No. 06-

IN THE

Supreme Court of the United States

COLTEC INDUSTRIES INC.,

Petitioner,

v.

UNITED STATES,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. In determining that a transaction may be disregarded for tax purposes, should a federal court of appeals review the trial court's findings that the transaction had economic substance *de novo* (as three courts of appeals have held), or for clear error (as five courts of appeals have held)?

2. Where a taxpayer made a good-faith business judgment that the transaction served its economic interests, and would have executed the transaction regardless of tax benefits, did the court of appeals (in acknowledged conflict with the rule of other circuits) properly deny the favorable tax treatment afforded by the Internal Revenue Code to the transaction based solely on the court's "objective" conclusion that a narrow part of the transaction lacked economic benefits for the taxpayer?

PARTIES TO THE PROCEEDINGS

Pursuant to Supreme Court Rule 14.1, petitioner states that all parties to the proceedings in the court whose judgment is sought to be reviewed are listed in the caption.

RULE 29.6 STATEMENT

The parent corporation of Coltec Industries Inc is EnPro Industries, Inc. The real party in interest in this matter is Goodrich Pump & Engine Control Systems, Inc., whose parent corporation is Goodrich Corporation. Goodrich Corporation has no parent corporation and no publicly held company owns 10% or more of its common stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Coltec Industries Inc ("Coltec") respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit.

JUDGMENT FOR WHICH REVIEW IS SOUGHT

The opinion of the Federal Circuit is published at 454 F.3d 1340 (Fed. Cir. 2006), and is reproduced in the Petition Appendix ("Pet. App.") at 1a-33a. Its order denying rehearing is unpublished and is reproduced at Pet. App. 124a. The opinion of the United States Court of Federal Claims is published at 62 Fed. Cl. 716 (2004), and is reproduced at Pet. App. 34a-123a.

JURISDICTION

The judgment of the Federal Circuit was entered on July 12, 2006. Pet. App. 1a. The Federal Circuit denied rehearing on September 19, 2006. Pet. App. 124a. This Court has jurisdiction pursuant to 28 U.S.C. § 1254.

STATUTES OR OTHER PROVISIONS INVOLVED

Relevant portions of the Internal Revenue Code, 26 U.S.C. §§ 351, 357, and 358 (1996), are reproduced at Pet. App. 125a-129a.

STATEMENT OF THE CASE

Faced with exploding asbestos injury claims against two of its subsidiaries, and the threat that asbestos plaintiffs would attempt to pierce the corporate veil to reach other corporate assets once insurance was exhausted, Coltec in 1996 engaged in a restructuring to isolate asbestos litigation management functions and asbestos liabilities in a single, well-capitalized

subsidiary. Coltec later sold shares in the new subsidiary to third-party banks, thereby recognizing for tax purposes the real economic losses already suffered by Coltec in the form of contingent asbestos liabilities. Coltec reflected this loss on its 1996 consolidated tax return. The IRS refused to allow the loss, assessed a deficiency, and denied Coltec's claim for a refund after Coltec paid the deficiency. Coltec then filed suit in the United States Court of Federal Claims. That court, after a 12-day bench trial with 29 witnesses, Pet. App. 62a, held that Coltec was entitled to the refund. On appeal, the Federal Circuit acknowledged that Coltec had complied with the statutory requirements for recognizing a tax loss, but invoked a crabbed version of the judicially created economic-substance doctrine to disregard that transaction for tax purposes.

The Federal Circuit engaged in impermissible judicial freewheeling that nullified petitioner's statutory rights. Moreover, the decision below is rife with conflict with the decisions of other federal courts of appeals and of this Court. First, in the most fundamental of its holdings below, the Federal Circuit expressly disapproved the rule of the United States of Court of Appeals for the Fourth Circuit "that a transaction will be disregarded only if it both lacks economic substance and is motivated solely by tax avoidance." Pet. App. 24a n.14. The Federal Circuit held instead that "a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." *Id.* at 24a. Indeed, the important question of the proper substantive standard under the economic-substance doctrine is the subject of a three-way split in the courts of appeals. Tellingly, the IRS Chief Counsel has acknowledged the three-way circuit conflict, and stated that "time will tell" what this Court ultimately rules. Donald L. Korb, *Korb Gives Speech on Economic Substance Doctrine* (Jan. 25, 2005), *available at* 2005 TNT 16-22 (LEXIS); *Korb Acknowledges*

U.S. Supreme Court May Need To Clarify Economic Substance Doctrine, Daily Tax Rep. (BNA) (Oct. 27, 2006).

Second, the Federal Circuit dispensed with the findings of the trial court that the transaction had economic substance by arrogating to itself the power to decide that question "without deference" to the trial court's findings. Pet. App. 28a. In so ruling, the Federal Circuit deepened a mature and striking (now 5-3) conflict in the courts of appeals over the standard of review. That ruling was critical to the outcome of this case because the judgment would not have been reversed if the Federal Circuit had paid proper deference to the findings of fact of the trial court.

Third, the Federal Circuit's analysis of the economic substance of the transaction has given rise to still more conflicts with precedents of this Court and other courts of appeals. The Federal Circuit reached its desired result by analyzing not the economic substance of the transaction as a whole, but the one slice of the transaction that resulted in tax benefits. Although its analysis of even that slice of the transaction is flawed, the Federal Circuit's surgical approach directly contravenes the established rule of other circuits, grounded in holdings of this Court, that the entire transaction must be considered. It also contravenes the longstanding rule set by this Court that taxpayers may structure real economic transactions to achieve tax savings. The Federal Circuit's rule that the IRS may isolate a tax-motivated element of a transaction, and require a showing of independent nontax economic benefits for each element, essentially eliminates taxpayers' ability to structure transactions using the type of tax planning that has been sanctioned by this Court.

Tax scholars and practitioners have long lamented the confusion and uncertainty that pervades the economic-substance doctrine. With the IRS aggressively invoking the doctrine, and with the governing judicial standards in disarray, taxpayers face unpredictability in structuring *bona fide* transactions

while taking tax considerations into account. This Court's intervention is imperative.

A. Statement Of Facts

The following summary of the facts is based upon the findings of fact after a bench trial by the Court of Federal Claims.

1. *The Asbestos Crisis*. "[A] tsunami of cases" alleging asbestos-related injury has swept over the nation's courts in the past three decades. Pet. App. 36a; *Ortiz* v. *Fibreboard Corp.*, 527 U.S. 815, 821 (1999) (discussing the crisis caused by the "elephantine mass" of asbestos-injury filings). Over 600,000 asbestos-injury claims had been filed nationally by the end of 2000. Stephen J. Crandall et al., RAND Inst. for Civil Justice, *Asbestos Litigation Costs and Compensation: An Interim Report* vi (2002) ("RAND Study"). Perhaps as many as 1 to 3 million claims will ultimately be filed. *Id.* at 77.

With many claims resulting in multimillion dollar judgments, "the financial viability of companies that manufactured or distributed products utilizing asbestos, as well as their insurance companies, was placed in jeopardy." Pet. App. 36a. The spiraling costs of litigation and liability began to exhaust insurance coverage, and 56 companies filed for bankruptcy between 1980 and 2002. *Id.* at 36a-38a. Moreover, even companies that never manufactured or distributed asbestos products became targets when plaintiffs "[s]eeking deeper pockets . . . began to assert corporate veil piercing claims designed to hold parent companies liable for the asbestos-related activities of their subsidiaries and/or successor companies." *Id.* at 38a. "By 1996, at least nine companies that were defendants in asbestos litigation faced such claims and, in seven of those cases, the federal and state courts involved ruled that the corporate veil could be pierced." *Id.* at 39a (citing cases).

2. *Coltec's Asbestos Risks*. The risk of corporate veil piercing was of paramount concern to Coltec, a publicly-

traded holding company that in 1996 consisted of 28 companies with net sales exceeding $1 billion and equity value of $1.5 to $2 billion. Pet. App. 40a. Coltec had asbestos risk through two subsidiaries: Garlock Inc ("Garlock") and The Anchor Packing Company ("Anchor"), a wholly owned subsidiary of Garlock.

Garlock, which Coltec acquired in 1976, had manufactured asbestos products. Pet. App. 40a. Aside from its direct liabilities, Garlock in 1987 had acquired Anchor, a distributor of asbestos-containing products. *Id.* In 1993, Anchor discontinued business operations, and "[b]y 1996, Anchor's only assets were nearly depleted insurance coverage and a small building in Louisiana." *Id.*

Asbestos claims continued to mount, and "[b]y the early 1990's, Anchor and Garlock were or had been defendants in approximately 100,000 asbestos cases." Pet. App 41a. A consulting firm in 1996 estimated the present value of Anchor's contingent asbestos liabilities *net of insurance recoveries* to range as high as $281.8 million, and Garlock's to be $88.5 million. C.A. J.A. 2751. The Government's own expert acknowledged that "the primary source of legal risk facing Coltec was the risk that the corporate veil would be pierced between Anchor [and] related companies, especially Garlock and Coltec." C.A. J.A. 3331.

3. *Coltec's Pre-1996 Risk Management Efforts.* John Guffey became the president and chief operating officer of Coltec in March, 1991 (and eventually the chief executive officer). Guffey, formerly the president of Garlock, was deeply familiar with the asbestos crisis, and he undertook to define a strategy for navigating that crisis. Pet. App. 41a. As the trial court found, "Guffey was very concerned that Garlock did not have a long-term strategy for management of asbestos litigation, including dealing with potential veil piercing claims, and he did not want these issues to distract management or cause problems with the daily operations of Garlock or other Coltec Group companies." *Id.* Thus, in 1992, Guffey created a spe-

cial Asbestos Litigation Department within Garlock to manage asbestos claims and insurance carrier relations "that was physically and otherwise isolated from other Coltec . . . operational and management functions." *Id.*

4. *Planning for the Transaction at Issue.* Joseph Andolino was a Coltec officer with responsibility for business development and tax, among other duties. Pet. App. 43a. "Andolino had frequent discussions with Coltec senior management about the uncertain and growing asbestos liability situation," *id.*, and Guffey had encouraged Andolino to address those risks.

In 1995, Andolino met with Arthur Andersen, Coltec's accounting firm and auditor, "to discuss overall tax planning," including dealing with an anticipated $240 million gain from the sale of a subsidiary. Pet. App. 43a. Andolino rejected various Andersen proposals, but at the end of the meeting an Andersen partner mentioned that he was aware Coltec had significant contingent asbestos liabilities and that he knew of a transaction involving the establishment of a litigation management corporation, funding of the liability, and a potential tax benefit. *Id.* at 43a-44a. Andolino was intrigued by the idea because such a restructuring would ameliorate Coltec's "'grave concerns about veil piercing'" and further Guffey's strategy "'to isolate the asbestos problem.'" *Id.* at 44a.

Although aware of the tax benefits of the transaction, Guffey – whose testimony the trial court specifically found to be "candid and credible," Pet. App. 80a – "'would have approved the restructuring in any event because of the benefits of protecting the assets of Coltec and Garlock from veil piercing claims.'" *Id.* at 31a. Furthermore, by isolating the asbestos liabilities and litigation management in a single subsidiary, "Guffey believed that the proposed transaction could further achieve operational objectives that he had been pursuing since he became President and CEO of the Coltec Group, as well as be helpful in recovering the costs of litigation management from Garlock's insurers." *Id.* at 45a. Timothy

O'Reilly, Coltec's chief asbestos litigation counsel, favored creation of the separate asbestos-litigation subsidiary "because it would help O'Reilly better identify and allocate costs so that additional insurance carriers might agree to contribute to the costs of managing Garlock and Anchor asbestos liabilities and potentially focus plaintiffs' attorneys on one pocket for recovery," and because, among other benefits, "placing the asbestos liabilities into a separate corporation could only help improve efforts to maintain Garlock's and Coltec's separate corporate identity to avoid 'veil piercing' claims." *Id.*

Coltec commenced planning the transaction in early 1996. As the trial court stated, noting a study that over 70% of veil-piercing decisions involved inadequately funded subsidiaries, "[i]t was very important for Coltec to establish a liability management company that was capitalized with sufficient assets to pay anticipated future net asbestos liabilities after insurance." Pet. App. 46a. To that end, Coltec engaged expert consulting firms to project future liabilities and potential insurance coverage. The final report contained low, medium, and high estimates, which the government's expert witness at trial conceded were reasonable. *Id.* at 47a-48a. The high estimate of net projected liability was $371.2 million (which, as noted above, included $88.5 million for Garlock, and $281.8 million for Garlock's subsidiary, Anchor).

5. *The Creation and Funding of the New Asbestos-litigation Subsidiary*. On June 6, 1996, Coltec decided to reconstitute an existing subsidiary that had discontinued business operations as a "'case management subsidiary,'" renaming it the Garrison Litigation Management Group, Ltd. ("Garrison"). Pet. App. 52a.

Coltec structured the transaction with the intent to isolate the Garlock and Anchor liabilities in Garrison while providing sound capitalization designed to enable Garrison to pay those liabilities, thereby minimizing the risk of veil-piercing. Coltec conservatively chose to fund the high estimate of $371.2 million of net asbestos liability. Pet. App. 50a. Gar-

lock created a long-term financial instrument to capitalize Garrison by having a viable subsidiary (Stemco Inc, which manufactured truck and auto parts) issue a 15-year promissory note to Garlock for $375 million plus interest at a floating rate. *Id.* at 52a-53a. Garlock then contributed to Garrison (i) the Stemco note, (ii) the stock of Anchor, (iii) the rights to all future asbestos insurance recoveries, (iv) the furniture, fixtures, and equipment used by the asbestos litigation department, and (v) all files and records relating to the asbestos litigation. Additionally, all 12 employees in Garlock's Asbestos Litigation Department were assigned to Garrison. *Id.* at 54a. In exchange for Garlock's contributions, Garrison (i) issued to Garlock 100,000 shares of Garrison common stock, (ii) assumed Garlock's asbestos liabilities, and (iii) agreed to manage, defend, and administer asbestos claims against Garlock. Since the goal was to strengthen rather than weaken the corporate veil around Anchor, Garrison did not assume Anchor's liabilities directly; it instead became Anchor's immediate parent corporation. Thus, after the transaction a plaintiff would have to pierce the veil of both Anchor and Garrison before reaching Garlock's and Coltec's assets. Garlock's basis in its Garrison shares after this transaction was just over $379 million, *id.*, which equaled Garlock's basis in the contributed assets, without reduction for the contingent asbestos liabilities transferred to Garrison. Coltec also transferred $14 million to Garrison in exchange for almost 100,000 shares of common stock and 1.3 million shares of preferred stock. *Id.* at 75a.

6. *The Third-party Stock Sale*. After Garrison was formed, Coltec began seeking third-party investors in Garrison. Pet. App. 55a-56a. Coltec had several motives in pursuing the sale. Consistent with the goal of isolating the asbestos problem, having third-party investors in Garrison would reinforce the distinction and separateness of the isolation vehicle. Selling Garrison stock to sophisticated investors would set the price and other terms of an arm's-length sale and would serve as a template for and facilitate subsequent sales of Garrison

stock. And it would allow Garlock to recognize for tax purposes the economic loss inherent in the business it contributed to Garrison. On December 20, 1996, Garlock sold its 100,000 shares of Garrison stock to two banks for $500,000. *Id.* at 98a-99a.

The banks did extensive due diligence on the proposed transaction, and the parties negotiated the terms vigorously. Pet. App. 56a. The Court of Federal Claims found that the sale was an arm's-length transaction. *Id.* at 107a.

7. *Tax Loss*. Garlock's transfer to Garrison of the Anchor shares, the assets associated with the business of managing the asbestos liabilities, and the Stemco note (which funded the asbestos liabilities) gave Garlock a basis of $379.2 million in the 100,000 Garrison shares it owned. Garlock's sale of those shares to the banks for $500,000 in an arm's-length transaction resulted in a capital loss of $378.7 million in 1996 that reflected the then present value of the future uninsured asbestos-related costs and expenses. Coltec used the loss to offset approximately $247.9 million in other capital gains in 1996, and carried forward the balance. Pet. App. 5a. The IRS audited Coltec's return, refused to recognize the loss, and assessed a deficiency. *Id.* at 6a-7a. Coltec paid the tax and claimed a refund, which the IRS denied.

B. Proceedings Below

1. *Court of Federal Claims*. Coltec timely filed suit for the refund in the Court of Federal Claims. That court held that Coltec was entitled to declare the loss and to receive a refund.

The IRS raised all manner of defenses, but the Court of Federal Claims roundly rejected them. The court held that the Garrison transaction satisfied the requirements for a tax-deferred transfer of property to a controlled corporation for stock under section 351 of the Internal Revenue Code, and Garrison's assumption of Garlock's contingent liabilities did not reduce Garlock's basis in Garrison's stock under section 358. Pet. App. 78a-91a.

The Court of Federal Claims also rejected the Government's attempt to rely on the statutory anti-abuse provision of section 357(b)(1), which provides that a liability assumption is considered money received, "for purposes of section 351 or 361" if the "principal purpose" for the assumption was to avoid income tax "on the exchange" or was not a *bona fide* business purpose. 26 U.S.C. § 357(b)(1) (1996). The court accepted the "candid and credible" testimony of Guffey that the tax benefit was not the "'principal reason'" behind the transaction; rather, it was to control better the asbestos litigation and exposure. Pet. App. 80a.

The court also found that "Guffey had every reason to be concerned about veil piercing claims against Garlock and Coltec in light of Anchor's diminishing insurance coverage," and credited testimony that Coltec needed security against "challenges from the plaintiff bar to pierce the corporate veil" or otherwise "get beyond Anchor into the Garlock assets and/or the Coltec assets." Pet. App. 82a.

The court further found that, based on Guffey's experience, "[t]he isolation of Garlock's contingent liability exposure from Coltec's core business also was an important factor in the company's ability to attract a suitor that might be willing to acquire the entire Coltec Group." Pet. App. 82a. The tax benefits of offsetting other capital gains "paled in comparison" to the business benefits of the transaction. *Id.* at 84a. Moreover, there was nothing artificial or transitory about the arrangement; "[t]he contingent asbestos liabilities assumed clearly were related to Anchor's, Garlock's, and Garrison's ordinary business, and the management and minimization of such liabilities were essential to the continued viability of Anchor and potentially Garlock." *Id.* at 90a. In this respect, the court noted that the events giving rise to the asbestos liabilities well antedated the transaction; Garlock, Stemco, and Garrison continue to function; and the separate Garrison transaction was an important factor in the later Goodrich acquisition of Coltec. *Id.* Thus, the court "determined that the

record in this case establishes that Garrison's assumption of Garlock's contingent asbestos liabilities had a '*bona fide*' business purpose." *Id.* at 91a. The court then held that the arm's-length sale of stock to the banks properly gave rise to a loss. *Id.* at 97a-114a.

Finally, the court rejected the Government's attempt to seek shelter under the judicially-crafted "economic substance" doctrine. The court stated that it "already ha[d] considered and held that Coltec satisfied the tax avoidance and business purpose tests in Section 357(b), therefore, *ipso facto*, the 'economic substance' doctrine is satisfied, since that doctrine requires proof of at least one of these tests." Pet. App. 115a. It further opined that, where "a taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers." *Id.* at 119a.

2. *Federal Circuit.* On appeal, the Federal Circuit reversed. Like the trial court, the Federal Circuit held that the transaction complied with all statutory requirements. Pet. App. 17a. It held that the statutory business purpose test of section 357(b)(1) applied only to gain/loss determinations under sections 351 and 361, and not to basis calculations under section 358. *Id.* at 16a-17a. Nonetheless, after rejecting the trial court's constitutional concerns, it applied a narrow and contested version of the common-law economic-substance test and reversed the judgment.

The Federal Circuit began by declaring its formulation of the "general principles" of the economic-substance doctrine. First, "a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." Pet. App. 24a. Second, the taxpayer bears '"an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance.'" *Id.* at 24a-25a. Third, "the economic

substance of a transaction must be viewed objectively rather than subjectively," and subjective purpose is simply a "pertinent" factor in making this objective determination. *Id.* at 25a. Fourth, "the transaction to be analyzed is the one that gave rise to the alleged tax benefit." *Id.* at 26a. Finally, "[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference." *Id.* at 28a.

In judging economic substance, the Federal Circuit treated the creation of the Garrison subsidiary as a series of distinct "transactions." The court acknowledged that the creation of a separate subsidiary to manage asbestos litigation may have had economic substance, but stated myopically that the only relevant "transaction" "is Garrison's assumption of Garlock's asbestos liabilities in exchange for the $375 million note," because "[i]t is this exchange that provided Garlock with the high basis in the Garrison stock." Pet. App. 29a.

Focusing on this narrow element of the transaction, the Federal Circuit rejected the claim that this exchange had economic reality. First, it did not accept that, as a result of the exchange, "'Garrison obtained the right to any "upside" if the future asbestos liabilities turned out to be less than the high estimate at the time of the contribution.'" Pet. App. 30a n.17. Despite its emphasis on economic substance as strictly an objective test, the Federal Circuit dismissed this consideration because "[t]here is no indication that this was viewed as a business purpose at the time of the transaction." *Id.* It regarded the half-million dollars that the banks later paid to own this upside opportunity as "nominal." *Id.*

Second, the Federal Circuit rejected Coltec's argument that the strengthened defense against veil-piercing claims gave the transaction economic substance, even though the trial court found such a purpose and credited CEO Guffey's testimony that he would have approved the transaction for that reason even in the absence of tax benefits. Pet. App. 31a. According to the Federal Circuit, economic substance is established "not by the subjective views of the taxpayer's corporate officers,"

and "objectively, there is no basis in reality for the idea that a corporation can avoid exposure for past acts by transferring liabilities to a subsidiary." *Id.* at 31a-32a. Therefore, the "assumption of Garlock's liabilities in exchange for the Stemco note . . . must be disregarded for tax purposes." *Id.* at 33a.

REASONS FOR GRANTING THE PETITION

Since *Gregory* v. *Helvering*, 293 U.S. 465 (1935), courts have disregarded "sham transactions without economic substance . . . for tax purposes." *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 736-37 (1977). In *Gregory*, this Court upheld the Government's determination that a stock transfer that the taxpayer claimed was a corporate reorganization was in reality a dividend, ruling that such "an elaborate and devious form of conveyance masquerading as a corporate reorganization" is a "transaction [that] upon its face lies outside the plain intent of the statute." 293 U.S. at 470. But

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

Frank Lyon Co. v. *United States*, 435 U.S. 561, 583-84 (1978).

Deep conflicts in the courts of appeals have emerged over the economic-substance doctrine[1] in the wake of *Frank Lyon*,

[1] Courts have variously referred to the doctrine that emerged from *Gregory* as the economic-substance, *United Parcel Serv. of Am., Inc.* v. *Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001), substance-over-form, *In re Comdisco, Inc.*, 434 F.3d 963, 965 (7th Cir. 2006), or sham-transaction doctrine, *Horn* v. *Commissioner*, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). See Korb, *supra* (noting that the same doctrine goes by various names). Some courts refer to the sham-transaction doctrine as the

and the decision below presents those conflicts for resolution by this Court. First, there is a 5-3 split over the question of whether the standard of review is *de novo*. Second, there is a deep three-way split on the fundamental question of the proper standard for determining whether a court may disregard a transaction even though it complies with the statute. Finally, the Federal Circuit's analysis of the relevant transaction and its economic substance is contrary to the rulings of this Court and multiple courts of appeals.

I. COURTS HAVE ADOPTED CONFLICTING STANDARDS OF REVIEW OF TRIAL COURT FINDINGS ON ECONOMIC SUBSTANCE.

The Federal Circuit's ruling that the trial court's finding of economic substance was "a legal conclusion . . . we review without deference," Pet. App. 28a, draws that court into conflict with precedents of multiple courts of appeals and of this Court. This Court should resolve the conflict.

A. The Decision Below Deepens A Mature 5-3 Split In The Circuits Over The Proper Standard Of Review.

At least five circuits have correctly recognized that economic-substance determinations "raise predominately factual questions," and therefore clear error review is the proper standard. *Rexnord, Inc.* v. *United States*, 940 F.2d 1094, 1096 (7th Cir. 1991); *Comdisco* v. *United States*, 756 F.2d 569, 575 (7th Cir. 1985); *Nicole Rose Corp.* v. *Commissioner*, 320 F.3d 282, 284 (2d Cir. 2003); *ACM P'ship* v. *Commis-*

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overall test, consisting of a subjective inquiry into "business purpose," and an objective inquiry into "economic substance." *See, e.g., Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001); *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985). The Federal Circuit, in keeping with its view that *Gregory* established a strictly objective test, refers to the entire doctrine as the "economic substance" doctrine, *see, e.g.*, Pet. App. 8a, 23a, and treats "business purpose" and "economic substance" as synonyms, *id.* at 28a-29a.

sioner, 157 F.3d 231, 245 (3d Cir. 1998); *Black & Decker Corp.* v. *United States*, 436 F.3d 431, 441 (4th Cir. 2006); *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511 (D.C. Cir. 2000). Such courts find that none of the traditional justifications for less deferential review applies to these fact-intensive determinations. See *Rexnord, Inc.*, 940 F.2d at 1097 (the appellate court is not "in a better position to weigh the relative significance of specific facts and assess the total character of the relationship . . . than the district court, who as the trier of fact heard the relevant testimony as well as reviewed the documentary evidence").

On the other side of the divide, the Federal Circuit has now joined a distinct minority of circuits that apply a *de novo* standard to determinations of economic substance. See Pet. App. 28a; *James* v. *Commissioner*, 899 F.2d 905, 909 & n.5 (10th Cir. 1990) (acknowledging circuit split); *Dow Chem. Co.* v. *United States*, 435 F.3d 594, 599 & n.8 (6th Cir. 2006) (applying *de novo* review to trial court's "ultimate conclusion" that the transaction was a sham).

Finally, at least four other circuits are internally divided, with panel decisions applying conflicting standards.[2] This Court should act to eliminate confusion on this important issue, which is squarely presented by the holding below and would be dispositive in this case.

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[2] *Compare*, *e.g.*, *Lukens* v. *Commissioner*, 945 F.2d 92, 97 (5th Cir. 1991), *with Compaq Computer Corp.* v. *Commissioner*, 277 F.3d 778, 780-81 (5th Cir. 2001); *Massengill* v. *Commissioner*, 876 F.2d 616, 619 (8th Cir. 1989), *with IES Indus., Inc.*, v. *United States*, 253 F.3d 350, 351 (8th Cir. 2001); *Thompson* v. *Commissioner*, 631 F.2d 642, 646 (9th Cir. 1980), *with Sacks* v. *Commissioner*, 69 F.3d 982, 986 (9th Cir. 1995) (acknowledging intra-circuit conflict); and *Karr* v. *Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991), *with Kirchman* v. *Commissioner*, 862 F.2d 1486, 1490 (11th Cir. 1989).

B. The Decision Below Conflicts With Decisions Of This Court Requiring Deference To Trial Court Findings Of Fact On Economic Substance.

Not only does the decision below on standard of review deepen the conflict in the circuits, but it also runs afoul of precedents of this Court. In *Bazley* v. *Commissioner*, 331 U.S. 737 (1947), this Court reviewed the finding of the Tax Court that a recapitalization "had 'no legitimate corporate business purpose' and was therefore not a 'reorganization' within the statute." *Id.* at 739. This Court resolved "as a matter of law" the question of the scope of the statutory term "reorganization," holding that "[a] 'reorganization' which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under § 112." *Id.* at 743. But the Court also emphasized that "whether in a particular case a paper recapitalization is no more than an admissible attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court." *Id.* at 742. Finding "no misconception of law" that infected the Tax Court's application of law to facts, the Court's inquiry was at an end, "since the facts as found by the Tax Court br[ought] them within" the legal rule the Court established. *Id.* at 743.

Similarly, in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945), the Tax Court had found that the declarations of a liquidating dividend were "mere formalities designed 'to make the transaction appear to be other than what it was', in order to avoid tax liability"; this Court held that those findings of fact of lack of economic substance were controlling, and the court of appeals was not permitted to draw different inferences from the record. *Id.* at 333-34.[3]

[3] At one time, this Court regarded the Tax Court's findings of fact as conclusive; this Court later held that the same deference applied to fact findings of the Tax Court as applied to any other trial court. *Commissioner* v. *Duberstein*, 363 U.S. 278, 291 n.13 (1960). The relevant point

This Court has always drawn distinctions between how transactions are characterized under the tax code (which may be reviewed *de novo*) and factual findings of economic substance (which are reviewed for clear error). In *Frank Lyon*, where the issue was whether a sale-and-leaseback transaction was a "sale" giving rise to deductions or a mortgage agreement and loan, this Court held that the "general characterization of a transaction for tax purposes" is a question of law subject to *de novo* review. 435 U.S. at 581 n.16. Here, however, the issue that the Federal Circuit decided *de novo* is not the legal characterization of a transaction under the tax code, but whether the Garrison transaction had any possible nontax economic benefits for Coltec. See Pet. App. 28a-33a. These are factual issues for which the trial court's findings warrant deference. *Bazley*, 331 U.S. at 742-43; *Frank Lyon*, 435 U.S. at 581 n.16 (citing *American Realty Trust* v. *United States*, 498 F.2d 1194, 1198 (4th Cir. 1974)), which holds that determinations of economic substance are factual issues for the jury).

This Court should resolve the sharp and mature conflict in the circuits over the standard of review, and vindicate its longstanding rule that such trial court findings are reviewed deferentially. This case presents an especially good vehicle to decide that question, since Coltec would have prevailed if the Federal Circuit had deferred to the well-supported findings of the Court of Claims on economic substance.[4]

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for this petition is that trial court determinations of economic substance are findings of fact, and thus only subject to clear error review.

[4] The Federal Circuit stated that "the underlying relevant facts are in large part undisputed." Pet. App. 28a. That statement is true insofar as the court is referring to the history and structure of the Garrison transaction and the stock sale to the banks. However, issues of whether the transaction appreciably affected Coltec's beneficial nontax interests, *id.* at 32a-33a, were of course hotly disputed facts between Coltec and the IRS. *Cf. Pullman-Standard* v. *Swint*, 456 U.S. 273, 287 (1982) ("'ultimate facts'" like "subsidiary facts" may be subject to deferential review).

II. THERE IS A DEEP CONFLICT IN THE CIRCUITS ON THE SUBSTANTIVE STANDARD FOR DETERMINING WHEN A TRANSACTION MAY BE DISREGARDED UNDER THE TAX LAWS.

The Federal Circuit's decision has also deepened a recognized split in the circuits over the proper substantive standard to apply in determining whether to disregard a transaction that otherwise qualifies for favorable tax treatment under the Code.

1. The Federal Circuit held that such a transaction should be disregarded if it "lacks economic substance," and "the economic substance of a transaction must be viewed objectively rather than subjectively." Pet. App. 23a, 25a. Subjective purpose is simply a "pertinent" factor in making this objective determination. *Id.* at 23a. The court further held:

> While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance.

Id. at 24a (footnote omitted). In so ruling, the Federal Circuit acknowledged a conflict with the Fourth Circuit:

> We think that the rule adopted by the Fourth Circuit and reiterated in *Black & Decker* [*Corp. v. United States*, 436 F.3d 431 (4th Cir. 2006)] – that a transaction will be disregarded only if it both lacks economic substance and is motivated solely by tax avoidance – is not consistent with the Supreme Court's pronouncements in cases such as *Frank Lyon.*

Id. at 24a n.14.

2. The conflict of authority is far deeper than the Federal Circuit acknowledged. Since this Court declared in *Frank Lyon* that the Government must honor "a genuine multi-party

transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached," 435 U.S. at 583-84, the courts of appeals have developed three divergent standards under the economic-substance doctrine. Specifically, the circuits have divided over whether this Court has mandated a "conjunctive," "disjunctive," or "unitary" test. Indeed, the IRS's chief counsel has acknowledged a three-way split of authority that invites this Court's intervention. *Supra* at 2-3.[5]

a. *Conjunctive Test.* The Fourth and D.C. Circuits have adopted a two-prong "conjunctive" test. The Fourth Circuit has held: "To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, *and* that the transaction has no economic substance because no reasonable possibility of a profit exists." *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985). (emphasis added). In light of *Frank Lyon*, the Fourth Circuit concluded that "a transaction cannot be treated as a sham unless the transaction is shaped solely by tax avoidance considerations." *Id.* at 92; *Black & Decker*, 436 F.3d at 441.

The D.C. Circuit has adopted the same rule. That court noted that "[t]he Supreme Court's approach in [*Frank Lyon* and *Consumer Life*] demonstrates the separability of the 'business purpose' and the economic gain tests." *Horn* v. *Commissioner*, 968 F.2d 1229, 1238 (D.C. Cir. 1992). "[A]

[5] The circuit conflict is extensively discussed in the scholarly literature. See, *e.g.*, Korb, *supra*; Zachary Nahaas, Note, *Codifying the Economic Substance Doctrine: A Proposal on the Doorstep of Usefulness*, 58 Admin. L. Rev. 247, 257 (2006); Yoram Keinan, *The Many Faces of the Economic Substance's Two-Prong Test: Time For Reconciliation?*, 1 NYU J.L. & Bus. 371, 407-16 (2005); Michael H. Paravano & Melinda L. Reynolds, *Tax Shelters: Evaluating Recent Developments*, 685 PLI/Tax 895, 913-18 (2005).

transaction undertaken for a nontax business purpose will not be considered an economic sham even if there was no objectively reasonable possibility that the transaction would produce profits." *Id.* at 1237 (emphasis omitted); *id.* at 1237-38 ("'The test inquires into the existence of a business purpose for the transaction and evaluates the economic substance of the transaction. The latter evaluation is to be guided by a more precise test of whether there is a reasonable possibility of a profit. Only if neither test were satisfied would the transaction be considered a sham transaction.'") (quoting Karen N. Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 Fla. L. Rev. 659, 670 (1989)).

b. *Disjunctive Test.* A second group of circuits (the Sixth, Eleventh, and Federal Circuits) have adopted a "disjunctive" test, holding that the absence of either objective economic substance or subjective business purpose is fatal to the transaction. In *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001), the Eleventh Circuit stated that the "sham-transaction doctrine . . . . provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, *or* if the transaction serves no business purpose." *Id.* (emphasis added). Additionally, "[o]nce a court determines a transaction [has no economic effects], no further inquiry into intent is necessary." *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989). On the flip side, "[e]ven if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance." *United Parcel Serv. of Am., Inc.* v. *Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001) ("*UPS*").

Similarly, the Sixth Circuit has held that:

> "The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses." If the transaction has economic substance, "the

> question becomes whether the taxpayer was motivated by profit to participate in the transaction." *"If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the [subjective] inquiry is never made."*

Dow Chem., 435 F.3d at 599 (citations omitted, alteration in original, emphasis added). The Federal Circuit follows the same disjunctive test, as noted above. Pet. App. 23a-24a. Thus, under the rule of the Sixth, Eleventh, and Federal Circuits, an objective determination of lack of economic benefits alone is enough to disallow a transaction for tax purposes.

c. *Unitary Test*. In yet a third camp sit the Third, Ninth, and Tenth Circuits. In *ACM Partnership* v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998), the Third Circuit held that "[t]he inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them." *Id.* at 247 (quoting *Casebeer* v. *Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990)); *accord James*, 899 F.2d at 908-09 (viewing "business purpose and economic substance" as "factors to consider" in its sham transaction analysis). These courts expressly reject the Fourth Circuit's test. *Casebeer*, 909 F.2d at 1363 (finding the Fourth Circuit test "has no merit" because "the Court's holding in *Frank Lyon* was not intended to outline a rigid two-step analysis"); *James*, 899 F.2d at 908-09 (finding the Ninth Circuit to have a "better approach" than the Fourth Circuit). The Third Circuit explained its divergence from the Fourth Circuit framework as follows: "[The] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." *ACM*, 157 F.3d at 247 (quoting *Casebeer*, 909 F.2d at 1363).

These courts, like the "conjunctive" test circuits, depart from the second group of "disjunctive test" circuits because a finding of lack of objective economic substance does not end the inquiry. Compare, *e.g.*, Pet. App. 23a-24a, and *Kirchman*, 862 F.2d at 1492, with *ACM*, 157 F.3d at 251-57 (holding that the transaction lacked objective economic substance, and then proceeding to analyze the taxpayer's subjective business purposes). To support this approach, these courts reason: "From the time of *Gregory*'s analysis of the 'rational business purpose,' courts have evaluated taxpayers' purposes when determining whether a transaction has economic substance." *In re CM Holdings, Inc.*, 301 F.3d 96, 106 (3d Cir. 2002).[6]

As the last quotation indicates, this Court's intervention is imperative not only to bring uniformity to administration of the federal tax laws, but also because the Federal Circuit's ruling is directly contrary to this Court's precedents. *Gregory* emphasized subjective purpose in disallowing a corporate reorganization that lacked "business or corporate purpose," but was instead "a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character," with "the sole object . . . to transfer a parcel of corpo-

[6] As for other circuits, decisions in the Second Circuit are conflicting. *See Nicole Rose*, 320 F.3d at 284; *Gardner* v. *Commissioner*, 954 F.2d 836, 839 (2d Cir. 1992) (per curiam); *Gilman* v. *Commissioner*, 933 F.2d 143, 147 (2d Cir. 1991). The positions of the First and Seventh Circuits are ambiguous. *Dewees* v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988). The Fifth and Eighth Circuits have noted the intercircuit conflicts but declined to take a definitive position. *Compaq Computer*, 277 F.3d at 781-82; *IES Indus.*, 253 F.3d at 353-54. Adding to the confusion, there are competing formulations of what is necessary to show objective economic substance, *see, e.g.*, *ACM*, 157 F.3d at 235 n.6; *Bail Bonds by Marvin Nelson, Inc.* v. *Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987), and whether subjective business purpose must be a principal or only a partial purpose, *compare, e.g.*, *Zmuda* v. *Commissioner*, 731 F.2d 1417, 1421 (9th Cir. 1984), *and Friedman* v. *Commissioner*, 869 F.2d 785, 792 (4th Cir. 1989), *with Peat Oil & Gas Assocs.* v. *Commissioner*, 100 T.C. 271 (1993), *aff'd sub nom. Ferguson* v. *Commissioner*, 29 F.3d 98 (2d Cir. 1994).

rate shares to the petitioner." 293 U.S. at 469. Similarly, this Court has distinguished between "a sham" that is "a mere device *intended* to obscure the character of the transaction" and "a bona fide business move." *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935) (emphasis added); *Frank Lyon*, 451 U.S. at 583-84 (sham transaction is one "shaped solely by tax-avoidance features"). The Federal Circuit used the language of *Gregory* but, in conflict with other circuits, improperly redefined "business purpose" as strictly an objective concept equivalent to economic substance. See *supra* n.1. It did so even though Congress in section 357(b)(1) had specified a narrower, subjective "business purpose" test for property transfers with controlled corporations, and declined to make that test applicable to basis calculation under section 358. 26 U.S.C. §§ 357(b)(1), 358 (1996); Pet. App. 16a-17a.

This case is an excellent vehicle for resolving the three-way circuit conflict on the substantive standard because Coltec would have prevailed in the Fourth and D.C. Circuits, where unquestionably a transaction is not a sham so long as it has at least a subjective business purpose, and quite possibly in circuits applying the unitary test, where the taxpayer's subjective business purpose would be taken into account. The Federal Circuit did not question the trial court's findings that Coltec executives were motivated by a desire to protect against veil piercing and would have executed the Garrison transaction regardless of tax benefits. Rather, it held that "[t]hese subjective views of Coltec's executives, even if credited, as they were by the Court of Federal Claims, are insufficient to establish economic substance," because "economic substance is measured from an objective, reasonable viewpoint, not by the subjective views of the taxpayer's corporate officers." Pet. App. 31a.

3. The Federal Circuit's analysis of the transaction for economic substance highlights even more confusion among the lower courts. This Court long ago established the rule that, in determining economic substance, "*the transaction must be*

viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant," *Court Holding Co.*, 324 U.S. at 334 (emphasis added),[7] and that rule continues to prevail in most circuits.[8] Thus, the Fourth Circuit – in a case like this one involving both an assumption of contingent liabilities by a corporate affiliate and a third-party sale – characterized the transaction as consisting of those two phases, and remanded the case to the district court to resolve the IRS's claim that the "two-phase transaction" lacked economic substance. *Black & Decker*, 436 F.3d at 433, 442.

The Federal Circuit, by contrast, did not analyze the two-phase transaction, or even the more limited transaction recapitalizing Garrison through the transfer by two corporations of numerous assets in exchange for stock and the assumption of liabilities. Instead, it took that transaction and carved out a transfer by Garlock of solely the Stemco note in exchange for solely the assumption of liabilities. In the apt phrase of one commentator, the Federal Circuit took "a scalpel to carve out an isolated part of a transaction," Sheryl Stratton, *Korb, Practitioners Discuss Economic Substance Cases* (Oct. 27, 2006), *available at* 2006 TNT 208-2 (LEXIS), demanding a showing

[7] *See Gregory*, 293 U.S. at 470 (analyzing "the whole undertaking"); *Frank Lyon*, 435 U.S. at 581-83 (analyzing totality of transaction and identifying 26 factors relevant to the sham inquiry).

[8] *Hutton* v. *United States*, 501 F.2d 1055, 1061 (6th Cir. 1974) (stating "the district court properly looked to the entire transaction in assessing the economic realities"); *American Elec. Power Co.* v. *United States*, 326 F.3d 737, 742 (6th Cir. 2003) (rejecting the taxpayer's argument to segregate the transaction into separate, economically meaningful transactions and requiring the "plan as a whole" to have economic substance); *Kirchman*, 862 F.2d at 1493-94 ("Petitioners are correct in asserting that the tax court was obligated to analyze the entire transaction."); *UPS*, 254 F.3d at 1019-20 (resisting the government's attempt to segregate, from UPS's express mail business, parcel insurance arrangements under which it paid deductible premiums directly to an offshore affiliate, because the arrangements "figure[d] in a bona fide, profit-seeking business" and "simply altered the form of an existing, bona fide business").

of objective economic substance specifically for the exchange of the Stemco note in return for the transfer of asbestos liabilities that the note funded. Pet. App. 28a-30a.

This Court has declared that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory*, 293 U.S. at 469. Similarly, in *Frank Lyon*, this Court said that "[t]he fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." 435 U.S. at 580. The rule of the Federal Circuit – that the court may identify a single, tax-motivated component of an integrated transaction as the relevant one for applying the economic-substance doctrine – cannot be reconciled with the longstanding legal right recognized by this Court. Only the Third Circuit has parsed a transaction almost as finely as the Federal Circuit, drawing fire from leading tax commentators for a "surgical approach" that isolates the "tax-motivated transaction steps" of an integrated transaction, thus dictating the outcome under the economic-substance doctrine. David P. Hariton, *The* Compaq *Case*, *Notice 98-5, And Tax Shelters: The Theory Is All Wrong*, 94 Tax Notes 501, ¶ 26 (Jan. 28, 2002) (discussing *ACM*, *supra*). The Federal Circuit's arbitrary definition of the transaction in this case illustrates the perils of the standardless common-law power that some federal courts are now wielding to deny taxpayers benefits that Congress has conferred in the tax code. If courts are permitted to dissect a transaction so finely and examine only the tax-motivated component, it will eradicate taxpayers' legal right to minimize tax liability.

Moreover, the Federal Circuit's analysis of economic substance, even as to the narrow slice of the transaction that it identified as relevant, is highly flawed. Although full exposition of economic substance awaits the merits briefs, the Fed-

eral Circuit disregarded the exchange of the Stemco note for the transfer of liabilities because purportedly the exchange had "absolutely no [e]ffect on third party asbestos claimants." Pet. App. 32a. While such plaintiffs could continue to sue Garlock, and while the restructuring did not effect release of any claims against Garlock for the asbestos injuries it caused, the Federal Circuit overlooked the effect of the transaction on the risks posed to Coltec and Garlock of *Anchor's* liabilities, which constituted 76 percent of the high estimate of Coltec's net asbestos exposure. *Id.* at 31a-32a. Garlock had acquired Anchor in 1987, long after most, if not all, of Anchor's asbestos sales were made.[9] The risk to Garlock and Coltec after recapitalizing Garrison would arise, in time, only if there were grounds to pierce both the Anchor and Garrison corporate veils.

Despite the claim to clairvoyance in the opinion below about how courts would treat future veil-piercing claims against Coltec, "the current state of veil-piercing law is chaotic," Stephen B. Presser, *The Bogalusa Explosion, "Single Business Enterprise," "Alter Ego," and Other Errors*, 100 Nw. U. L. Rev. 405, 411 (2006), and "[t]here simply are no bright-line rules for deciding when courts will pierce the corporate veil," Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. Corp. L. 479, 513 (2001). In the face of this uncertainty, Coltec had legitimate and objective business reasons to engage in a corporate restructuring to strengthen its defenses against veil piercing. The restructuring ended the relatively brief Garlock-Anchor ownership connection, which would be the predicate for piercing of Garlock's veil. Coltec would continue to be the majority owner of Garrison, but Coltec's

[9] Asbestos had largely disappeared from commercial use by the 1970s. *In re Joint E. & S. Dist. Asbestos Litig.*, 129 B.R. 710, 737 (E.D.N.Y. 1991), *vacated on other grounds*, 982 F.2d 721 (2d Cir. 1992). But asbestos-related disease often has a latency period as long as 40 years, so new claims arise long after the exposure occurred. *Amchem Prods., Inc.* v. *Windsor*, 521 U.S. 591, 598 (1997).

corporate veil would be strengthened in multiple ways. First, Garrison – which received shares in Anchor, and did not assume Anchor's liabilities, only Garlock's – would be the direct parent of Anchor, whose veil would have to be pierced before Garrison's veil could be pierced to get to Coltec. Second, the new structure, in which Garrison would be a distinct but not wholly owned subsidiary of Coltec, underscored the separateness of the two corporations. Indeed, it is ironic that the Federal Circuit claimed that isolating asbestos liability in a separate corporation was solely a tax contrivance, and then in the next breath acknowledged that the banks that purchased the Garrison shares set up separate subsidiaries to protect against veil-piercing claims, even though they had no tax reason to do so. Pet. App. 32a. Third, veil piercing is an exercise of a court's equitable powers based on the specific facts of the case, *FMC Finance Corp.* v. *Murphree*, 632 F.2d 413, 422 (5th Cir. 1980), and one of the principal factors that commonly leads to veil piercing is undercapitalization of the subsidiary, *Eagle Transport Ltd.* v. *O'Connor*, 470 F. Supp. 731, 733 (S.D.N.Y. 1979); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 113 (1985). The full and conservative funding of Garrison's projected net asbestos liabilities by the $375 million Stemco note insulated Coltec from charges of undercapitalization, thus minimizing the chances of veil piercing.

Given that many once-healthy companies have been brought down by asbestos liabilities, Coltec had substantial reason to reorganize to protect corporate assets from veil-piercing claims, and gain thereby (as the trial court found) also the derivative benefit of enhancing its "ability to attract a suitor that might be willing to acquire the entire Coltec Group." Pet. App. 82a. Indeed, the isolation of asbestos liabilities in a well-capitalized Garrison was a major factor that enabled the sale of Coltec to The B.F. Goodrich Company (now Goodrich Corporation) in 1999. *Id.* at 59a, 83a-84a. "[A] transaction has a 'business purpose' . . . as long as it fig-

ures in a *bona fide*, profit-seeking business." *UPS*, 254 F.3d at 1019. Despite the Federal Circuit's claim that "objectively, there is no basis in reality" to this corporate restructuring, Pet. App. 31a-32a, strengthening corporate veils by any legal means is an economically substantial and common tactic for corporations faced with potentially devastating liabilities.

The economic-substance doctrine is not a source of common-law power for a court to substitute its judicial sense of the economic benefits of corporate transactions for the good-faith business judgment of experienced corporate officers and lawyers deeply conversant with asbestos liability, thereby depriving a taxpayer of benefits to which it is entitled by the plain terms of the Internal Revenue Code. Sham transactions generally involve transitory arrangements with no connection to the taxpayer's historic business and artificial losses with no economic corollary, *UPS*, 254 F.3d. at 1019-20; the economic-substance doctrine cannot be used against a taxpayer where (as here) the transaction "precipitated the realization of actual economic losses arising from a longterm, economically significant investment." *ACM*, 157 F.3d at 251 (citing *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554 (1991)); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 17-18 (2000) (defending *Cottage Savings* exception to economic-substance doctrine for transactions "tied to ordinary business operations").

III. THIS COURT'S REVIEW IS NECESSARY NOW TO RESTORE PREDICTABILITY TO THE ADMINISTRATION OF FEDERAL TAX LAWS.

As the conflicts discussed above betray, "[n]otwithstanding the doctrine's longevity, . . . the exact contours of the business purpose requirement, and even its proper formulation, remain unclear." 2 Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions, & Buyouts* ¶ 609, at 6-194 (2003). "[T]he courts have struggled with defining the concepts of 'economic substance,'" Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 4.3.4A at S4-

19 (Supp. No. 2, 2006), and the result is a doctrine that is "open [to] multiple interpretations." Bankman, *supra*, at 29.

This Court's review now is vital because of the IRS's increasing aggressiveness in asserting that transactions lack economic substance whenever a taxpayer attempts to structure a high-dollar transaction to secure favorable tax consequences. See Eileen J. O'Connor, *Enforcement Is Progressing, Justice Department Attorney Testifies At Senate Finance Hearing*, 114 Tax Notes 42 (June 14, 2006). As a result, a growing number of tax cases are being decided in the courts on the basis of the economic-substance doctrine, with 13 decisions in the courts of appeals since 2000.[10] This number understates the accelerating pace of controversy, since many taxpayers have accepted settlements rather than litigate. *Id.*; B. John Williams, Jr., *IRS Chief Counsel Offers Tax Shelter Resolution Strategies*, 40 Tax Notes 20 (Feb. 25, 2003).

With conflicting standards and frequent appellate reversals, commentators deplore the lack of "predictability in tax planning and fairness in outcome" arising from recent cases such as the one here.[11] Critics rightly attack the Federal Circuit's decision as an example of how courts "applying broad equitable principles can lead to unintended consequences and inject

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[10] See, in addition to the cases cited already *supra*, *TIFD III-E, Inc.* v. *United States*, 459 F.3d 220 (2d Cir. 2006); *Long Term Capital Holdings v. United States*, 150 Fed. App'x 40 (2d Cir. 2005); *Aeroquip-Vickers, Inc.* v. *Commissioner*, 347 F.3d 173 (5th Cir. 2003), *cert. denied*, 543 U.S. 809 (2004).

[11] David Lupi-Sher, *Corporate Tax Shelters Regain Vitality*, 92 Tax Notes 11 (July 2, 2001) (internal quotation marks omitted); Karen C. Burke, Black & Decker *in the Fourth Circuit: Tax Shelters and Textualism*, 111 Tax Notes 315 (Apr. 17, 2006); Richard M. Lipton, *What will be the Long-Term Impact of the Sixth-Circuit's Divided Decision in* Dow Chemical*?*, 104 J. Tax'n 332 (2006); Craig W. Friedrich, *IRS Rebuffed in Three-Fold Attack on Aircraft Financing*, 32 J. Corp. Tax'n 36 (2005); Susan Simmonds, *Year In Review: Shelter Cases Highlight Uncertain Outcomes*, 109 Tax Notes 45 (Jan. 3, 2005); Nicholas Gunther, *Economics and* Compaq v. Commissioner, 97 Tax Notes 555 (Oct. 28, 2002).

confusion into the [tax] law." Dean Weiner & Christopher W. Campbell, *Right Results? Wrong Theories!* – Coltec Industries *and* Castle Harbour, J. Corp. Tax'n (forthcoming 2006). In particular, the Federal Circuit's narrow definition of the transaction that must be proven to have economic substance has an unsettling effect on tax planning:

> The problem for the rest of us is that any transaction that involves any tax planning at all has one or more aspects or elements that are tax motivated and serve no nontax purposes. . . .
>
> The *Coltec* court thus adds to the general confusion as about what the economic substance doctrine is, when and how it should be applied, and whether it has become an all-purpose talisman to be invoked by the court at its discretion in setting tax policy.

John F. Prusiecki, Coltec*: A Case of Misdirected Analysis of Economic Substance*, 112 Tax Notes 524 (Aug. 7, 2006); John F. Prusiecki, *Economic Substance – The Debate Rages*, 112 Tax Notes 1193 (Sept. 25, 2006); Sheryl Stratton, *Government, Tax Bar Disagree Over Impact of* Coltec, 212 Tax Notes 1 (Nov. 1, 2006).

Taxpayers need to predict *ex ante*, and with reasonable accuracy, the tax consequences of transactions they contemplate; doctrinal disarray is especially intolerable given the typically high financial stakes in transactions that the IRS seeks to disqualify. This Court should grant review to clarify the scope and validity of the economic-substance doctrine; resolve the circuit conflicts; and restore greater certainty to the administration of federal tax law.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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