BLACK & DECKER’S CONTINGENT LIABILITY SHELTER: ‘A THING OF GRACE AND BEAUTY’?*

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The recent district court decision in Black & Decker v. United States has been heralded as a major setback for the government’s litigation of contingent liability shelters, Burke says. This article seeks to explain what happened in Black & Decker based on a close reading of the parties’ briefs and other publicly available documents. A fuller understanding of the case, she argues, suggests that the district court’s October summary judgment for the taxpayer should be reversed by the Fourth Circuit on appeal, and that the government has persuasive statutory arguments that have yet to be decided on the merits. The Black & Decker decision, says Burke, also sheds light on the challenges faced by generalist district courts in attempting to deal with tax shelter transactions that are purposefully designed to exploit ambiguous statutory language. The article flows from the author’s study of the Supreme Court’s Hendler decision, which will appear in a forthcoming book, Business Tax Stories (Foundation Press, Bank and Stark, eds.). The author acknowledges the assistance of Judith Lihosit in providing research support.

I. Introduction

A federal district court recently granted summary judgment for Black & Decker Corp. (B&D) in a tax refund case involving $57 million of taxes and interest arising from a contingent liability transaction.1 The decision has been heralded as a major setback for the government in its efforts to combat contingent liability shelters, which were widely marketed during the 1990s.2 Indeed, strict constructionists have hailed Black & Decker as a sign of judicial reluctance to invoke the economic substance doctrine as a “statutory trump card” or to “render interpretations beyond the clear meaning of the statute.”3 Even former government officials have argued that Black


2In Notice 2001-17, 2001-9 IRB 730, Doc 2001-2017, 2001 TNT 13-4, the IRS alerted taxpayers that it was aware that contingent liability shelters were being marketed for the purpose of accelerating and potentially duplicating tax deductions. The Notice warned that losses generated by those transactions would be disallowed for federal income tax purposes and identified contingent liability shelters as “listed transactions” subject to reporting and registration requirements. For an overview of the IRS’s administrative guidance concerning contingent liability shelters, see I Staff of the Joint Comm. on Tax’n, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations 131-32 (JCX-10-03) (Feb. 13, 2003) [hereinafter JCT Report].

& Decker and another recent taxpayer victory\(^4\) demonstrate the need to "rein in" the government's "overreaching arguments" in these high-profile tax shelter cases.\(^5\) On the issue of economic substance, the court held that the fact that a corporation conducted real activities and has nontax effects on third parties may be taken as objective evidence of economic substance, even though the underlying transaction is stipulated to have been undertaken solely for tax avoidance purposes. If that view of economic substance is accepted, it would indeed break new ground.

This article seeks to explain what happened in Black & Decker based on a close reading of the parties' briefs and other publicly available documents in the case.\(^6\) Because Black & Decker was decided on a motion for summary judgment, it should have furnished a decisive test of the government's statutory arguments against contingent liability shelters. Unfortunately, the court seems to have misapprehended both the nature of the parties' statutory arguments and the legal conclusions that would have been necessary to support the taxpayer's summary judgment motion. Having rejected an earlier motion for summary judgment by the government in August 2004,\(^7\) the court seems to have believed that only nonstatutory challenges remained to be addressed in its October ruling. That view was reinforced by the taxpayer's litigation strategy, which aggressively exploited the apparent opening afforded by the court's August ruling to divert attention from the government's statutory arguments. A fuller understanding of the case suggests that the district court's October ruling should be reversed by the Fourth Circuit on appeal and that the government has persuasive statutory arguments that have yet to be decided on the merits.\(^8\)

II. Background of Black & Decker

A. Transaction and Procedural History

During 1998 B&D sold three of its businesses, generating a large capital gain.\(^9\) In the same year, B&D decided to outs...
preferred stock would be equal to the amount of cash transferred unreduced by the assumed liabilities and that the $561 million loss on sale of the preferred stock would be recognized for federal tax purposes. (Deloitte Ltr. at 11-12.) Deloitte discussed various nontax reasons for the transaction. (Id. at 2-5.) B&D lacked adequate internal resources to meet healthcare challenges and needed to involve an outside service provider to implement a “Medicare risk HMO system” for its retirees. 12 The proposed restructuring was intended to align the interests of B&D’s outside healthcare consultants, William M. Mercer Inc. (Mercer), more closely with those of B&D’s management by offering them an equity stake. 13 It was represented that a principal purpose of the transaction was to realize cost savings with respect to the assumed contingent liabilities through “aggressive liability management,” and that the “pre-tax cost savings” to be realized from the restructuring would “substantially exceed” related costs. (Id. at 8.)

Because B&D self-insured its employee healthcare benefits, it would profit to the extent that BDHMI was successful in lowering healthcare costs. B&D retained, however, full decisionmaking over its healthcare plan. To attract outside investors, it was thus necessary to limit the claims that BDHMI might eventually be called on to pay. BDI, which held the common stock of BDHMI, agreed to provide additional capital in the event that BDHMI’s cash on hand would be insufficient to pay the healthcare claims as they materialized. By virtue of its investment in BDHMI through an affiliate (Hansen International Ltd.), Mercer enhanced its opportunities to earn consulting fees. On December 29, 1998, B&D’s preferred stock was sold to the DeVita trust for $1 million; Robert A. DeVita was a former B&D employee. 14

B. Statutory Provisions

The central statutory issue was whether the preferred stock acquired by the Series C Transferors had a basis of $561 million (as claimed by B&D) or only $1 million (as claimed by the government). Under the government’s view, B&D sustained no loss on the sale of the preferred stock, because the sales price was equal to its basis. Of the several alternative theories advanced by the government for determining basis, the most straightforward was that the stock basis, under sections 357 and 358, was equal to the basis of the property contributed in exchange thereby ($561 million cash) less the amount of liabilities assumed ($560 million). Section 357(a) provides that, for purposes of gain recognition, assumption of liabilities in an otherwise qualifying section 351 exchange will normally not be treated as money or other property (boot). Section 358(d)(1) requires a corresponding downward adjustment to the transferee’s stock basis to reflect liabilities relieved, thereby preserving any potential gain not recognized on the transfer.

Sections 351(a) and 358(d)(1) derive from the provisions enacted in 1939 to overturn the Supreme Court’s decision in Hendler v. United States, 303 U.S. 564 (1938). Before Hendler, both the government and taxpayers had “tacitly assumed” that assumption of liabilities in a corporate reorganization did not constitute money or other property. 15 In Hendler, however, the Court held that the corporate transferee had received the equivalent of cash as a result of the transferee’s “assumption and payment” of its liabilities, triggering gain under the Revenue Act of 1928. Alarmed that Hendler would impede business reorganizations and allow a tax-free basis step-up in earlier transactions, Congress hastily amended the statute to nullify the government’s victory. 16 Assumption of liabilities would no longer be considered boot, but the transferee’s basis would be reduced to ensure that the deferred gain would be preserved rather than entirely eliminated. While Hendler was a “slain dragon” after the 1939 amendments, the precise contours of liability assumptions were never clarified. 17

The modern contingent liability shelter seeks to take advantage of a perceived ambiguity in the operation of sections 357(c)(3) and 358(d)(2), which were added to the code in 1978 to deal with the problem of so-called “deductible” liabilities that have not yet generated a tax benefit to the transferee. 18 Suppose A transfers property worth $80 with a basis of $50, subject to a liability of $30, to a corporation in exchange for stock worth $50 (the net value of the transferred property). If the liability is a typical “fixed” liability (for example, a bank loan), sections 357(a) and 357(d)(1) reach the economically correct result. A recognizes no gain from relief of liabilities and takes a basis of $20 ($50 original basis less $30 liability) in

(affirming that the BDHMI transaction was Pogash’s idea, not that of Raymond Brusca, B&D’s vice president of benefits and then president of BDHMI.)

12 As a rationale for outsourcing, B&D argued that its human resources department “generally resisted significant measures to control healthcare costs because of their potential impact on employee relations.” (B&D Feb. 5, 2004, Br. at 15.) Even after formation of BDHMI, however, “Brusca could not implement changes to [B&D’s] health benefit plan without the approval of the human resources department.” (Jt. Pretrial Order Sept. 30, 2004, at 22-23.)

13 The government noted that a worksheet prepared by an outside consultant, Charles Habliston, identified the problem that BDHMI was intended to address as “[s]ignificant pre-tax capital gains . . . generated by the recent divestiture of non-core businesses.” (Gov. Dec. 30, 2003, Br. at 7-8.)

14 In its Enron investigation, the JCT Report recommended that the tax law not “permit use of accommodation parties such as employees, consultants, or advisors, to serve as a party in a transaction or arrangement” intended to provide delivery of tax benefits to a taxpayer. See JCT Report, supra note 2 at 25-26.


16 See Revenue Act of 1939, ch. 47, 53 Stat. 862, section 213 (adding subsection (k) to section 112 and amending section 113(a)(6)).


the transferred stock, preserving A’s built-in gain of $30 ($50 value of stock received less $20 basis). If A’s liability were instead a “deductible” liability (for example, an account payable that A would have been entitled to deduct when paid had she not transferred the business), however, A’s basis in the stock should be $50 to avoid overstatement of potential gain. Stock basis should not be reduced by the amount of the deductible liability because the income from relief of liability ($30) and the corresponding deduction ($30) produce a wash. Sections 357(c)(3) and 358(d)(2) accomplish that result by excluding the deductible liability in determining A’s liabilities relieved and, simultaneously, by not deducting stock basis by the amount of the excluded liability.

While Hendler was a ‘slain dragon’ after the 1939 amendments, the precise contours of liability assumptions were never clarified.

Section 357(c)(1), enacted in 1954, triggers immediate gain recognition on relief of liabilities in excess of basis.19 Although the 1939 code’s drafter were aware that relief of “excess” liabilities could reduce the transferor’s stock basis below zero, pre-Hendler administrative practice suggested that any negative amount could be eliminated without triggering gain.20 When applicable, section 357(c)(1) turns an otherwise tax-free incorporation into a partially taxable exchange to the extent that the transferor shifts responsibility for payment of excess liabilities to the transferee while retaining tax benefits attributable to those liabilities. Because deductible liabilities by definition have not yet produced any tax benefit to the transferor, they should be exempt from this partial reinstatement of Hendler. Consistent with the principles enunciated in Crane v. Commissioner, 331 U.S. 1 (1947), and arguably already implicit in Hendler, the transferor should not realize income in this situation.21 Regarding deductible liabilities, sections 357(c)(3) and 358(d)(2) may thus be viewed as having restored sections 357 and 358 to their 1939 form.22

Under the section 357(c)(3) exemption, the net result is often equivalent to treating the transferor as having received cash equal to the assumed liability and then allowing the transferee to deduct the liability as if it were paid immediately. Because the transferee may be entitled to deduct the liability on subsequent payment, however, the overall result is two deductions — one to the transferor and the other to the transferee — a result more favorable than allowed in taxable acquisitions.23 That opportunity to “clone” losses associated with deductible liabilities, together with a strained reading of sections 357(c)(3) and 358(d)(2), set the stage for contingent liability shelters designed to accelerate and potentially duplicable losses.

C. Selling of a Shelter: Why Now?

During the 1990s, accounting firms such as Deloitte aggressively marketed various “tax products,” including contingent liability shelters which were designed to reduce or eliminate corporate taxes. As a technical matter, contingent liability shelters relied on Rev. Rul. 95-74, 1995-2 C.B. 36, in which the IRS ruled that a transferee’s stock basis need not be reduced when contingent environmental liabilities were assumed in a section 351 incorporation. The ruling also allowed the transferee to deduct or amortize the expenses related to the assumed liability. The Service’s position represented a “significant boon” for businesses with contingent environmental liabilities, tort claims, or other postretirement employee benefits (in accounting jargon, OPEBs).24

Before Rev. Rul. 95-74, it was uncertain whether a transferee in a section 351 transaction would be permitted to deduct assumed contingent liabilities. Indeed, Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), decided under section 112(b)(5) of the 1939 code (the predecessor of section 351), held squarely that contingent liabilities assumed by a corporate transferee had to be capitalized as part of the cost of acquiring the transferee’s business. Holdcroft rejected the taxpayer’s claim that, under the general nonrecognition policy of section 351, a corporate transferee should be entitled to a deduction (when paid) for ordinary and necessary business expenses of its corporate predecessor. According to Holdcroft, the obligation to pay those expenses did not arise from operation of the transferee’s business and hence should not be treated as a loss or expense of that business; it did not matter that the claims against the predecessor business were contingent and unliquidated.

While Holdcroft has never been overruled, the IRS’s position in Rev. Rul. 95-74 was widely viewed as a renunciation of its earlier victory. In agreeing not to follow Holdcroft under the facts presented, the IRS nevertheless sought to limit the scope of the ruling to transactions involving transfer of a business and associated liabilities for non-tax-avoidance purposes.25 It also

19Because B&D transferred only cash (or cash equivalents) in the section 351 exchange, the gain recognition provision of section 357(c)(1) was moot.
20See supra note 15 at 19.
21See Kahn and Oosterle, “A Definition of ‘Liabilities’ in Internal Revenue Code Sections 357 and 358(d),” 73 Mich. L. Rev. 461, 472 (1975) (“The term ‘liability’ in both sections should be limited to those obligations that, if transferred, would constitute an amount realized by the transferor under the Crane doctrine.”)
22In effect, these provisions simply ignore deductible liabilities for purposes of both gain recognition and basis determination, producing the same result as if those liabilities were entirely outside section 357.
23See Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders par. 10.40[4][a], at 10-94 (7th ed. 2000) (rather than deduct seller’s liability, buyer must include it in basis of acquired property).
25See Rev. Rul. 80-198, 1980-2 C.B. 113 (IRS will not follow Holdcroft when substantially all of the business assets associated with the liabilities are deferred).

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specifically warned that clear-reflection-of-income principles under section 482 could be invoked to prevent mismatching of income and deductions. While not all of the environmental remediation costs discussed in the ruling were deductible items, the IRS nevertheless concluded that the rationale of section 357(c)(3) was equally applicable to contingent liabilities that give rise to capital expenditures. Thus, the IRS interpreted the "limiting language" of section 357(c)(3) expansively to cover liabilities that have not yet been reflected in the basis of the transferor's assets (or given rise to a deduction).26

Rev. Rul. 95-74 laid the groundwork for the marketing of contingent liability shelters. For example, Deloitte's promotional materials included a PowerPoint slide captioned "Why Now" that indicated that the ruling had "clarified treatment of contingent liabilities" in section 351 transactions to allow a deduction to the transferee. (Gov. Dec. 30, 2003, Br. at 18.) An essential component of contingent liability shelters was the segregation of liabilities from the underlying business associated with those liabilities. To generate a large capital loss on a prearranged sale of the transferor's stock following the section 351 transfer, the transferor had to transfer cash or other high-basis assets while retaining low-basis assets and business operations that had given rise to the underlying contingent claims. By segregating assets from liabilities, those transactions challenged one of the fundamental premises of Rev. Rul. 95-74, namely, that the transferor had transferred substantially all of the business assets related to the assumed contingent liabilities.

III. Government Loses Round One

A. Denial of Summary Judgment

In December 2003 the government moved for summary judgment on the grounds that there were no genuine issues of material fact and that as a matter of law, B&G did not realize a capital loss when it sold the Series C preferred stock of BDHMI. (Gov. Dec. 30, 2003, Motion.) The government's motion raised a novel argument concerning the section 357(c)(3) exemption, namely, that the transferor (B&G) was required to reduce its stock basis to reflect assumed contingent liabilities unless the transferee (BDHMI) was entitled to deduct the associated expenses when paid. (Gov. Dec. 30, 2003, Br. at 14-16.) The government argued that B&G would receive the equivalent of a double deduction if it were permitted to exclude the assumed contingent liabilities under section 357(c)(3) and eventually deduct the associated expenses when paid by BDHMI.27 Because the code should not be construed to permit the equivalent of a double deduction, absent a clear declaration of intent by Congress, the government viewed section 357(c)(3) as excluding assumed liabilities only to the extent that the transferee (rather than the transferor) would be entitled to deduct the associated expenses.

On August 3, 2004, Judge Quarles dismissed the government's motion in a brief opinion that began by noting that the statute "does not explicitly state whether contingent liabilities must be deductible by the transferee or transferee in a section 351 transaction to fall within" the section 357(c)(3) exemption.28 He then reviewed the legislative history of section 357(c)(3) as added in 1978 and amended by the Technical Corrections Act of 1979.29 The legislative history focused primarily on whether payment of deductible liabilities would have given rise to a deduction by the transferor and indicated that section 357(c)(3) was not intended to affect the transferee's tax accounting for the excluded liabilities.30 Thus, Judge Quarles concluded that the legislative history did not support the government's interpretation of section 357(c)(3).

The dismissal of the government's motion seems quite unremarkable. Apparently, neither party expressly briefed the court on the pre-1978 law governing deductibility to the transferee of assumed contingent liabilities.31 Based on Holdcroft, assumed liabilities did not generate a deduction to the transferee when paid but rather were capitalized as part of the cost of acquisition. The government's interpretation might thus have rendered section 357(c)(3) inoperative: The transferor would never be permitted to exclude deductible liabilities because, under Holdcroft, the transferee would never be entitled to deduct those liabilities when paid. An unstated premise of the government's argument seems to have been that, even before 1978, Holdcroft did not apply to assumed liabilities in certain section 351 transactions.32 In responding to the government's motion, B&G had no incentive to

26Matthias, supra note 24 at 120-121.

27Under section 482 and clear-reflection-of-income principles, the Service reallocated deductions attributable to employee healthcare claims from BDHMI to B&G, on the theory that BDHMI was merely a conduit for paying B&G's employee healthcare claims. (Gov. Dec. 30, 2003, Br. at 22; Jt. Pretrial Order Sept. 30, 2004, at 18.) The government maintained that the section 482 issue was never adjudicated. (Gov. Sept. 24, 2004, Resp. at 7 n.6.)


29See Pub. L. No. 95-600, sections 365(a) and 365(c) as amended by the Technical Corrections Act of 1979, P.L. 96-222, section 103(a)(12).


31The holding in Holdcroft is described in a footnote in the government's brief in support of its summary judgment motion. (Gov. Dec. 30, 2003, Br. at 18 n.17.)

32The IRS's misgivings concerning unrestricted application of Holdcroft may help explain the cryptic statement in the

(Footnote continued on next page.)
the IRS when clever taxpayers learned how to manipulate it. Nevertheless, the IRS carefully sought to delimit the scope of the ruling, which was based on the policy rationale set forth in a 1969 general counsel memorandum. While Holdcroft had been a decisive victory for the government, the GCM discerned a tension between Holdcroft and a competing policy-oriented interpretation of section 351 aimed at facilitating tax-free incorporations that dated back to 1924. In Holdcroft, the Eighth Circuit stated that sections 112(b)(5) and 113(a)(8) (the predecessor of section 362) of the 1939 code related only to the basis of the transferred assets in the transferee’s hands; thus, those provisions did not justifiably allow a deduction to the transferee. Nevertheless, the GCM considered that clear-reflection-of-income principles under section 482 required matching of the transferee’s income and expenses when an entire business was acquired subject to liabilities. Finally, the GCM expressed concern that denying a deduction to the transferee on payment of the contingent claims might mean that the transferee would recover those expenses only on sale of its business because section 362 “makes no provision for a basis adjustment by the corporation to reflect the assumed liabilities.”

By contrast, Holdcroft followed the principle that deductibility of expenses represents a limited exception to the general rule of capitalization. It is unclear whether a court today would find Holdcroft’s capitalization rationale more persuasive than a broad policy-oriented approach to section 351. Applying Holdcroft, a court might

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33Alternatively, B&D maintained that any deviation lacked “legal significance.” (Pogash Dep. at 193-94.) B&D maintained that the BDHMI transaction “followed the tax laws as interpreted by the government” in published rulings and technical advice to IRS field agents. (B&D Feb. 5, 2004, Br. at 8-9.)
well conclude that BDHMI should not receive a deduction on payment of the assumed liabilities. Nondeductibility of the expenses by BDHMI would not necessarily mean, however, that B&D would actually receive a "double deduction" when the expenses were paid. Although the government had reallocated the corresponding deductions to B&D under section 482 principles, B&D had not actually sought to deduct them. (B&D Feb. 5, 2004, Br. at 20 n.23.) Under B&D’s theory, the deductions properly belonged to BDHMI, not B&D.38 Moreover, under Skelly Oil v. United States, 394 U.S. 678 (1969), the government could disallow a second deduction to B&D on payment. (Gov. Dec. 30, 2003, Br. at 23.)

As a practical matter, however, the mischief would already be done once the capital loss on the stock sale was allowed, because B&D would effectively be able to accelerate a deduction for contingent claims that would otherwise be deferred until actual payment. By virtue of that acceleration, B&D could potentially improve its overall tax situation (assuming sufficient capital gains to be offset by the 1998 capital loss) even if neither B&D nor BDHMI were allowed a second deduction on payment. For companies that self-insure their healthcare plans, however, the Supreme Court, in United States v. General Dynamics Corp., 481 U.S. 239, 245-46 (1987), expressly disallowed a deduction for reserves for contingent claims. In that case (apparently not cited by the parties), General Dynamics sought to deduct amounts that it was obligated to reimburse to its employees (for example, as a result of doctor’s visits that had already taken place) but for which employees had not yet filed claims by year end. Because the events that would give rise to liability under B&D’s healthcare plan during 1999-2007 had not yet occurred, the BDHMI transaction could be viewed as a blatant end run around General Dynamics. Indeed, if the BDHMI transaction were respected, any company that self-insured its employees would be competitively disadvantaged by failing to undertake a contingent liability shelter to accelerate a deduction for reserves for future claims.

Rather than address the acceleration issue, B&D sought to divert attention from the government’s double deduction argument by suggesting that it was somehow inconsistent with the corporate double-tax system.39 It is, of course, axiomatic that subchapter C preserves built-in gains and losses in both the transferor’s stock basis and the transferee’s asset basis on a section 351 transfer of a business and associated liabilities. Indeed, Rev. Rul. 95-74 is premised on the assumption that such duplication of built-in losses (once to the transferor and again to the transferee) is generally appropriate when an entire business (or a substantial portion of its assets) and associated liabilities are transferred. If liabilities may be transferred independently of the underlying business, however, the risk is much greater that such a transaction can be turned into an “off the shelf” tax avoidance product.

Thus, the crux of the issue raised by the BDHMI transaction was simply the availability of the section 357(c)(3) exemption — as claimed by B&D — "whether or not the contingent liabilities are transferred together with an existing business." (Karter Mar. 16, 2004, Ltr.) If the transaction fell outside the section 357(c)(3) exemption, B&D’s basis in the preferred stock would be reduced, under the general rule of section 358(d)(1), to reflect the $560 million of assumed liabilities, leaving B&D with no loss on the later sale. B&D could not rely on section 358(d)(2) to prevent a reduction in the basis of its preferred stock because section 358(d)(2) is applicable only if the assumed liabilities are "excluded" under section 357(c)(3).

**Properly understood in the historical context of Hendler, Crane, and Focht, section 357(c)(3) is an exclusionary provision that should be construed narrowly.**

Although apparently not cited by the parties, the definition of accounts payable in the 1978 legislative history indicates that Congress never intended that the section 357(c)(3) exemption would apply to a transfer of liabilities separate from an existing business. The General Explanation of the Revenue Act of 1978 to the 1978 Act states that "for purposes of this provision, accounts payable mean, in general, those trade accounts payable and other liabilities . . . which relate to the transferred trade or business and which constitute cash method items."40 (Emphasis added.) Given the ambiguity in the statute, a court might well look to this contemporary understanding to determine the scope of the section 357(c)(3) exemption.41 When Congress amended section 357(c)(3) in 1979, it extended the exemption to liabilities of an accrual-basis taxpayer and deleted the requirement that the excluded liability must be an account payable. It continued, however, to describe deductible liabilities as those liabilities "which relate to the transferred trade or business."42

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38B&D argued that, by analogy to an insurance company, BDHMI would make a profit for its shareholders “if it manages costs sufficiently well to pay out less than the actuarially forecast amount of the assumed liabilities.” (B&D Feb. 5, 2004, Br. at 31.) B&D’s analogy seems inapposite, because any deductions to BDHMI for claims paid would not be matched by income for insurance premiums received by BDHMI. See GCM 34118 (matching principles). Nor did BDHMI bear the risk of loss for excess claims. (Gov. Mar. 10, 2004, Br. at 16.)

39B&D claimed that “[i]f there is nothing nefarious about this duplicated gain or loss, it is built into the very structure of our corporate tax rules.” (B&D Feb. 5, 2004, Br. at 35 n.31.)

40Staff of Joint Comm. on Tax’n, General Explanation of the Revenue Act of 1978 219 (1979); see also S. Rep. No. 1263, supra note 18 (stating that the provision was not intended to affect the definition of the term liabilities for purposes of section 357(a) and (b)). While the legislative history does not purport to define the term “trade or business,” a transfer exclusively of cash or other liquid assets should present a relatively easy case.

41See, e.g., United States v. Iverson, 162 F.3d 1015, 1022 (9th Cir. 1998).

Ultimately, the interpretation of section 357(c)(3) rests with the courts, not the IRS. Properly understood in the historical context of Hendler, Crane, and Focht, section 357(c)(3) is an exclusionary provision that should be construed narrowly. The legislative history expressly states that liabilities may not be excluded to the extent they have previously been deducted by the transferor. The reason is simply that no exclusion is needed or appropriate if the transferor has already received the tax benefit associated with the liabilities. Similarly, no exclusion is warranted if the transferor (rather than the transferee) is entitled to a future deduction when contingent claims are actually paid, because the transferor has not been deprived of any tax benefit. Thus, the essence of the government’s double-deduction argument was that, if B&D (rather than BDHMI) was the proper party to deduct the healthcare claims from B&D’s workforce as they matured, B&D should not be permitted to accelerate that future loss on sale of the preferred stock. (Gov. Dec. 30, 2003, Br. at 14.)

**C. Limits of August Ruling**

Unfortunately, the government’s framing of its double-deduction argument may have left the court confused about the underlying statutory issues. The court signaled its predilection on May 6, 2004, when it asked counsel to brief the issue of whether the BDHMI exchange qualified as a section 351 exchange. In response, both parties stipulated, for purposes of summary judgment, that the BDHMI exchange qualified under section 351. (Gov. May 27, 2004, Resp. at 1; B&D June 8, 2004, Resp. at 1-2.) The government maintained that the section 351 issue was not susceptible to summary judgment even though it represented the logical first step in the contingent liability transaction. B&D agreed that the only issue properly raised was the interpretation of section 357(c)(3). Thus, it should have been abundantly clear to all concerned that the August ruling was limited to a discrete issue of statutory interpretation, namely, whether there was any basis for the government’s technical argument that section 357(c)(3) linked the treatment of the transferor and the transferee. Given the subsequent turn of events, however, the precise scope of the court’s August ruling clearly remained highly contentious.

In a judicial conference held on July 30, 2004, statutory interpretation received relatively little attention. In response to a question from Judge Quarles concerning a transfer solely of contingent liabilities, the government reiterated its position, under Rev. Rul. 95-74, that the transferee would not be allowed a deduction if the underlying business were segregated from the assumed liabilities. (Tr. of July 30, 2004, Conf. at 29.) B&D asserted that the treatment of the transferee was irrelevant, because the statute did not require “symmetry” between the transferor and transferee. (Id. at 27.) While Judge Quarles’s August ruling might be understood as endorsing B&D’s view that application of section 357(c)(3) is not conditioned on deductibility of the assumed expenses by the transferee, it clearly stops short of concluding that the section 357(c)(3) exemption applies even if the assumed liabilities are segregated from the underlying business. To the extent there was a genuine issue of fact whether the underlying business had been transferred, dismissal of the government’s summary judgment motion would have been appropriate. Judge Quarles also expressed concern about the circular financing arrangement and seemed to suggest that B&D’s motive for the

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45B&D claimed that the government had engaged in a “thinly-veiled attempt to obfuscate the summary judgment issue by its awkward and unorthodox presentation of its argument.” (B&D Feb. 5, 2004, Br. at 8.)
46The court directed the parties to brief “whether [B&D’s] transfer of approximately $561 million in contingent liabilities to BDHMI qualifies as a property in exchange for stock transaction under 26 U.S.C. section 351.” (May 6, 2004, Order.)
47The section 351 issue raised a factual question whether the preferred stock was “nonqualified preferred stock” within the meaning of section 351(g)(1). (Gov. May 27, 2004, Resp. at 4.) Alternatively, if the transaction lacked a business purpose, section 351 would not apply and the basis of the stock would be its cost, that is, the fair market value of the property received in the exchange. See id. at 5; Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184, 188-89 (Ct. Cl. 1954). Under that theory, the government claimed that the cost basis of the stock should be $1 million, as evidenced by the amount realized on sale the following month.
48B&D objected that the government had “taken the Court’s directive to advocate several arguments plainly beyond the scope of its summary judgment motion.” (B&D June 8, 2004, Resp. at 2-5; see B&D May 27, 2004, Supp. Mem. at 5-6.) Thus, B&D objected to the government’s “obvious reference to the transaction as a ‘contingent liability tax shelter, implying some furtive motive’”; it also objected to the government’s attempt to assimilate the BDHMI transaction to Enron’s “nearly identical” transactions. (B&D June 8, 2004, Resp. at 4.)
49As discussed below, the parties later disagreed over the scope of the court’s ruling concerning (1) whether the BDHMI exchange qualified under section 351 and (2) whether the assumed contingent liabilities were excluded under sections 357(c)(3) and 358(d)(2). The government also maintained that it had “never stipulated or conceded that section 351 applies in this case,” “nor did the Court adjudicate the issue” in its August ruling. (Gov. Sept. 24, 2004, Resp. at 41-42.)
50Interestingly, B&D admitted in this colloquy that, before Rev. Rul. 95-74, the law was apparently that the transferee was not entitled to deduct assumed liabilities because such an assumption “was a cost of acquiring a business.” (Tr. of July 30, 2004, Conf. at 34, apparently a reference to Holdcroft.) B&D also alluded to the “intensely factual issue as to whose deduction it is” as a reason for dismissing the government’s summary judgment motion. (Id. at 30.)
BDHMI transaction might present an issue of fact to be decided at trial. He urged the parties to bring up any other factual and legal issues necessary to expedite a decision in the case.

IV. Taxpayer Wins Round Two

A. Grant of Summary Judgment

Denial of the government’s summary judgment motion appeared to set the stage for a trial on the merits. In late August 2004, however, B&D moved for summary judgment on its complaint and the government’s counterclaim. The government filed a response in late September opposing the motion, and B&D responded to the government in early October. On October 20, 2004, without a hearing, the court granted B&D’s refund claim and dismissed the government’s counterclaim. According to the court, the government argued that “the BDHMI transaction was a tax avoidance vehicle that must be disregarded for tax purposes.” Based on the Fourth Circuit’s two-pronged test for determining whether a transaction will be treated as a “sham,” the court held that the BDHMI transaction must be respected because it had economic substance.

With only slight differences, the analytical framework of the court’s October decision bears an uncanny resemblance to that of B&D’s August memorandum in support of its motion. B&D characterized the government’s case as “disregarding BDHMI as a sham” and countered that “Moline Properties [v. Commissioner, 319 U.S. 436 (1943)], established the now time-honored principle that a corporation which conducts legitimate and substantial business activities must be respected, as business purpose and economic substance are self-evident” in that situation. (B&D Aug. 30, 2004, Mem. at 4.) Although the court’s October ruling refers throughout to the “BDHMI transaction” (rather than BDHMI), the court’s recitation of undisputed facts focused almost exclusively on whether BDHMI engaged in meaningful economic activity, not whether the underlying BDHMI transaction had sufficient economic substance to be respected for tax purposes.

B&D’s 29-page memorandum also asserted that no statutory issues remained to be addressed, devoting barely half a page to sections 351, 357, and 358. It stated perfunctorily that the court’s August ruling established that the transfer of cash to BDHMI and assumption of contingent liabilities “was a Section 351 transaction within the terms of the Code” and that B&D must therefore be allowed a $560 million loss on the sale of the preferred stock unless “a non-statutory doctrine” entitled the government “to ignore or otherwise recast the transaction.” (B&D Aug. 30, 2004, Mem. at 4.) B&D cited the court’s August decision as authority for the proposition that, under sections 357(c)(3) and 358(d)(2), B&D’s stock basis was not reduced for assumed liabilities.

In rebuttal, the government noted that the August ruling “[did] not, however, go that far,” but rather addressed only a “very discrete aspect” of sections 357(c)(3) and 358(d)(2). (Gov. Sept. 24, 2004, Resp. at 2, 6 n.3.) In August the court had determined only that the legislative history did not support the interpretation of section 357(c)(3) urged by the government. Moreover, the court had not ruled on whether the transaction qualified under section 351 or whether the liabilities assumed by BDHMI were, in fact, excluded under section 357(c)(3) as required to invoke section 358(d)(2). (Id. at 22-23.) Several statutory issues had not previously been considered by the court, including whether the “the basis rules of section 358, operating in conjunction with the ‘principal purpose’ rule of section 357(b),” required B&D to reduce its stock basis by the assumed liabilities under section 358(a)(1)(A)(ii), and whether, in the alternative, B&D’s promise to pay future healthcare expenses incurred in 1999-2007 on behalf of B&D’s employees and retirees and substantial business activities which have meaningful economic consequences for BDHMI and third parties?” (B&D Aug. 30, 2004, Mem. at 4.)

The government claimed that B&D’s argument based on Moline Properties was essentially a smokescreen to “divert the Court’s attention away from the real question.” (Gov. Sept. 24, 2004, Resp. at 30.) According to the government, the court was required to analyze whether the BDHMI transaction had economic substance, not whether “BDHMI engages in some semblance of business activity.” (Id. at 2.) B&D asserted that “the Court already has ruled that [B&D] correctly interpreted the relevant Code provisions, namely, sections 357 and 358.” (B&D Sept. 23, 2004, Rep. at 20; see B&D Aug. 30, 2004, Mem. at 4.)
could be expected to contain healthcare costs, Brusca replied or product liability claims'' and that he ''effectively liability transaction by using contingent environmental Pogash had initially recommended a similar ''contingent transaction demonstrated that the transaction served the internal documents around the time of the BDHMI engager in the transaction.' (Oct. 21, 2004, Motion.) Perhaps the court thought the phrase ''tax avoidance'' in its revised opinion. (B&D matter — but later agreed, at B&D's request, to substitute admitted a motive of ''tax evasion'' — a far more serious placed in an awkward position: It could either permit the case to go forward to trial or, alternatively, concede a tax avoidance motive but nevertheless argue that section avoidance, the government maintained that B&D had fastened onto the idea of a special-purpose liability management vehicle without thoroughly investigating whether the BDHMI structure could effectively contain healthcare costs. According to the government, internal documents around the time of the BDHMI transaction demonstrated that the transaction served the tax purpose of claiming a loss equal to reserves for the future healthcare claims, and that B&D's outside healthcare consultants believed they were being asked to invest in BDHMI to facilitate delivery of tax benefits to B&D. The government's section 357(b) tax avoidance claim seemed unavoidably to require a factual determination of B&D's motivation for the BDHMI transaction. As evidence of tax avoidance, the government maintained that B&D had fastened onto the idea of a special-purpose liability management vehicle without thoroughly investigating whether the BDHMI structure could effectively contain healthcare costs. According to the government, internal documents around the time of the BDHMI transaction demonstrated that the transaction served the tax purpose of claiming a loss equal to reserves for the future healthcare claims, and that B&D's outside healthcare consultants believed they were being asked to invest in BDHMI to facilitate delivery of tax benefits to B&D. (Id. at 18.) Finally, the notion that BDHMI was formed to contain healthcare costs was undercut by the fact that Pogash had initially recommended a similar “contingent liability transaction by using contingent environmental or product liability claims” and that he “effectively admitted that . . . tax savings was a principal purpose for engaging in the transaction.” (Id. at 16-17.) Because the section 357(b) issue was clearly crucial for summary judgment purposes, it is surprising that B&D's earlier memorandum failed to address it. B&D was thus placed in an awkward position: It could either permit the case to go forward to trial or, alternatively, concede a tax avoidance motive but nevertheless argue that section avoidance, the government maintained that B&D had fastened onto the idea of a special-purpose liability management vehicle without thoroughly investigating whether the BDHMI structure could effectively contain healthcare costs. (Id. at 1.) For the court to sustain the summary judgment motion, B&D still needed to demonstrate at a minimum that the government’s “reliance on section 357(b) is wholly misplaced” because section 357(b) “is not relevant in determining stock basis and, therefore, can have no impact on [B&D’s] claimed stock loss.” (Id. at 3.) Ultimately, B&D's strategy may have backfired. Apparently, the court was so confused about the relevance of section 357(b) that it failed to appreciate the significance of B&D's concession that its sole motivation was tax avoidance. Indeed, the court initially believed that B&D had admitted a motive of “tax evasion” — a far more serious matter — but later agreed, at B&D's request, to substitute the phrase “tax avoidance” in its revised opinion. (B&D Oct. 21, 2004, Motion.) Perhaps the court thought the terms were interchangeable. In its October ruling, the court failed to state any conclusions of law concerning the statutory issues in dispute, focusing instead exclusively on nonstatutory challenges. Specifically, the court failed to rule that the BDHMI exchange qualified as a section 351 transaction; the contingent liabilities assumed by BDHMI were properly excluded under sections 357(c)(3) and 358(d)(2); and B&D's stock basis was not reduced under section 358(a)(1)(A)(ii) by money received even though B&D stipulated that the tax avoidance rule of section 357(b) was applicable. Without specific rulings on essential issues of law that were properly raised, the court’s October ruling is clearly untenable and its findings premature concerning the economic substance of the BDHMI transaction.

B. Section 357(b) and Stock Basis

Section 357(b) has mostly enjoyed a relatively tranquil existence since it was added to the code as part of the 1939 anti-

In July 1999 a statutory fix to section 357(b) was passed by both the House and the Senate as part of legislation that President Clinton then vetoed. The proposed fix would have strengthened the tax avoidance rule of section 357(b) by changing “the” principal purpose to “a” principal purpose and by striking the phrase “on the exchange.” The 1999 amendment was intended

82See Bittker and Eustice, supra note 23, par. 3.06[3] at 3-29 to 3-30. While the business purpose rule of section 357(b) should be construed narrowly to avoid undermining the general rule of section 357(a), B&D’s concession that tax avoidance was its sole motivation rendered that issue moot.

When asked about B&D’s analysis of whether BDHMI could be expected to contain healthcare costs, Brusca replied that: “We didn’t know. I mean it was a structure and we were going to try it.” (Gov. Sept. 24, 2004, Resp. at 16.)
specifically to ensure that an assumption of liabilities that might not generally be taken into account for purposes of section 357 (including section 357(c)(3) deductible liabilities and certain contingent liabilities that might fall outside section 357 entirely) would be treated as boot if a principal purpose for the assumption was tax avoidance. Finally, the 1999 amendment was intended to “clarify” that, if an assumption of liabilities was treated as boot under section 357(b), the transferor’s basis in the transferee’s stock would be reduced by the amount of the liability. In other words, the amendment was addressed at precisely the type of contingent liability shelter involved in the BDHMI transaction.

Interestingly, a footnote in the Senate report specifically addressed the relationship between sections 357(b) (as modified), on one hand, and sections 357(c)(3) and 358(d)(2), on the other hand:

Section 357(b)(1) liabilities are not within the scope of section 357(c)(3) or section 358(d)(2). Thus, the transferee’s assumption of a liability under section 357(b)(1), as modified by the provision, is treated as the transferor’s receipt of money for purposes of 358 and related provisions.64

Of course, the legislative history of an unenacted amendment is unlikely to carry much weight in interpreting the original statute. Moreover, it might be argued that the footnote should be disregarded as a self-serving statement intended to bolster the government’s litigating position that the transferor’s stock basis must be reduced by “money” received when the tax avoidance rule of section 357(b) applies, notwithstanding sections 357(c)(3) and 358(d)(2).65 Nevertheless, the Senate report suggested that no modification of the basis rules of section 358 was needed to ensure that the transferor’s stock basis would be appropriately reduced by the amount of money received when contingent liabilities were assumed in a section 357(b) tax avoidance transaction.66 Interestingly, B&D seems to have neglected to direct the court’s attention to the 1999 proposals, even though the cited footnote directly contradicted B&D’s section 357(b) theory.67

Was there any statutory support for B&D’s claim that section 357(b) does not affect the transferor’s stock basis? Section 357(b) states quite simply that assumed liabilities shall be treated as “money received” by the transferor if a tax avoidance motive is shown. In turn, section 358(a)(1)(A)(ii) states that the transferor’s basis in the stock received in the section 351 exchange shall be reduced by “the amount of any money received” by the transferor. A common-sense interpretation based on the plain language of the statute might suggest that “money” means “money” in both places and B&D’s stock basis should therefore have been reduced by the $560 million of liabilities assumed, leaving B&D with a basis of $1 million and no loss on the stock sale.

B&D’s task was to refute this syllogism. Logically, B&D’s argument consisted of the following steps: (1) section 357(b) applies only for purposes of section 351(a), not for purposes of the basis provisions of section 358, and thus money for purposes of section 357(b) is not money for purposes of section 358(a)(1)(A)(ii); (2) assumption of liabilities is treated as money for purposes of section 358(a)(1)(A)(ii) (and therefore triggers a basis reduction) only if section 358(d)(1) applies, and section 358(d)(1) does not apply if section 358(d)(2) applies; and (3) section 358(d)(2) did apply to the BDHMI transaction because the assumed contingent liabilities were “excluded under section 357(c)(3)” and therefore no reduction in B&D’s stock basis was required even though the transaction was undertaken solely for tax avoidance purposes. (B&D Oct. 8, 2004, Rep. at 7-9.) Neither a literal nor a purposive interpretation requires that tortuous reading of the statute. Moreover, the court never held that the liabilities assumed by BDHMI were excluded under section 357(c)(3) as required to invoke section 357(d)(2).68

The government’s brief contains a technical analysis of the interrelationship between the relevant statutory provisions — demonstrating that, by operation of section 357(c)(2)(A), sections 357(c) and 358(d)(2) are expressly made inapplicable if section 357(b) applies. (Gov. Sept. 24, 2004, Resp. at 23-29.) Rather than repeat that analysis, it may be useful here merely to review the historical development of section 357(b) in relationship to the basis rules of section 358. The anti-Hendler amendments provided limited relief from the Supreme Court’s decision that assumption of liabilities was equivalent to the receipt

64S. Rep. No. 120, 106th Cong. p. 215 n.8 (1999); see also id. at 214 (basis reduction required under current law).

65The proposed section 357(b) fix dates back at least to February 1999. See Dept. of Treas., General Explanation of the Administration’s Revenue Proposals 117 (Feb. 1999) (indicating that a modification to the basis rule of section 358 might be necessary to achieve the intended result); see also Staff of Joint Comm. on Tax’n, Description of Revenue Provisions Contained in the President’s Fiscal Year 2000 Budget Proposal 200-201(similar analysis).

66The cited footnote was arguably intended primarily to address a related concern, namely, that an assumption of contingent liabilities might fall entirely outside section 357. See Blanchard and Hooker, supra note 63 at 943-944 (querying whether a statement in the legislative history could create “money” when relief of contingent liabilities might not otherwise be cognizable under section 357).

67In developing B&D’s section 357(b) theory, the lawyers at Miller and Chevalier might reasonably have been expected to know of the controversial 1999 proposed amendment. That apparent omission is all the more striking because B&D was at pains to portray both the IRS and Congress as having “considered the stock basis implications of section 357(b) and straightforwardly concluded that there [were] none.” (B&D Oct. 8, 2004, Rep. at 3.)

68B&D also raised semantic arguments concerning the meaning of “excluded” for purposes of section 358(d)(2). (B&D Oct. 8, 2004, Rep. at 7.) B&D sought to bolster its section 357(b) argument by representing that the IRS had “twice stated that section 357(b) has no effect on basis.” (B&D Oct. 8, 2004, Rep. at 6.) The IRS determined in two FSAs that no basis reduction for assumed contingent liabilities was required even though the tax avoidance rule of section 357(b) potentially applied. See FSAs 199905008, Doc 1999-5118, 1999 TNT 25-64 (Oct. 29, 1998), and 199929015, Doc 1999-24825, 1999 TNT 142-53 (Apr. 20, 1999). As B&D conceded, however, FSAs have no precedential value.
of money on an incorporation or reorganization. That relief was expressly limited by the tax avoidance rule of section 112(k) (the predecessor to section 357(b)), which retained the Hendler rule that assumption of liabilities is equivalent to receipt of money for gain recognition and basis determination. The 1939 legislation sought to establish “a system under which ... recognition of gain and determination of basis [would] be under uniform equitable rules,” retroactive to 1924. Congress viewed the Hendler result as inequitable in non-tax-avoidance transactions but understood that the basis provisions needed to be correlated with the gain recognition provisions to ensure that deferral of gain was merely temporary.

In effect, the 1939 amendments reinstated the pre-Hendler administrative practice of requiring a reduction in the transferor’s basis in property received in nonrecognition exchanges, whether or not assumption of liabilities was treated as money for purposes of gain recognition. Basis was increased by the amount of any gain recognized to the extent that assumption of liabilities was treated as money under the tax avoidance exception contained in section 112(k). But, whether or not an assumption of liabilities was treated as money under the tax avoidance rule for purposes of gain recognition, the transferor’s basis was reduced by the amount of liabilities assumed. From that perspective, it makes no sense — contrary to the theory espoused by B&D in support of its motion for summary judgment — to treat an assumption as money under section 357(b) for purposes of gain recognition but not to reduce basis by the amount of the liability assumed. That treatment would create a disjunction between the gain recognition and basis provisions, contrary to the clear intent of the 1939 amendments.

By contrast, the government’s technical interpretation of the literal statutory language is entirely consistent with the goal of preserving proper coordination between the gain recognition and basis provisions. Only assumed liabilities that fall outside section 357 — deductible liabilities excluded by virtue of section 357(c)(3) and liabilities that are not sufficiently fixed to be taken into account — have no effect on section 358 stock basis (ignoring certain post-1999 statutory changes discussed below).

70See Surrey, supra note 15 at 31 n.100 (“Proper coordination between the recognition of gain provisions and the basis provisions” required an “assumption to be treated as ‘money’ [equal] to the amount of the liability for purposes of gain recognition.”).
71See Paul and Mertens, supra note 60 at section 17.38; T.D. 4939, 1939-2 C.B. 112, 116 (noting that the new provision “in general confirms the Bureau’s practice with respect to the recognition of gain or loss and the determination of basis of property acquired” in nonrecognition transactions).
72See H.R. Rep. No. 855, supra note 36 at 20 (“This provision applies whether or not the assumption of the liability or the taking subject to the liability is considered money under Section 112(k).”).
73Under the 1939 code, it was a matter of indifference whether basis was reduced because an assumption was treated as money under the predecessor of section 357(b) or deemed to be money under the predecessor of section 358(d)(1); in both instances, basis was reduced by the amount of liabilities assumed.

C. Liabilities Not Cognizable Under Section 357

Thus, if the assumed liabilities were cognizable as liabilities for purposes of section 357, they should have necessarily reduced B&D’s basis in the preferred stock unless they constituted deductible liabilities that were properly excluded under section 357(c)(3). Of course, B&D is still free to argue that the assumed liabilities were not liabilities for purposes of section 357 because they were too contingent to be taken into account for federal tax purposes. If the assumed liabilities fell entirely outside section 357, then sections 358(d)(1) and (2) would be inapplicable. Nevertheless, B&D’s stock basis could arguably be reduced under section 358(a)(1)(A)(i), to the extent that BDHMI’s obligation to pay future expenses fell within the term “other property.” (Gov. Sept. 24, 2004, Resp. at 29-30.) Before Hendler, it was an open question whether relief of liabilities was money or other property, because a future payment obligation could be viewed as a valuable contractual benefit. Hendler seems to have settled that issue, at least for liabilities cognizable under section 357, by treating an assumption as the equivalent of money equal to the amount of the assumed liabilities, thereby avoiding difficult valuation issues.

In 2000 Congress enacted section 358(h) as a substitute for the 1999 proposed amendment to section 357(b). For transactions occurring after the effective date, section 358(h) provides a broad definition of the term “liability” for the limited purpose of reducing the transferor’s basis in potentially abusive situations. Under section 358(h),
a “liability” is defined essentially as any fixed or contingent obligation to make payment that could reasonably be taken into account by the parties in an arm’s-length transaction, regardless of whether such an obligation would be cognizable under other provisions of the code. Thus, a liability that is too contingent to be cognizable under section 357 may nevertheless be taken into account under section 358(h) for purposes of reducing the transferor’s stock basis. Concerned that such a broad definition of liabilities might spawn new tax shelter abuses, Congress opted to apply section 358(h) narrowly rather than define the term liability generally.

Fortunately, a court may address the BDHMI transaction on its own terms without becoming unduly entangled in deciphering section 358(h) or how it fits with the rest of the statute. While some obligations may clearly be too contingent to be cognizable under section 357, B&D and its tax advisers seem to have insisted throughout that the contingent healthcare claims should be treated as liabilities “as a matter of law” for federal tax purposes. (B&D Oct. 8, 2004, Rep. at 4, 14-16.) While that claim is self-serving, B&D should be held to its position in this particular case. B&D’s prompt sale of the preferred stock may be viewed as having adequately “fixed” the amount of the assumed liabilities so that the assumption may properly be taken into account for purposes of reducing B&D’s basis in the preferred stock. Such a narrow decision would conserve judicial resources and is consistent with the Supreme Court’s holding in Hendler that subsequent events may suffice to adequately fix the amount of money received on an assumption of liabilities.

Rather than attempt to determine broadly when an assumption of contingent liabilities must be taken into account, courts should focus pragmatically on “whether the consequences of getting the accounting wrong are tolerable.” While it may often be difficult to determine precisely when future obligations of a taxpayer should be recognized for tax purposes, contingent liability tax shelters rested on a willful misreading of sections 357(c)(3) and 358(d)(2) that should be rejected under both a literal and a purposive interpretation of the statute. Courts need to invoke the economic substance doctrine only if the statutory arguments against the position taken by B&D and other users of those shelters are fully considered and rejected on the merits. While an economic substance analysis should be used sparingly, the Supreme Court has long held that literal compliance with the code is not sufficient. Indeed, the outcome in Hendler was decisively influenced by the Court’s rejection of a formalistic approach in a case decided two months earlier, Minnesota Tea v. Helvering, 302 U.S. 609, 613 (1938), in which Justice Sutherland opined famously that “[a] given result at the end of a straight path is not made a different result because reached by following a devious path.”

V. Conclusion

The district court’s two opinions in Black & Decker — one dismissing the government’s summary judgment motion and the other granting the taxpayer’s summary judgment motion — are exceedingly short. To any experienced tax lawyer familiar with contingent liability transactions, it should have been obvious based on even a casual reading of the two opinions side by side that this was a case in which tax shelter litigation had run amok. With the benefit of hindsight, the government’s framing of its summary judgment motion arguably contributed to the court’s confusion concerning the underlying statutory issues. But the opposing side appears to have placed more weight on the August ruling than it could reasonably bear, while successfully seeking to deflect attention from the government’s statutory and tax policy arguments.

81See prop. reg. section 1.752-7(b) (defining a “section 1.752-7 liability” as the amount of cash that a willing assignor would pay to a willing assignee to assume the liability in an arm’s-length transaction). By analogy to section 358(h), the proposed partnership regulations pertain to any fixed or contingent obligation to make payment to which section 752 does not otherwise apply. See prop. reg. section 1.752-1(a)(1)(ii).

82As support for this conclusion, B&D cited Merkel v. Comm’r, 192 F.3d 844, 1999 TNT 182-7 (9th Cir. 1999), addressing the definition of liabilities for purposes of determining insolvency under section 108. In fact, the majority in Merkel expressly rejected the notion of defining liabilities “as including all liabilities discounted by the probability of their occurrence.” Id. at 850. In economic terms, an assumed liability might be defined as any obligation to make future payments that a buyer and seller could reasonably take into account in determining purchase price; for tax purposes, such a definition is “both clear and unworkable.” Crane, “More on Accounting for the Assumption of Contingent Liabilities on the Sale of a Business,” 3 Fla. Tax Rev. 615, 635 (1997).

83The Supreme Court narrowly held that Hendler received boot to the extent that the transferee “assumed and paid” its bonded indebtedness. Hendler, 303 U.S. at 566. Ironically, the origin of the Hendler dispute was Hendler’s refund claim on account of deductions for unamortized bond discount and premiums payable on redemption, based on the theory that the bonded indebtedness remained Hendler’s obligation. See Survey, supra note 15 at 2-3. The government did not argue that assumption of Hendler’s bank loans and accounts payable (Footnote continued in next column.) constituted boot. See id. at 4. As Hendler illustrates, the inherently factual issue of whether liabilities properly belong to the transferor or the transferee may lead to unexpected tax consequences.

84Cran, supra note 80 at 644. In General Dynamics, Justice O’Connor recognized the need to balance “competing interests in permitting accrual accounting and protecting the public fisc” when assessing whether liabilities should be treated as fixed for tax purposes. General Dynamics, 481 U.S. at 251. B&D’s contingent healthcare claims were apparently not sufficiently fixed to have been “booked” for financial purposes. (Pogash Dep. at 90-91.) See FSA 200134008 (May 15, 2001) (discussing contingent healthcare liabilities).

85But cf., Coltec Indus. Inc. v. United States, Doc 2004-21316, 2004 TNT 214-16 (Ct. Fed. Cl., Oct. 29, 2004) (stating 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”).
Although B&D won the initial skirmish, the outcome of the pending Fourth Circuit appeal seems clear: The district court’s October ruling should be reversed for failing to state essential conclusions of law and for ignoring genuine issues of fact. The litigation also sheds light on the challenges faced by generalist district courts in attempting to deal with tax shelter transactions that are purposefully designed to exploit ambiguous statutory language. Judges not versed in tax law must often rely on the parties to present technical arguments concerning difficult statutory material in a manner that illuminates rather than obscures the relevant issues. As the Black & Decker litigation illustrates, judges must also be equipped to pierce misconstructions of the statutory language if they are to deal successfully with abusive tax shelters.84

In conclusion, Judge Quarles’s perception of B&D’s contingent liability shelter as “a thing of grace and beauty” misses the mark. (Tr. of July 30, 2004, Conf. at 28-29.) While the aesthetic appeal of a tax shelter clearly lies in the eye of the beholder, Black & Decker underscores the need for judges to observe the most punctilious standards of impartiality and to avoid even the appearance of pro-government or pro-taxpayer bias.85 Judges concerned with maintaining a reputation for competence and evenhandedness should steadfastly resist any temptation to rely uncritically on either party — the government or the taxpayer — in arriving at conclusions of law and findings of fact. In the end, a judge’s task is not to admire tax shelters but to adjudicate them.

84See Canellos, “How To Curb Aggressive Shelter Activity,” Tax Notes, Nov. 22, 2004, p. 1156 (arguing that curtailing tax shelters requires willingness by courts to “apply code provisions in accordance with their purpose [and] to subject to special scrutiny transactions that . . . are obviously motivated by tax avoidance,” as well as willingness by “conscientious practitioners to exercise a monitoring and shaming function in reviewing shoddy tax shelter products”).

85The transcript of the July 30, 2004, conference is revealing concerning Judge Quarles’s view of tax shelters. (See Tr. of July 30, 2004 Conf. at 7, stating that “You have to admire the transaction, though, don’t you? . . . I now [understand] why my former tax partners got paid so much.”)

### Appendix

**Black & Decker:**
- Plaintiff’s Brief in Opposition to Defendant’s Motion for Summary Judgment (Feb. 5, 2004)
- Plaintiff’s Supplemental Memorandum on the Application of Section 351 in Support of Its Opposition to Defendant’s Motion for Summary Judgment (May 27, 2004)
- Plaintiff’s Response to United States’ Memorandum on the Application of Section 351 (June 8, 2004)
- Plaintiff’s Reply to Defendant’s Opposition to Plaintiff’s Cross-Motion for Summary Judgment (Sept. 23, 2004)
- Plaintiff’s Reply to Defendant’s Opposition to Plaintiff’s Motion for Summary Judgment (Oct. 8, 2004)

**United States:**
- Defendant’s Motion for Summary Judgment (Dec. 30, 2003)
- Reply to Plaintiff’s Brief in Opposition to Defendant’s Motion for Summary Judgment (Mar. 10, 2004)
- United States’ Submission in Response to the Court’s Order Dated May 6, 2004 (May 27, 2004)
- United States’ Response to Plaintiff’s Supplemental Memorandum Regarding the Application of Section 351 (June 8, 2004)
- United States’ Response in Opposition to Plaintiff’s Motion for Summary Judgment (Sept. 24, 2004)

**Miscellaneous:**
- Tax Opinion Letter From Deloitte & Touche LLP to Harry Pogash, vice president taxes (Black & Decker Corporation) (Jan. 20, 1999)
- Excerpts From Deposition of Harry Pogash, vice president taxes (Black & Decker Corporation) (May 20, 2003)
- Counterclaim (Mar. 4, 2004)
- Order by Honorable William D. Quarles Jr., to Counsel of Record (May 6, 2004)
- Transcript of Motions Hearing Before the Honorable William D. Quarles Jr. (July 30, 2004)
- Joint Pretrial Order (Sept. 30, 2004)
- Plaintiff’s Motion to Clarify Memorandum and Order (Oct. 21, 2004)
- Notice of Appeal (Dec. 20, 2004)