage Black & Decker, however, because it would mean that BDHMI's preferred stock was really worth more than the \$1 million price at which Black & Decker sold it to the trust controlled by Black & Decker's former executive.

But the tax advantage gained by overestimating the value of the contingent liabilities far outweighs the disadvantage. The former executive's preferred stock is subject to reciprocal puts and calls, entitling BDHMI to redeem and the former executive to resell the BDHMI preferred stock to BDHMI at a formula price that depends on whether BDHMI is successful in controlling healthcare costs as compared with the actuarial prediction, subject to a cap of \$5 million. So the most that Black & Decker could lose as a consequence of a high estimate is the \$4 million difference between the price paid by the former executive and the amount BDHMI would have to pay to repurchase his stock on the exercise of either the put or the call. Meanwhile, Black & Decker stood to save hundreds of millions of dollars in taxes as a result of the transaction. Indeed, one can envision the \$4 million that the former executive stood to net on the deal as an accommodation fee paid to help Black & Decker facilitate its plan. (The stock Black & Decker sold to Hansen was subject to a similar put-call arrangement. *See supra* note 4.)

In any case, the government has not raised the argument that the contingent liabilities were improperly valued (although it probably should have). A coordinated issue paper prepared by the IRS demonstrates that the government is sensitive to the possibility that taxpayers might misvalue the liabilities employed in contingent liability shelters. *See Appeals Coordinated Issue Paper "Settlement Guidelines: IRC Section 351 Contingent Liability Capital Loss Transactions" (Issue 8)*, available at http://www.irs.gov/pub/irs-utl/asg_cont_liab_final_20040504_redacted.pdf.

⁶²US MSJ, *supra* note 4, at 14.

⁶³*Id.* Section 357(c)(3)(A) states (in the passive voice) that it applies to liabilities "the payment of which . . . would give rise to a deduction." There is no indication by whom the payment must be deductible to fall within the provision.

⁶⁴Application of section 357(c)(3) is not important in its own right; it is important because it triggers application of section 358(d)(2). Section 358(d)(2) is actually the provision that creates the double benefit.

⁵⁹Karen C. Burke, "Black & Decker's Contingent Liability Shelter: 'A Thing of Grace and Beauty'?" *Tax Notes*, Jan. 31, 2005, p. 577, at 583.

⁶⁰E.g., Daniel Halperin, "Assumption of Contingent Liabilities on Sale of a Business," 2 *Fla. Tax. Rev.* 673, 702 (1996) (an immediate deduction is economically equivalent to a delayed deduction assuming proper adjustment for the time value of money). Deducting the present value of a future obligation produces the appropriate tax result if the taxpayer is denied an interest deduction for the period between the deduction and the eventual payment. *Id.* at 679 and n.14. Here Black & Decker will be allowed a deduction on the BDHMI notes it holds, and payment of those notes will fund discharge of the contingent liabilities assumed by BDHMI. *See supra* note 22. The benefit of the interest deduction will, however, be offset in whole or substantial part by BDHMI's offsetting interest income the burden of which will be borne economically by Black & Decker as the only common shareholder of BDHMI. Even if BDHMI is in a loss position throughout its existence so it never pays tax on the interest income, Black & Decker will bear the burden of BDHMI's tax on the interest income on reconsolidation, given that BDHMI's NOLs (to be inherited by Black & Decker) will have been diminished by the amount of BDHMI's interest income. *See supra* note 4. Thus, allowing Black & Decker an interest deduction for payments on its BDHMI notes does not change the reality that a current (discounted) deduction is the present value equivalent of a deferred deduction.

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above, neither Black & Decker nor BDHMI is allowed a deduction for payment of the contingent healthcare claims, the government's policy objection to applying section 357(c)(3) falls away. I will assume *arguendo*, however, that the government is correct that Black & Decker continues to be allowed a deduction for the contingent healthcare claims paid by BDHMI after the section 351 exchange.

Given that assumption, should the government's policy argument be accepted? Is it likely to be accepted? These are difficult questions. As I explain below, the resolution ultimately depends on how willing the Fourth Circuit is to eschew a plain meaning approach to statutory interpretation in favor of a purposive approach.

2. The policy against allowing a double tax benefit for a single economic loss. The government's policy claim is that to apply section 357(c)(3) (and hence section 358(d)(2))⁶⁵ to liabilities that continue to be deductible by the transferor following a section 351 exchange would be to frustrate the policy against allowing two tax benefits for one economic loss, absent clear evidence that is what Congress intended.⁶⁶ As demonstrated above in my explication of Example 1, if the transferor retains the right to deduct the contingent liability after the section 351 exchange, the government's assertion that application of sections 357(c)(3) and 358(d)(2) would combine to create a double tax benefit for a single economic cost is correct.⁶⁷ However, the question remains whether the policy rationale underlying sections 357(c)(3) and 358(d)(2) would be frustrated by *not* applying those sections.

3. The policy of preserving the contributing shareholder's pretax position. The policy goal of the basis and liability assumption rules that apply to section 351 exchanges is (or at least should be) to create a level playing

field for those transactions taxwise.⁶⁸ The rules should not create a tax bias either in favor of or against incorporation. Two of the rules, sections 357(c)(3) and 358(d)(2), were enacted in 1978 to serve this policy goal and to resolve what had been an oft-litigated issue, one that had split the courts of appeals⁶⁹ and led the Tax Court to reverse itself.⁷⁰ The difficulty was that a literal application of the pre-1978 versions of sections 357(c) and 358(d)(1) to run-of-the-mill incorporations of going businesses — such as the incorporation of proprietorships and partnerships — frequently overtaxed the contributing shareholder.

Consider the following example:

Example 2. Taxpayer P, on the cash method of accounting, contributes to newly formed S corporation all of its assets and liabilities, as follows:

Assets	FV	Liabilities	FV
Land (basis: \$60)	\$100	Payables	\$75
Receivables (basis: \$0)	\$85		
Total	\$185	Net Worth	\$110

But for section 357(c)(3), this transaction would generate gain. Specifically, P would be taxed under section 357(c)(1) on gain equal to the \$15 excess of the total amount of liabilities assumed by S — \$75 — over P's basis in the assets transferred — \$60. Furthermore, but for section 358(d)(2), P's basis in its S stock would be \$0,⁷¹ implying an inherent gain of \$110 for P following the

⁶⁵See *supra* note 64.

⁶⁶US MSJ, *supra* note 4, at 16. The government cites two cases for this rule militating against double deductions, *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969), and *Charles Ifeld Co. v. Hernandez*, 292 U.S. 62 (1934). In *Skelly Oil*, the taxpayer included in income proceeds from the sale of natural gas and took a percentage depletion allowance computed as a fraction of the sale proceeds. In a later period, when the taxpayer was required to refund a portion of the sale proceeds, the question was whether the deduction should be (a) for the full amount of the refund or (b) for the amount of the refund less the aliquot share of the percentage depletion allowance. The Court held (b) was correct, because (a) would permit the practical equivalent of a double deduction, and there was no "clear declaration" that is what Congress intended. *Skelly Oil*, 394 U.S. 678, at 684.

In *Charles Ifeld*, a parent corporation took deductions in early years from losses attributable to two consolidated subsidiaries. In a later year when it dissolved the subsidiaries, it sought to deduct the excess of its investment in the subsidiaries over the amount recouped on liquidation. The Court held that the losses were not permitted by the consolidated return regulations then in place, and added that "[t]he allowance claimed would permit [the taxpayer] twice to use the subsidiaries' losses for reduction of its taxable income. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers." *Charles Ifeld*, 292 U.S. 62, at 68.

⁶⁷See text accompanying *supra* notes 43-50.

⁶⁸S. Rep. 275, 67th Cong, 1st Sess., reprinted at 1939-1 C.B. (part 2) 189 (predecessor of section 351 and related provisions, "if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound . . . permit business to go forward with the readjustments required by existing conditions."); *Hempt Bros., Inc. v. United States*, 490 F.2d 1172, 1177 (3d Cir. 1974). ("Section 351 has been described as a deliberate attempt by Congress to facilitate the incorporation of ongoing businesses.")

⁶⁹Compare *Thatcher v. Commissioner*, 533 F.2d 1114 (9th Cir. 1976) (holding that the excess of assumed liabilities over basis of transferred assets in a section 351 exchange was taxable to the transferor-shareholder), with *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972) (holding that a cash method taxpayer's accounts payable were not liabilities for purposes of determining section 357(c) gain in a section 351 exchange and that a literal reading of section 357(c) was contrary to the statute's purpose and inequitable).

⁷⁰Compare *Thatcher v. Commissioner*, 61 T.C. 28 (1973) (holding that section 357(c) triggers gain to the extent liabilities transferred in a section 351 exchange exceed basis of contributed property, even when the liabilities would give rise to a deduction had they been paid by the transferor), and *Raich v. Commissioner*, 46 T.C. 604 (1966) (same), with *Focht v. Commissioner*, 68 T.C. 223 (1977) (holding that liabilities that would have given rise to a deduction to the transferor are excluded when determining if and to what extent transferor has section 357(c) gain).

⁷¹Section 358(a), (d)(1) (\$60 substituted basis reduced by \$75 for assumed liabilities and increased by \$15 for gain recognized).

exchange, a position worse than P occupied before the exchange. Because applying sections 357(c)(1) and 358(d)(1) in circumstances like those would overtax P and thus would impede incorporation transactions, Congress added sections 357(c)(3) and 358(d)(2) to correct the problem.⁷²

Before the transaction P's tax position was as follows:

+\$40	unrealized appreciation in the land
+\$85	future income from receivables
-\$75	inchoate deduction from payables
+\$50	net income

P's tax position is preserved by allowing P to avoid section 357(c) gain on the exchange and giving P a \$60 substituted basis in the S stock received (worth \$110), implying a \$50 gain,⁷³ a result that is reached by applying sections 357(c)(3) and 358(d)(2).

Conceptually, applying those sections makes sense in cases like Example 2. In a sale or exchange transaction *not* subject to a nonrecognition rule, the seller is treated as though the seller received cash in the amount of any liability transferred to the buyer. When a nonrecognition rule like section 351 applies, however, then rather than treating the transferred liability as boot, the usual solution is to treat it as a return of capital, which forces the seller to reduce her basis — a la section 358(d)(1). That insures that any debt-generated income is deferred, rather than excepted from tax completely, a result consistent with the underlying policy of deferring rather than exempting gain in nonrecognition transactions. When the transferred liability would be deductible by the transferor before the exchange, however, the transferor forfeits a deduction of equal value to the liability transferred. In those circumstances, the transferor is taxed appropriately by ignoring the transferred liability altogether, for both basis and income measurement purposes, since the income and lost deduction attributable to the liability transfer cancel out.⁷⁴

4. Reconciling the policies. Let's turn now to an example more closely analogous to Black & Decker's transaction. This example will demonstrate that *not* applying sections 357(c)(3) and 358(d)(2) will serve both the policy of not allowing two tax benefits from one economic loss and treating incorporation transactions neutrally from a tax standpoint.

Example 3. Taxpayer P, using the cash method of accounting, holds the following assets and liabilities. P contributes to S the land and the payables. *P retains the receivables.*

Assets	FV	Liabilities	FV
Land (basis: \$100)	\$100	Payables	\$75
Receivables (basis: \$0)	\$85		
Total	\$185	Net Worth	\$110

Assuming (consistent with Step 1 of the government's argument) that P retains the right to deduct the payables even after they are transferred to S, the better result from a policy standpoint is *not* to apply sections 357(c)(3) and 358(d)(2). That will preserve P's preincorporation tax position. If sections 357(c)(3) and 358(d)(2) apply, on the other hand, then P gets an undeserved tax windfall, as summarized in Table 1.

Table 1. Results to P in Example 3 Depending on Whether Transferor-Shareholder's Stock Basis Is Reduced for Assumed Liabilities

	Before Exchange	After Exchange	
		Section 357(c)(3)/ Section 358(d)(2) do not apply	Section 357(c)(3)/ Section 358(d)(2) do apply
Unrealized gain or loss	\$0 (land) ^a	\$0 (stock) ^b	-\$75 (stock) ^c
Income	+\$85 ^d	+\$85 ^d	+\$85 ^d
Deduction	-\$75 ^e	-\$75 ^e	-\$75 ^e
Net income	+\$10	+\$10	-\$65

^aBefore the exchange, P owned land with a basis and value of \$100.

^bAfter the exchange, the value of P's stock is \$25. If sections 357(c)(3) and 358(d)(2) *do not* apply, then basis is \$25, a substituted basis of \$100 reduced by the \$75 of assumed liabilities.

^cIf sections 357(c)(3) and 358(d)(2) apply, P has a \$100 substituted basis.

^dThe receivables were held back in the exchange so they are taxed to P.

^eThe example assumes that the government is correct in its assertion that P is allowed to deduct the payables even though they are assumed and paid by S.

As Example 3 demonstrates, if the first step in the government's summary judgment argument is accepted, the second step arguably should be accepted too, if the determination is based on achieving the right outcome as a matter of policy; if sections 357(c)(3) and 358(d)(2) were to apply, P would enjoy an undeserved windfall. Critically, however, the government's argument is without support in the text of the code or its legislative history.

5. Parsing sections 357(c)(3) and 358(d)(2) and the legislative history. The government's argument does not square with the language of section 357(c)(3), which provides in relevant part:

⁷²Revenue Act of 1978, Pub. L. No. 95-600, section 365; S. Rep. No. 95-1263 (1978), reprinted at 1978-3 C.B. 315.

⁷³True, \$10 of the \$50 of net income before the exchange was ordinary, and all \$50 of the gain after the exchange is capital. Although that might be a significant point if P were an individual, corporations like Black & Decker do not enjoy a capital gains rate preference.

⁷⁴E.g., Burke, *supra* note 59, at 580; Kahn and Oesterle, *supra* note 33, at 468; cf. section 108(e)(2).

(3) Certain liabilities excluded

(A) In general. If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either —

- (i) *would give rise to a deduction*, or
- (ii) * * *

then, for purposes of [section 357(c)(1)], the amount of such liability shall be excluded in determining the amount of liabilities assumed. (Emphasis added.)

The critical passage — “*would give rise to a deduction*” — does not specify either to whom or when the deduction must be allowed. The government would have the court manufacture a wholly new prerequisite to the application of section 357(c)(3), that is, that the transferor not be allowed to deduct the transferred liability following the exchange.

The legislative history does not support such a construction. The committee report accompanying the 1978 Act codifying sections 357(c)(3) and 358(d)(2) implies that Congress focused on the question whether payment of the liability would have given rise to a deduction to the transferor before the transfer if the transfer had not taken place.⁷⁵ In *Black & Decker*, if no section 351 exchange had taken place then indisputably Black & Decker would have been permitted a deduction for the liability when paid. The legislative history implies that this is all that section 357(c)(3) requires.

Moreover, the legislative history states (somewhat cryptically) that “the provision is not intended to affect the corporate-transferees’ tax accounting for the liabilities” and that Congress “codif[ie]d the approach taken by the Tax Court in *Focht*,” a case that demurred on the question whether the transferee should be allowed a deduction for liabilities assumed in a section 351 exchange.⁷⁶ Both statements imply that Congress was agnostic on the question whether the *transferee* should be allowed a deduction, but did not even consider the possibility that the *transferor* might be allowed a deduction following the exchange. That undermines the government’s argument that Congress intended section 357(c)(3) to be inapplicable when the transferor retains the right to the deduction following the transfer. (It also

undermines the anterior point, discussed above, that the transferor should be entitled to the deduction, given that this possibility apparently was not even considered.)

The government’s argument to the contrary, to the extent it is based on the legislative history, is unpersuasive.⁷⁷ The government asserts that because the phrase in the legislative history, “payment thereof by the transferor would have given rise to a deduction,” is in the subjunctive, it implies a condition contrary to fact: “Congress was contemplating a deduction that would have been available to the taxpayer absent the transfer, but that, in fact, was no longer available after the transaction.”⁷⁸ If the government’s grammatical parsing of that phrase in the legislative history is correct, it merely demonstrates that Congress did not entertain the possibility that the transferor might be allowed a deduction following the transfer. It does not imply, as the government argues, that Congress silently contemplated a case in which liabilities are transferred but the deduction is retained by the transferor and concluded that section 357(c)(3) should not apply.

D. Summary and Conclusion

Ideally, neither Black & Decker nor BDHMI should be allowed to deduct the healthcare claims. If a deduction is denied both taxpayers, sections 357(c)(3) and 358(d)(2) can be applied to Black & Decker’s transaction without creating a tax windfall. True, application of those sections will accelerate Black & Decker’s ability to enjoy the tax benefit attributable to the contingent healthcare claims (the tax benefit will take the form of a loss on the sale of BDHMI stock). But that is unobjectionable, because the accelerated loss is discounted to present value. (Perhaps the present value of the liabilities was overestimated by Black & Decker, but the government has not raised that argument.)

Because BDHMI is not a party to the litigation, however, the court must confront the government’s summary judgment argument. First, it must determine whether Black & Decker is entitled to deduct the claims when BDHMI pays them. The government argues that Black & Decker is entitled to deduct the claims, which the government apparently concluded was a necessary concession given its assertion that BDHMI was not entitled to deduct the claims. The government’s argument is flawed conceptually, unless BDHMI is viewed as Black & Decker’s agent. A finding by the Fourth Circuit that BDHMI was acting as Black & Decker’s agent would overlook Black & Decker’s concession to the contrary and would create tension with Supreme Court precedent that suggests (in a different context) that unequivocal evidence is required to find a controlled corporation is acting as agent for its shareholder. If the court determines that Black & Decker is *not* entitled to deduct the claims when paid by BDHMI, the government’s argument fails.

⁷⁵See S. Rep. No. 95-1263, at 183, reprinted at 1978-3 C.B. (vol. 1) 315 (liabilities excluded under section 357(c)(3)(A) “to the extent payment thereof by the transferor would have given rise to a deduction”) (emphasis added). The Senate report also indicates that enactment of sections 357(c)(3) and 358(d)(2) was prompted by “unintended difficulties for certain cash basis taxpayers who incorporate a going business.” *Id.* The government’s appellate brief explains that the exception for liabilities that would give rise to a deduction under section 358(d)(2) is therefore limited to situations when a taxpayer incorporates a going business. US App. Br., *supra* note 10, at 57. Although it is clear from the Senate report that concern for those taxpayers was the impulse for the legislative change, there is no statement in the legislative history that application of the provisions was intended to be so limited.

⁷⁶*Focht v. Commissioner*, 68 T.C. 223, 238 (1977). (“We need not decide here the tax consequences to the transferee when it pays the assumed liabilities.”)

⁷⁷As discussed above, the government’s policy argument for the nonapplication of sections 357(c)(3) and 358(d)(2) is strong *provided* the government is correct that the transferor is entitled to deduct transferred liabilities after the exchange.

⁷⁸US App. Br., *supra* note 10, at 58.

However, in the unlikely event the Fourth Circuit concludes that Black & Decker is entitled to deduct the claims when they are paid by BDHMI, the court must go on to address whether section 357(c)(3) should be applied literally — in which case Black & Decker will get a double tax benefit from a single economic cost — or should be held not to apply given the undeserved tax windfall that would redound to Black & Decker. Resolution of that issue depends on whether the Fourth Circuit construes the code literally or purposively. Given that the issue can be avoided as explained above, I do not expect the Fourth Circuit to confront it directly.

Although the term excluded in section 358(d)(2) appears unambiguous on its face, a literal interpretation leads to bizarre, perhaps absurd, results in routine, non-shelter-related applications of sections 357 and 358.

If the government is well-advised, presumably it has already issued statutory notices of deficiency to BDHMI for all tax years since the section 351 exchange in question. The notices should deny BDHMI's claimed deduction for all healthcare expenses that have been paid since the transaction, and the IRS should deny all deductions for those claims to the extent they arise in the future.

IV. The Government's Alternative Argument

A. Should Section 358(d)(2) Be Read Literally?

Recall that Black & Decker's position depends on the application of section 358(d)(2), the paragraph that carves certain deductible liabilities out of the rule that liability assumptions by the transferee corporation trigger a basis reduction for the transferor shareholder. Application of section 358(d)(2) turns on whether the liabilities in question are *excluded* from section 357(c)(1) by section 357(c)(3). Section 357(c)(2)(A) provides that section 357(c)(1) "shall not apply to any exchange . . . to which [section 357(b)] applies." Black & Decker's concession that the transaction was motivated solely by tax avoidance triggers application of section 357(b), and displaces section 357(c)(1).⁷⁹ The government argues that if section 357(c)(1) does not apply in the first place, the liabilities cannot be excluded from section 357(c)(1), which is necessary for section 358(d)(2) to apply.

There is a significant problem with the government's argument. Although the term "excluded" in section 358(d)(2) appears unambiguous on its face, a literal interpretation leads to bizarre, perhaps absurd, results in routine, non-shelter-related applications of sections 357 and 358. Interpreting section 358(d)(2) literally also contravenes a published ruling. Accordingly, the government's argument should be rejected.⁸⁰

⁷⁹See *supra* note 15 and accompanying text and *supra* note 24.

⁸⁰This is a role reversal for the government when compared with the argument described in Part III. There the government (Footnote continued in next column.)

I develop that conclusion below using three examples. Example 4 is similar to Black & Decker's transaction, and it shows how the government's argument would prevent Black & Decker from duplicating the tax benefit from its liabilities. Examples 5 and 6 illustrate the anomalous results that the government's argument would create in routine section 351 transactions.

B. Reading 358(d)(2) Literally Prevents a Windfall

Consider the following example:

Example 4. P holds land and contingent environmental liabilities associated with P's contamination of the land. P contributes the land to S and S agrees to assume responsibility for the contingent environmental liabilities. The purpose behind P's contribution is tax avoidance — P is attempting to duplicate the deduction attributable to the environmental liabilities and to accelerate P's ability to take advantage of the tax benefit from the liabilities through a sale of the S stock received in the exchange. The details of the contributed asset and liabilities are as follows:

Asset	FV	Liabilities	FV
Land (basis: \$100)	\$100	Environmental damage	\$50
		Net Worth	\$50

Under *Crane*, S's assumption of P's \$50 liability is treated as part of P's amount realized, together with the \$50 worth of S stock P takes back in exchange for P's land. Section 357(a) provides that this liability is *not* treated as boot for purposes of section 351; however, section 357(b) trumps section 357(a) because the liability assumption was not undertaken for a bona fide business purpose (other than tax avoidance).⁸¹ Thus, P is forced to treat S's assumption of the \$50 liability as money received in the exchange and to recognize gain realized on the exchange to that extent.⁸² In Example 4, as in *Black & Decker*, there is no gain realized.

P's basis in the S stock received in the exchange could be alternatively (1) a \$100 substituted basis or (2) a \$100 substituted basis *decreased* by the \$50 liability assumed by S, depending on how the court parses section 358(d)(2). The liability is unquestionably described in section 357(c)(3) because its payment "would give rise to a deduction."⁸³ The taxpayer will take the position that this triggers application of section 358(d)(2). On the other hand, section 358(d)(2) carves out only liabilities "*excluded* under section 357(c)(3)," and in this case the

was relying on the policy underlying the statute, rather than a close reading of the text. For this argument, stressing policy will presumably be the taxpayer's role.

⁸¹See *supra* note 25.

⁸²Sections 357(b), 351(b).

⁸³Remediating the damage may be capital expenditure; however, the IRS has ruled that the reference to "deduction" in section 357(c)(3) should be read to include capital expenditures. See Rev. Rul. 95-74, 1995-2 C.B. 36 (Holding (1)).

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liability cannot be excluded under section 357(c)(3) because section 357(b) trumps section 357(c)(1). In other words, section 357(c)(3) cannot operate to exclude the liability from section 357(c)(1) because section 357(c)(1) does not apply in the first place. A literal interpretation of section 358(d)(2) thus leads to the conclusion that P's basis is \$50, which foils P's plan to duplicate and accelerate the tax benefit attributable to the liability since P's S stock is worth \$50.

Of course, P's environmental liability is analogous to Black & Decker's contingent healthcare claims and the government is pressing the Fourth Circuit to adopt that literal construction of section 358(d)(2).⁸⁴ Superficially, that argument appears persuasive since the terms of the statute appear ambiguous. Nonetheless, applying the statute literally produces results that appear to be at odds with any reasonable congressional purpose, as illustrated below.

C. Reading 358(d)(2) Literally Causes Odd Results

The results in Example 5 are straightforward. Example 5 will serve as a point of reference for Example 6, in which the results are less straightforward.

Example 5. P holds land, accounts receivable, and accounts payable. P contributes the land and the accounts receivable to S and S agrees to assume the accounts payable. The details of the contributed assets and liabilities are as follows:

Assets	FV	Liabilities	FV
Land (basis: \$50)	\$100	Payables	\$51
Receivables (basis: \$0)	\$60		
Total	\$160	Net Worth	\$109

The contributing shareholder, P, takes a substituted basis in the stock received in exchange for the contributed assets, undiminished by the liabilities assumed by the transferee corporation, S. Thus P's basis is \$50. Section 357(c)(1) would apply but for section 357(c)(3), because the amount of assumed liabilities exceeds the basis of the contributed land; however, section 357(c)(3) excludes the liabilities assumed from section 357(c)(1), because payment of the liabilities "would give rise to a deduction." Exclusion under section 357(c)(3) invokes section 358(d)(2), and spares P from having to reduce P's S stock basis for the liability assumption. That result squares with the gain deferral objective of the section 351 basis adjustment rules given that before the contribution P was sitting on \$59 of net income (including the gain inherent in the land), and after the exchange the \$59 of income is preserved as a built-in gain in P's S stock.⁸⁵

⁸⁴US App. Br., *supra* note 10, at 51-53.

⁸⁵Preexchange, P has a \$50 unrealized gain on the land, and \$60 of unreported income from the receivables for a total gross income of \$110; subtracting P's \$51 of deductible liabilities results in a net income of \$59. Postexchange, P holds stock worth \$109 with a basis of \$50.

Now consider another example that is only slightly different from Example 5. The starkly different tax results that follow from the slight change in facts shows the anomaly created by the literal interpretation of section 358(d)(2) the government is advocating.

Example 6. Same as Example 5 except the amount of the assumed liabilities is reduced slightly so that liabilities assumed no longer exceed the adjusted basis of the land. The details of the contributed assets and liabilities are as follows:

Assets	FV	Liabilities	FV
Land (basis: \$50)	\$100	Payables	\$50
Receivables (basis: \$0)	\$60		
Total	\$160	Net Worth	\$110

Although the change from Example 5 is trivial (liabilities have been reduced by only \$1) the analysis is more complicated, given that the amount of liabilities assumed no longer exceeds the basis of the assets transferred. As in Example 5, the liabilities assumed are *of the type* described in section 357(c)(3), but the liabilities are no longer *excluded* under section 357(c)(3), given that section 357(c)(1) does not apply in situations when liabilities do not exceed basis. Accepting the government's argument that the phrase "excluded under section 357(c)(3)" in section 358(d)(2) should be applied literally leads to the conclusion that section 358(d)(2) does not apply to situations like Example 6, in which liabilities do not exceed basis. If that is right, P's S stock basis is \$0, or a substituted basis of \$50 reduced by the \$50 of liabilities assumed in the transaction.⁸⁶

The bottom line is that rather than preserving P's preincorporation status quo — \$60 of net income — P's position has been made substantially worse. P now holds stock worth \$110 with a zero basis. Comparing Examples 5 and 6 shows that a \$1 reduction in the liabilities assumed by S wipes out \$50 of stock basis for P. It is difficult to imagine that Congress intended to create that arbitrary distinction when they promulgated sections 357(c)(3) and 358(d)(2), but it is a clear consequence of the government's argument.⁸⁷

D. A Literal Reading Contravenes a Rev. Rul.

The government's position is contrary to Rev. Rul. 80-198,⁸⁸ which explains that section 358(d)(2) carves out

⁸⁶Section 358(a), (d)(1).

⁸⁷Glenn Coven pointed out the perils of a literal interpretation of section 358(d)(2) 26 years ago just after sections 357(c)(3) and 358(d)(2) were codified. He concluded that section 358(d)(2) should be read to prohibit basis reduction attributable to the assumption of any liability "described in" section 357(c)(3), "regardless whether section 357(c)(1) is actually applicable." He found that the results that follow from a literal application of section 358(d)(2) "would be absurd. The unfortunate draftsmanship of section 358(d)(2) cannot be permitted to produce such a result." Coven, *supra* note 34 at 71-73.

⁸⁸1980-2 C.B. 113. The government is ordinarily bound by its published guidance. See *supra* note 41.

from section 358(d)(1) “liabilities defined in section 357(c)(3),” implying that the term “excluded” in section 358(d)(2) should not be read literally, but instead should be construed to apply to liabilities of the type referred to in section 357(c)(3) (that is, liabilities payment of which would give rise to a deduction). Under that construction, the term “exclude” in section 358(d)(2) is effectively being read to mean “excludable.”⁸⁹

The view expressed in Rev. Rul. 80-198 that section 358(d)(2) refers to liabilities defined in section 357(c)(3) — as opposed to those excluded by section 357(c)(3) — is not mere dicta; it is central to the ruling’s holding. The facts of the ruling are as follows.

Rev. Rul. 80-198. A, a doctor, runs a medical practice as a proprietorship. The practice holds tangible assets, accounts receivable, and accounts payable. A contributes the assets and receivables to a corporation and the corporation agrees to assume the accounts payable. The details of the contributed assets and liabilities are as follows:

Assets	FV	Liabilities	FV
Tangibles (basis: \$30)	\$40	Payables	\$10
Receivables (basis: \$0)	\$20	Mortgage on tangibles	\$10
Total	\$60	Total	\$20
		Net Worth	\$40

Rev. Rul. 80-198 is similar to Example 6 in that liabilities do not exceed the basis of the assets transferred (so section 357(c)(1) is not implicated). The ruling concludes that A’s basis in the stock received in the exchange is \$20, or a substituted basis of \$30 computed by reference to the assets transferred *reduced* by the \$10 mortgage assumed by the corporation. The ruling explains that no reduction in basis is appropriate on account of the assumed accounts payable given that section 358(d)(2) “provides that section 358(d)(1) does not apply to the amount of any liabilities *defined* in section 357(c)(3) such as accounts payable that would have been deductible by A as ordinary and necessary business expenses under section 162 in the taxable year paid if A had paid those liabilities prior to the exchange.”⁹⁰

If the government’s argument in *Black & Decker* were accepted then, on the facts of Rev. Rul. 80-198, section 357(c)(3) would not be found to *exclude* the payables A transferred to the corporation, section 358(d)(2) would not apply, and A would wind up with a stock basis of \$10 (a substituted basis of \$30 reduced by the \$20 of liabilities assumed in the exchange). The effect would be to create a tax bias against incorporations, given that A’s preincorporation tax position — \$20 of net income — would be

made worse by the section 351 exchange. After the exchange, A would hold stock worth \$40 with a basis of \$10.

E. Section 358(d)(2) Should Not Be Read Literally

If the government’s argument is rejected and the court instead adopts the view expressed in Rev. Rul. 80-198, the outcome is more sensible. First, the inconsistency between Examples 5 and 6 is cleared up given that application of section 358(d)(2) would not be made to turn on whether debt exceeds basis, or on whether section 357(b) displaces section 357(c). Second, a core principle of section 351 and the correlative basis rules would be preserved, namely, that gain inherent in contributed property should be preserved for the shareholder, *but not increased*, to avoid creating tax impediments to incorporation transactions.⁹¹

That outcome would be contrary to the literal terms of section 358(d)(2), but the Fourth Circuit must choose between carrying out congressional purpose by a nonliteral, purposive interpretation, on one hand, or frustrating congressional purpose and creating an arbitrary distinction, on the other. To me the choice seems clear. To rule in the government’s favor on this argument would perhaps be just given the nature of the transaction involved, but the decision would create uncertainty regarding the application of the relevant code provisions in countless run-of-the-mill incorporation transactions, a result that should be avoided if at all possible.

V. Concluding Remarks

Karen Burke has written that this tax shelter litigation has run amok.⁹² I agree. She blames the government for parceling out its arguments in a sequence that confused the court, and blames the district court for being confused. Both criticisms are valid. I have endeavored to show, however, that the government’s arguments are specious and that there is another argument available to the government that is better supported by policy and precedent than the ones it is advancing — specifically, the government should seek to deny both *Black & Decker* and *BDHMI* a deduction for payment of the contingent healthcare claims. The government should press that argument and should drop, or at a minimum deemphasize, its economic substance argument. The prevailing wisdom is that the contingent liability tax shelter is not the worst abuse the tax shelter industry has confected,⁹³ and the courts have already demonstrated a willingness to sanction it. The worst outcome for the government is *not* that its statutory arguments are rejected, because the loophole *Black & Decker* and others exploited has long

⁹¹See *supra* note 68.

⁹²Burke, *supra* note 59, at 589.

⁹³Alvin Warren Jr., “Understanding *Long Term Capital*,” *Tax Notes*, Feb. 7, 2005, p. 681, at 695 (“whatever one thinks about decisions such as *Black & Decker*, *Long Term Capital* is clearly a more egregious case”); James S. Eustice, “Abusive Corporate Tax Shelters: Old ‘Brine’ in New Bottles,” 55 *Tax L. Rev.* 135, 168-170 (2002) (expressing doubt that the IRS’s view on the contingent liability shelter will be validated by the courts).

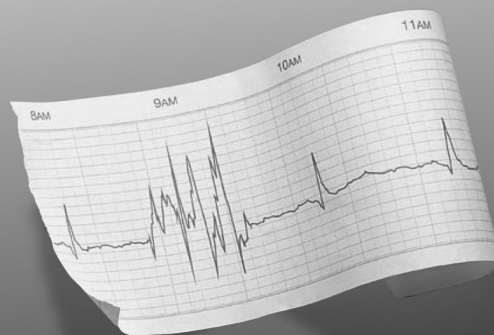
⁸⁹Cf. *Robinson v. United States*, 335 F.3d 1365, Doc 2003-16657, 2003 TNT 136-8 (Fed. Cir. 2003) (construing the term “included” in section 83(h) to mean “includable”).

⁹⁰Emphasis added.

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been closed. Rather, the worst outcome for the government would be further damage to the economic substance doctrine, damage that will undermine its utility in future cases when the government really needs it.

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