



International Tax ADVISORY ■

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U.S. Parent Received Taxable Dividends from Foreign Subsidiary in Step Transaction

In *Barnes Group Inc. and Subsidiaries v. Commissioner* (No. 13-4298, Nov. 5, 2014), the U.S. Court of Appeals for the Second Circuit affirmed the U.S. Tax Court's application of the step transaction doctrine to treat a series of transactions as dividend payments from a foreign subsidiary to its U.S. parent. The court also upheld accuracy-related penalties on the related deficiency, determining that the U.S. parent improperly relied on Revenue Ruling 74-503.

Background

Barnes Group Inc. (the "Taxpayer") is the U.S. parent of a manufacturing enterprise that comprises various domestic and foreign subsidiaries. The Taxpayer wanted to use excess funds and borrowing capacity of a second-tier Singaporean subsidiary ("Singapore"), a controlled foreign corporation (CFC), to expand its operations. To avoid tax on a dividend or loan from Singapore, the Taxpayer implemented a "reinvestment plan" using newly formed financing subsidiaries in Bermuda ("Bermuda") and Delaware ("Delaware") to facilitate a tax-free transfer of the excess cash.

The reinvestment plan had two parts. In Part I, the Taxpayer and Singapore transferred foreign currency to Bermuda in exchange for Bermuda stock in Section 351 transactions, then the Taxpayer and Bermuda transferred foreign currency and Bermuda stock to Delaware in exchange for Delaware stock (common for the Taxpayer and preferred for Bermuda), and finally, Delaware converted the foreign currency into U.S. dollars and lent the funds to the Taxpayer. Part II of the plan was similar except that Singapore first borrowed foreign currency from a Singaporean bank before making the Section 351 transfers. After the plan, Singapore and Delaware owned all of the common stock of Bermuda, Bermuda owned all of the preferred stock of Delaware, and Delaware loaned more than \$67 million to the Taxpayer.

The Taxpayer had obtained an opinion letter stating that the Taxpayer would not have a Section 956 income inclusion because Bermuda's basis in the Delaware preferred stock was zero, and Section 956 inclusions are limited to the adjusted basis of the investment in U.S. property. The opinion relied on Rev. Rul. 74-503 for support that Bermuda's basis in the Delaware stock was zero. That ruling involved the exchange of treasury stock for newly issued stock of another

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corporation in a Section 351 transaction. Applying Section 362, the ruling determined that the bases of treasury and unissued stock are zero, and thus the stock received by each corporation in the exchange was zero. The Taxpayer further argued that Rev. Rul. 2006-2 precluded the IRS from challenging its reasonable reliance on Rev. Rul. 74-503.

The IRS contended that Rev. Rul. 74-503, which applies to a single transaction, was inadequate support for the Taxpayer's series of integrated transactions. Rather, the reinvestment plan had to be considered as a whole and, applying substance over form principles, the plan should be treated as a dividend or loan from Singapore to the Taxpayer.

Tax Court Decision

The Tax Court (T.C. Memo 2013-109) sided with the IRS. The court found the substance of the reinvestment plan to be a dividend from Singapore to the Taxpayer, applying the step transaction doctrine due to the interdependent nature of the transactions. The Tax Court observed that the Taxpayer had failed to demonstrate that the Taxpayer and its subsidiaries had respected the form of the transactions. The only evidence proffered to show payment of interest on the Delaware loans and dividends on the preferred Delaware stock were tax returns, which the court found insufficient alone.

The Tax Court further determined that the Taxpayer was liable for accuracy-related penalties because the Taxpayer improperly relied on Rev. Rul. 74-503 and thus lacked reasonable cause for its understatement of income. According to the court, before the Taxpayer's reliance on the ruling could be justified, the Taxpayer had to demonstrate that the form of the reinvestment plan should be respected and that its facts were substantially similar to those in the ruling. The Tax Court stated that, even if it did respect the form of the Taxpayer's transactions, there were "substantial factual differences" between the ruling and the reinvestment plan that "far exceeded" the scope of the ruling.

Court of Appeals Decision

The Second Circuit affirmed the Tax Court's conclusions, holding that the Tax Court properly applied the step transaction doctrine to collapse the steps of the reinvestment plan under the "interdependence test." The court noted that the transactions occurred pursuant to an Agreement and Plan of Reinvestment that recognized "a single integrated plan." And though Delaware's loans to the Taxpayer were not expressly part of the agreement, the series of transactions would have been pointless without those transfers.

The Second Circuit also rejected the Taxpayer's argument that the step transaction doctrine was inapposite because the separate transactions served a valid business purpose. The court found the Taxpayer's assertions and explanations unpersuasive, finding "any non-tax benefit of including the financing subsidiaries... at best, a mere afterthought." The court held that the Tax Court's finding that the substance of the reinvestment plan was a dividend was not clearly erroneous. The court cited the paucity of evidence concerning the payment of interest or preferred dividends as support for its holding that the transactions were not "bona fide investments."

The appellate court agreed that the Taxpayer did not reasonably rely on Rev. Rul. 74-503 because the Taxpayer's position did not account for factual differences and ignored the impact of the step transaction doctrine. The court determined that the Taxpayer's reliance on the opinion of its professional adviser suffered from the same problem as its reliance on the ruling: "the opinion does not advise as to the tax consequences of the entire series of transactions." Indeed, the court observed that the opinion letter did not analyze the loans to be made to the Taxpayer and, as such, should not have been relied upon by "highly knowledgeable people" as an adequate analysis for the entire series of transactions.

Conclusion

The *Barnes Group* case should serve as a warning to taxpayers, substantively and procedurally. It is well known that many U.S. multinationals have significant cash reserves in foreign subsidiaries, and the IRS is particularly suspect of arrangements that purport to repatriate that cash tax-free. Taxpayers should be aware that judicial doctrines, such as substance-over-form and step transaction, could be invoked to disrupt their plans to make use of offshore reserves—especially in the U.S., which can implicate the complex CFC rules and Subpart F. To mitigate this risk, taxpayers should be mindful to apprise their professional advisers of all the relevant facts of a series of transactions. Otherwise, the advice received may not—indeed, may not be able to—serve as sufficient support for the taxpayer’s ultimate goals in the face of a challenge.

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