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Tax Court Upholds "Check-and-Sell" Strategy

Dover Corporation, et al. v. Commissioner, 122 T. C. 19 (2004)

Overview

In a major taxpayer victory, the Tax Court held, in *Dover Corporation, et al. v. Commissioner* ("*Dover*"), that a sale of stock of a second tier controlled foreign corporation ("CFC") is treated as a sale of assets used in a trade or business for U.S. federal income tax purposes as a result of a check-the-box election by the target effective shortly before the stock sale. The court's holding validates the so-called "check-and-sell" strategy for avoiding Subpart F income on the sale of stock of a second (or lower) tier CFC.

Background

Under Subpart F, certain income earned by a CFC, such as capital gains and other passive investment income, is deemed distributed to certain 10 percent U.S. shareholders and subject to federal income tax as ordinary income. (Actual distributions by a CFC to 10 percent U.S. shareholders are tax-free to the extent of previous inclusions of Subpart F income.) Subpart F income does not include, among other things, income from an active trade or business, which includes income from the disposition of assets used in the trade or business. There is no general "look-through rule" that would classify gain realized on the sale of an interest in an entity based on the nature of the entity's assets. Thus, gain realized by a CFC on the sale of subsidiary stock or an interest in a partnership is Subpart F income even if the subsidiary or the partnership would not realize Subpart F income on a sale of the assets because the assets are used in a trade or business.

Under the "check-the-box" elective entity classification rules, certain eligible foreign entities treated as corporations under local law may elect to be classified for U.S. income tax purposes as either (i) a partnership, if the entity has more than one owner, or (ii) an entity that is disregarded as separate from its owner, if the entity has a single member. If an entity elects disregarded entity status, it is deemed to distribute all its assets and liabilities to its parent in complete liquidation immediately before the close of the day preceding the effective date of the election. Such a deemed liquidation should qualify as a tax-free subsidiary liquidation under I.R.C. § 332.

The check-and-sell strategy is designed to avoid recognition of Subpart F income on the sale of the stock of a lower tier CFC by an upper tier CFC by having the target CFC elect disregarded entity status effective prior to consummation of the sale of its stock. As a result of the election, the target CFC is deemed to liquidate at the close of the day before the effective date of the election in a good tax-free subsidiary liquidation. The sale of the target's stock is treated for U.S. income tax purposes as a sale of the target's assets. If those assets were used in a trade or business by the target, the U.S. parent of the upper tier CFC takes the position that no Subpart F income was generated on the sale of the target stock because for U.S. tax purposes the sale was a sale of business assets.

In November 1999, the IRS issued proposed regulations (the so-called "extraordinary transaction rules") that would nullify the check-the-box election by the CFC target in the check-and-sell structure and treat the company as a corporation on the ground that the transaction was abusive. After substantial criticism, the IRS, in Notice 2003-46 (July 2003), withdrew the proposed regulations stating, among other things, that it was examining the appropriate

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treatment of the check-and-sell transaction under other provisions of the law. In *Dover,* the IRS attacked the check-and-sell transaction on what many saw as its principal vulnerability - whether the upper tier CFC should be treated as being engaged in the trade or business of the target CFC when the period between the deemed liquidation of the target CFC and the sale of the target was very short.

The Dover Case

In *Dover,* the taxpayer, a U.S. corporation, owned 100 percent of a U.K. holding company ("DH"), which, in turn, owned 100 percent of a U.K. operating company ("H&C"). Both companies were CFCs. On July 11, 1997, DH sold 100 percent of the stock of H&C for cash. At the time of the sale, H&C had not made a check-the-box election and apparently did not contemplate doing so. Subsequently, on December 3, 1998, most likely after consultation with U.S. tax advisors, the taxpayer petitioned the IRS under Treas. Reg. §§ 301.9100-1 and –3 on behalf of its former indirect subsidiary, H&C, to be granted an extension of time to elect disregarded entity status for H&C effective immediately before the closing of the sale of the H&C stock on July 11, 1997. After 14 months, the IRS granted the extension of time to make the check-the-box election on March 31, 2000, but warned that it was not agreeing with the position that the transaction did not generate Subpart F income.

Although the IRS accepted the form of the transaction as a sale of H&C's assets (contrary to the result under the extraordinary transaction proposed regulation), the IRS asserted a deficiency against the taxpayer (the 100 percent U.S. shareholder of DH) on the ground that the asset sale gave rise to Subpart F income because DH had not used H&C's assets in a trade or business. The court held that DH was deemed to be engaged in H&C's trade or business, citing published and private rulings, for the proposition that the surviving parent corporation in a tax-free subsidiary liquidation is considered to have been engaged in the subsidiary's pre-liquidation trade or business. The court also pointed to language in the check-the-box regulations stating in pertinent part "if the entity is disregarded [after a check-the-box election], its activities are treated in the same manner as a sole proprietorship, branch or division of the owner."

The court had to distinguished its prior ruling in *Arco Manufacturing Co. v. Commissioner*, 39 T.C. 377 (1962), which held that for purposes of classifying assets received in a tax-free subsidiary liquidation, the business history of the liquidating subsidiary did not automatically carry over to the parent. The court conceded that *Arco* was essentially on point, but that the IRS had effectively overruled *Arco* in subsequent public and private rulings and in the check-the-box regulations. The court concludes with what appears to be an admonishment to the IRS for not amending the check-the-box regulations to combat abusive transactions spawned by those regulations. The court said such transactions are a problem of the IRS's "own making, a problem that [the IRS] has allowed to persist by choosing 'not to amend the regulations to correct the problem.'"

Planning Considerations

Taxpayers who have adopted the check-and-sell structure should take some comfort in the *Dover* ruling whether or not their structure is under audit because it is a solid taxpayer victory. As a note of caution, however, the IRS has not indicated if it intends to appeal *Dover*. Moreover, an appeals court may disagree with the Tax Court's limited reading of *Arco* (and other cases) holding that the trade or business of a subsidiary that liquidated in a tax-free subsidiary liquidation does not necessarily carry over to the parent corporation. For planning purposes, perhaps most significantly, *Dover* strongly suggests that a check-and-sell structure is not vulnerable if it is implemented a reasonable period of time before the closing of the sale of the stock of the target CFC. Finally, the ability of the taxpayer in *Dover* to secure relief under Treas. Reg. § 301.9100-1 and –3 serves as an important reminder of the utility of those procedures.

For further information contact Eva Farkas-DiNardo (212-210-9592), Sam Kaywood (404-881-7481) and Kevin Rowe (212-210-9505).

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