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"Dover" and the Consequences of Check-the-Box Liquidations

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A business entity can be classified for Federal tax purposes as a corporation or a partnership or, if an entity has only one owner, it may sometimes be disregarded as an entity separate from that owner. In particular, under the so-called "check-the-box" Treasury Regulations, many single-owner organizations can elect by means of a simple filing with the Internal Revenue Service to be classified for Federal tax purposes as either disregarded entities or as associations taxable as corporations. If an entity previously treated as a corporation elects to become a disregarded entity, the Regulations provide that the entity is "deemed to . . . [distribute] all of its assets and liabilities to its single owner in liquidation." Elections to change the classification of an entity can be made retroactive for up to 75 days prior to filing, or for an even longer period with the permission of the IRS.

A recent Tax Court case, *Dover Corp. v. Commissioner*, 122 T.C. No. 19 (2004), addresses an aggressive, but ultimately successful (pending appeal), effort by a taxpayer to obtain a tax benefit through a deemed liquidation under these rules.

Background

Dover Corp. was a publicly traded Delaware corporation and the parent of a group engaged in industrial manufacturing. Dover Corp. filed a consolidated return with other members of the U.S. affiliated group of which it was the common parent. Dover Corp. also had foreign subsidiaries, including "Dover UK," a UK holding company that owned the stock of Hammond & Champness Limited ("H&C"), a UK corporation engaged in elevator installation and servicing.

On June 30, 1997, Dover UK and Dover Corp. entered into an agreement to sell the stock of H&C. The agreement and related documents were to be held in escrow until an escrow release date of July 11, 1997, pending satisfaction of certain conditions. On July 11, 1997, the buyer notified Dover UK that the escrow conditions had been satisfied. An opinion of UK counsel subsequently obtained by Dover UK (apparently in connection with this tax dispute) concluded that, as a matter of UK law, "beneficial title" to the H&C shares had been acquired by the buyer on that date.

Dover UK was clearly a controlled foreign corporation, or "CFC," as defined in the Internal Revenue Code. A US shareholder of a CFC is generally required to include in the shareholder's gross income its pro rata share of certain items of the CFC's income, including gain of the CFC from certain sales of stock. Accordingly, the gain to Dover UK from the sale of the stock of H&C would generally be taxed in the US to Dover Corp., as the US shareholder (through a Delaware subsidiary) of Dover UK.

In contrast to a CFC's gain on the sale of stock, a CFC's income from the sale of depreciable tangible property (other than real property), if is used or held for use in the trade or business of the CFC, does not have to be included in the income of the CFC's US shareholders.

If an appropriate election is made under the "check-the-box" Regulations, an eligible entity (which would include H&C) will be disregarded, and the entity's assets and business treated as a branch or division of its owner. If stock in a disregarded entity is sold, the sale is treated, for US tax purposes, as a sale by the entity's owner of the assets of the entity.

No disregarded entity election was made by H&C before or at the time of the sale of its stock, or within 75 days thereafter. In December 1998, however, Dover Corp. requested that the IRS grant an extension of time to H&C to make a disregarded entity election, effective immediately prior to the sale of the stock of H&C, which was stated in Dover Corp.'s request for relief to have occurred on June 30, 1997.

Although the IRS initially resisted this request, on the basis that Dover Corp. should not be able to avoid including in its income Dover UK's gain on the sale of the stock of H&C, it ultimately granted the requested extension of time to make the election, while indicating that no inference should be drawn that gain from the H&C sale would not be taxable to Dover Corp. In October 1999, H&C filed an election to

be disregarded as a separate entity, effective as of June 30, 1997.

Analysis

In the Tax Court proceedings, the Commissioner did not dispute the validity of the disregarded entity election and agreed that the effect of the election was to cause a liquidation of H&C for tax purposes, including a deemed distribution of all of H&C's assets to its sole shareholder. Thus, the sale of stock of H&C by Dover UK should be treated for tax purposes as a sale of H&C's assets.

The Commissioner argued, however, that the deemed liquidation, within a day prior to the stated date of the sale, did not cause the property of H&C to be used or held for use in Dover UK's trade or business, and, therefore, that Dover UK's gain on the deemed sale of those assets was required to be included in the income of Dover UK's US shareholder.

The opinion first considers whether the stock sale should be viewed as having occurred on June 30, 1997, rather than in the following month. The Commissioner argued that a finding of a June 30 sale date was required under the "duty of consistency," in light of Dover Corp.'s position in the request for permission to make a late election that the sale occurred on June 30; conversely, Dover Corp. argued that the request reflected a simple mistake of law and that the sale did not occur until July 11.

Both parties apparently believed that the period of time between the deemed liquidation and the sale (possibly as short as an instant or as long as 11 days) might influence the court's conclusion as to whether the assets of H&C were held by Dover UK for use in its business. The court ultimately concluded, however, that it need not resolve these questions to determine whether the sale gave rise to income taxable to Dover Corp.

The opinion reviews several cases and rulings arising in other areas of the tax law and cited by the parties as addressing whether the liquidation of a subsidiary into its corporate parent should result in the shareholder's being viewed as operating the business of its subsidiary and as holding the assets of the subsidiary for use in that business.

Of the four cases cited by the Commissioner, the one that seemed most closely on point, *Acro Manufacturing Co. v. Commissioner*, 39 T.C. 377 (1962), *aff'd*, 334 F.2d 40 (6th Cir. 1964), involved an actual liquidation of a subsidiary, followed immediately by the parent's sale of the distributed assets at a loss. The taxpayer in *Acro* argued that the character of the assets as held by the subsidiary for use in a trade or business, rather than as capital assets, should carry over to the parent, so that the parent could recognize an ordinary loss. The Tax Court and Court of Appeals held against the taxpayer, however, concluding that the assets were capital, rather than "trade or business," assets in its hands, because of the parent's ownership of the assets for a minimal, transitory period.

Subsequently to *Acro*, the IRS issued two published rulings, Rev. Rul. 75-223, 1975-1 C.B. 109, and Rev. Rul. 77-376, 1977-2 C.B. 107, concerning "partial liquidations" under the Internal Revenue Code as then in effect. The rulings address whether a sale of assets by a subsidiary and distribution of the proceeds by the subsidiary to the parent (pursuant to a plan of complete liquidation of the subsidiary) and thereafter by the parent corporation to its shareholders, qualified as a partial liquidation of the *parent* corporation.

The applicable Regulations set forth, as an example of a partial liquidation, a distribution resulting from "a genuine contraction of the corporate business." The rulings cited above, in reaching the conclusion that a partial liquidation had occurred, explain that a parent corporation into which a subsidiary is liquidated generally inherits the tax attributes of the subsidiary, so that, "[f]or most practical purposes, the parent corporation, after the liquidation of the subsidiary, is viewed as if it had always operated the business of the liquidated subsidiary."

The court in *Dover* noted that the position of the IRS in these rulings had been reaffirmed in a 1997 General Counsel Memorandum, in several private letter rulings applying the principles of the two published rulings to distributions intended to qualify as distributions in partial liquidation, and in a private letter ruling involving a deemed dividend in the context of an amalgamation of CFCs.

In applying these authorities in *Dover*, the court declined to follow the argument of the IRS that its own published guidance should be limited to the context of partial liquidations, since the court failed to see any basis for not applying the same rationale in the present case. The court further found that the published rulings and GCM cited above effectively precluded the IRS from continuing to rely on the principles previously articulated in *Acro* to deem Dover UK to hold the assets of H&C for any purpose other than for use in Dover UK's trade or business.

The court also found support for petitioner's position in a portion of the "check-the-box" Regulations which states that, if a business entity is disregarded, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." This treatment is not conditioned on there being a minimum period of time after the election during which the parent owns the disregarded entity. Taking all these authorities into account, the court found that Dover Corp. was correct to believe that the effect of H&C's disregarded entity election was to cause Dover UK to be viewed for Federal tax purposes as holding H&C's assets for the same "business" purpose that the assets had been held by H&C.

Observations

The Tax Court opinion seems to reflect a lack of patience with the failure of the IRS to act decisively with respect to well-publicized concerns concerning possible abuses of the check-the-box rules, especially in the foreign context. As the opinion notes, amendments to the Regulations had been proposed by the IRS in 1999 to deal with certain perceived abuses in the foreign context, but were withdrawn after a number of unfavorable comments.

The court further observed that the IRS in the Regulations could have imposed a requirement of minimum period of operations as a disregarded entity be-

fore treating the owner as being engaged in the trade or business of the subsidiary, but did not do so. The court concluded that it must apply the Regulations as written. On that basis, the assets of H&C were viewed as held by Dover UK for use in Dover UK's trade or business, and Dover Corp. prevailed in its position that the gain from the sale of the stock of H&C was not currently taxable to Dover UK's US shareholder.

Arguments could be made on both sides as to whether the ultimate result sought by the petitioner in this case gave rise to an abuse; indeed, legislation to overturn the result in *Dover* has been introduced in Congress. It seems likely, though, that most practitioners reviewing this decision will agree with the court's view that, to the extent the check-the-box Regulations themselves encouraged a perceived abuse of the tax system, the proper remedy for the IRS was to amend the Regulations, rather than to take positions in litigation that are difficult to reconcile with relatively well-established tax principles in other contexts concerning the consequences of the liquidation of a subsidiary into its corporate parent.

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