From the desk of Jeanne M. Kerkstra, Esq., CPA

Viewpoint
The Coltec Case: When A Rose Is Not A Rose (The Economic Substance Doctrine)

The IRS scored a significant victory in *Coltec Industries, Inc.* v. *United States*, Fed.Cir. No. 055111, 7/12/06. It's a very compelling story. We have a publicly traded company, Coltec, having sold a subsidiary and looking at paying approximately $241 million in capital gains. Understandably, they sought relief through offsetting capital losses. However, it would appear that the series of transactions that then occurred that same year was merely a shell game.

Pursuant to their accountants' advice, Coltec reorganized a dormant subsidiary into a special purpose entity. Coltec transferred property valued at about $4 million and its contingent liability of asbestos claim exposure to the special purpose entity - the Garrison Litigation Management Group, Ltd. ("Garrison"). Coltec also established an additional subsidiary - Garlock, Inc. ("Garlock"). Garrison issued stock to Coltec in exchange for approximately $14 million. It also issued stock to Garlock in exchange for its asbestos claims exposure and a note for $375 million as well as the possibility of advancing up to $200 million more. Garlock then issued its ownership interest in Garrison to two banks for nominal value. Garlock had to indemnify the two banks as well. It's interesting to note that the two banks themselves would not take outright the Garrison stock. They formed their own special purpose subsidiaries for this transaction.

At the philosophical end of the day, the U.S. Court of Appeals for the Federal Circuit found that no matter which fork in the road you traveled to determine liability for the asbestos claims in question, the roads all led to Coltec. Garrison and Garlock were merely subsidiaries of Coltec.

This may be a hard learned lesson for many tax practitioners. The Court acknowledged that if you follow the Internal Revenue Code technically, then Coltec would be able to recognize the $378.7 million capital loss that it was claiming. However, the Court then proceeded to say that there is something that outweighs the Code itself and that is the economic substance doctrine.

It is important to note that presumably one of the main problems with the Coltec case is that the Coltec executives admitted that one of the purposes for the series of transactions was tax avoidance. That would seem to be a huge problem right there. The IRS probably does not like hearing that.

It is interesting that the Court of Appeals seems to have gone out of its way to show how the transaction satisfied the Code and, therefore, "[t]he consequences that under the literal terms of the statute the basis of Garlock's Garrison stock is increased by the [note] and is not reduced by the assumed contingent asbestos liabilities. Ultimately the taxpayer would not be disqualified from claiming the capital loss." [Emphasis added].

However, the Court went on to find that Section 357(b) applied. Under this analysis they found that not only was the transaction done to avoid federal income tax on the exchange, but there was also no bona fide business purpose. The Court felt that no matter how many subsidiaries were established to move the asbestos claims exposure, Coltec always remained liable. The Court held that "Garrison's assumption of Garlock's liability in exchange for the [note] served no purpose other than

to artificially inflate Garlock's basis in its Garrison stock. That transaction must be disregarded for tax purposes. When that transaction is disregarded, the basis in the Garrison stock is unaffected by the [note]/assumed liability exchange."

Coltec is a hard learned lesson. Among other things, never say with the IRS in the room that something was done, even at least in part, for tax avoidance purposes.

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