



Federal Tax **ADVISORY** ■

MARCH 2, 2015

Precedents We Try to Forget

There are a number of rulings and court decisions against taxpayers that we may try to forget, in part because they just don't seem right. These mostly predate the advent of the economic substance doctrine, which now seems to serve as an all-purpose "taxpayer loses" tool for the IRS. But we need to remember the negative authorities because it is impossible to tell when they might be dusted off and used by the IRS.

Revenue Ruling 80-239

Rev. Rul. 80-239, 1980-2 C.B. 103, described a shareholder of an existing operating corporation, X, which had never paid a dividend. The shareholder had a good business reason for putting X under a new holding company, Y, and wanted to get cash out of the two corporations for the shareholder's own business purposes. After the shareholder contributed the stock of X to Y, Y borrowed cash and paid the cash to the shareholder along with all of the Y stock. The loan was secured by the stock of X, which guaranteed the loan, and later cash from X was paid to Y to repay the loan. The IRS ruled that the shareholder received a dividend from X, through Y as a conduit. It cited Reg. Section 1.301-1(l), which appears to contain broad authority to recharacterize payments of cash by a corporation to its shareholder as dividends even though they are not formal dividends.

In a sense, the ruling is obsolete. It was an IRS effort to deal with two ambiguities in the law at that time: (1) the overlap of a Section 351 exchange with boot and Section 304, and (2) the limitation of a brother-sister Section 304 dividend to the earnings and profits (E&P) of the acquiring corporation. The ruling created a third option that treats the cash as coming from the target. The ruling became obsolete when Section 304 was amended to provide for the Section 351 overlap and to count the E&P of both corporations. But the IRS never withdrew the ruling.

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Presumably, the ruling could not apply today if the cash distribution from Y occurred so much later that it could not be part of the stock exchange; and if it were part of the exchange, Section 304 could apply. Nevertheless, the continued existence of the ruling suggests that its basic theory might still be applied if the cash does in fact come from the subsidiary controlled foreign corporation (CFC).

In transactions similar to the one in the ruling, the IRS also may assert that the loan to the holding company is really equity of the holding company and perhaps even debt of the subsidiary, known as the *Plantation Patterns* problem. See *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972).

Basic, Inc.

Basic, Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977), ruled that the seller of stock did not really sell the stock. Basic owned Falls which owned Carbon. Carborundum wanted to buy the assets of Falls and Carbon, but they refused to sell. Therefore, Carborundum offered to buy the stock of each of Falls and Carbon, but did not consider it feasible to buy Carbon from Falls and then buy Falls from Basic; it thought it would have to pay twice for Carbon.

Therefore, the parties agreed that Falls would distribute the stock of Carbon to Basic and Basic would sell the stock of both corporations to Carborundum. Basic treated the receipt of the Carbon stock as a dividend and claimed the 85 percent dividends received deduction, took a stepped up basis in the stock of Carbon and reported a capital gain on the sale of the Falls stock. The court ignored the distribution of Carbon and treated Falls as selling the stock of Carbon.

The preliminary steps seem to have been in response to the peculiarities of the predecessor of Section 338, which allowed a purchaser of stock to obtain a basis step up for the assets inside the purchased corporation, without tax (aside from recapture), but only if the purchaser directly bought the stock; there was no ability to treat lower tier subsidiaries as having their stock sold and making the same election as to their assets. Therefore, it seems that the restructuring was as much or more for the tax benefit of Carborundum as for Basic.

One judge dissented, quite cogently. But *Basic* remains on the books and has been cited in some of the recent "tax shelter" decisions.

Conclusion

Both of these antitaxpayer authorities were motivated by IRS efforts to get at perceived abuses that can no longer occur. Nevertheless, the authorities remain available to support IRS assertions in completely different settings.

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