Selected US Tax Developments

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RECENT DEVELOPMENTS MAKE IT EASIER FOR US-BASED MULTINATIONALS TO DISPOSE OF FOREIGN SUBSIDIARIES

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One area of tax planning that has benefited greatly from the flexibility provided by the US check-the-box rules for classifying eligible entities is planning for the disposition of foreign subsidiaries. This article describes the so-called check-and-sell technique, and explores two recent developments that have had a favourable impact on that strategy.

KEYWORDS: CFC ■ SALE OF A BUSINESS

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One of the central features of the US income tax regime applicable to US-based multinational companies is that operating income of the group's foreign subsidiaries or a sale of their operating assets is generally not subject to US taxation until the

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earnings are repatriated to the United States.[1] In contrast, the gain on a sale by a foreign subsidiary of the stock of a lower-tier foreign subsidiary is subject to current taxation as subpart F income, even if the proceeds of the sale are retained by the selling subsidiary. One technique that taxpayers have used to defer the gain on a sale of a foreign subsidiary involves the US elective regime for classifying eligible entities as corporations or passthrough entities for US federal tax purposes ("the check-the-box rules"). In May 2004, this so-called check-and-sell technique survived a court challenge by the Internal Revenue Service (IRS).[2] In a more recent development, the American Jobs Creation Act of 2004[3] included an amendment to Code section 954 that significantly expands the scope of transactions that may benefit from the check-and-sell technique.

BACKGROUND

Code section 951 requires the United States shareholders of a controlled foreign corporation (CFC) to include in their income for the taxable year their proportionate share of the CFC's subpart F income.[4] The subpart F income of a CFC includes various categories of income specified in section 952, including foreign base company income. Such income is defined to include, among other things, certain passive income constituting foreign personal holding company income (FPHCI), including dividends, interest, royalties, rents, and annuities.[5] Of particular importance to the topic of this article, FPHCI also includes the excess of gains over losses from the sale or exchange of property that (1) gives rise to such passive income; (2) is an interest in a trust, partnership, or real estate mortgage investment conduit (REMIC); or (3) does not give rise to any income.[6]

The applicable Treasury regulations significantly expand the categories of gain that will result in FPHCI. Such gain includes not only gain from property that does not actually give rise to any income (as described in the statute), but also gain from

1 One notable exception exists for foreign base company sales or services income, to which the anti-deferral rules of subpart F of the Code apply. (Internal Revenue Code of 1986, as amended, herein referred to as "the Code." Unless otherwise stated, statutory references in this article are to the Code.) Note also that under Code section 956 earnings that have not actually been distributed by the foreign subsidiary to the US parent may be treated as having been repatriated if the earnings are invested in the United States or if the subsidiary's assets are pledged to support indebtedness of US members of the corporate group.

2 *Dover Corporation*, 122 TC 324 (2004).

3 American Jobs Creation Act of 2004, Pub. L. no. 108-357, enacted on October 22, 2004.

4 A CFC is generally any foreign corporation that is more than 50 percent owned (measured by vote or value) by United States shareholders. A "United States shareholder" is defined in section 951(b) to include only a US person that owns a 10 percent or greater voting interest in the CFC.

5 Code sections 954(a) and 954(c)(1)(A).

6 Code section 954(c)(1)(B).

property that does give rise to income (even to active income) unless the property is "used or held for use in" the CFC's trade or business.[7] How do these rules apply to a sale of an operating subsidiary? Consider the following example, illustrated in figure 1, in which a US corporation owns a two-tier structure of CFCs.

If Opco sells all of its assets, the gain recognized from the sale of those business assets will not constitute FPHCI, and USco will not be required to include the gain in its income until the proceeds are distributed by Opco.[8] In contrast, if Holdco sells all of the stock of Opco, the transaction will result in FPHCI, which will cause USco, the US shareholder of the selling CFC, to be subject to subpart F income inclusions. However, there are often competing considerations that can make a direct sale of the operating subsidiary's assets impracticable or undesirable. First, there may be regulatory restrictions (for example, banking or insurance laws) that prevent the subsidiary from transferring its assets or that prevent the business of the subsidiary from being conducted by another entity. In addition, a sale of the subsidiary's assets may have more adverse foreign income tax consequences than would a sale of its stock, as well as adverse real property or other local transfer tax consequences.

CHECK-AND-SELL TECHNIQUE

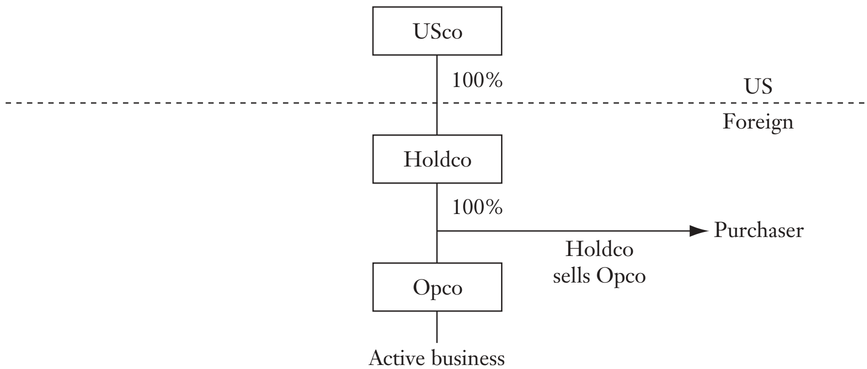
Although the foregoing issues may preclude an actual sale of the operating subsidiary's assets, it is often possible to achieve the desired US federal tax treatment by filing a "check-the-box election" under Treas. reg. section 301.7701-3(c). An entity or its owner may change the entity's classification for US federal tax purposes as a separate body corporate or as a fiscally transparent passthrough entity by filing an election designating how the entity wishes to be classified (unless the entity is considered a per se corporation under the applicable regulations). An entity that elects passthrough treatment will be treated as a partnership if it has more than one owner and will be disregarded as an entity separate from its owner (in a manner similar to a branch) if it has a single owner. If an entity is disregarded, its activities are treated in the same manner as a branch or division of the CFC parent and the parent is treated as directly owning all of the subsidiary's assets.[9] In the structure illustrated in figure 1, because Opco is 100 percent owned by Holdco, assuming that Opco is an eligible entity, it can elect to be treated for US tax purposes as a disregarded entity. As a result, a sale of the stock of Opco following a check-the-box election would be treated for US tax purposes as a sale of the subsidiary's

7 The importance of this distinction will become more evident in the discussion below of the IRS's argument against check-and-sell transactions.

8 Once the proceeds are distributed by Opco to Holdco, USco will be required to include the income under subpart F, even if Holdco does not distribute the income to USco, because the dividend in the hands of Holdco will constitute subpart F income.

9 Treas. reg. section 301.7701-2(a).

FIGURE 1



assets.[10] Thus, the check-and-sell technique converts what would otherwise be subpart F income into "good" income that is eligible for deferral until the gain is distributed by Holdco to USco.

Canadian Variation

The range of entities treated as per se corporations is fairly narrow, and for most foreign jurisdictions the regulations consider only public limited companies or their equivalents to be per se corporations. In the case of Canada, however, the entity classification rules treat any Canadian corporation or company as a per se corporation for US tax purposes unless the entity is a Nova Scotia unlimited liability company (NSULC) or the owners of the entity otherwise have unlimited liability under Canadian federal or provincial law.[11] Therefore, a typical Canadian company is not eligible to file a check-the-box election and avail itself of the check-and-sell technique. However, an alternative that may lead to a similar result would be to convert the Canadian subsidiary into an Alberta ULC.[12] Such a transaction could be structured to qualify for tax-free treatment in Canada, but would be treated as a liquidation of

10 Compare the tax treatment of a sale of the stock of a qualified real estate investment trust (REIT) subsidiary (QRS) or a qualified subchapter S subsidiary (QSSS) (both of which are treated as disregarded entities), where the selling shareholder is treated as having transferred the assets of the subsidiary to a newly formed corporation immediately before the sale and as having sold the stock of the subsidiary. The reason for the difference in treatment between a sale of those entities and a sale of an entity disregarded by reason of a check-the-box election is that the QRS and QSSS elections are specific to REIT and S corporation shareholders, respectively, and the subsidiaries are eligible to be disregarded only if they are owned by the selling REIT or S corporation. In contrast, a check-the-box election continues to be effective even if the ownership of the entity changes.

11 Alberta recently passed legislation authorizing the creation of an unlimited liability corporation (ULC), which is also eligible to file a check-the-box election.

12 Another alternative would be to convert the subsidiary into an NSULC by continuing it into Nova Scotia and then amalgamating it into an NSULC.

the company for US tax purposes.[13] Note that a ULC would be treated as a pass-through entity by default, so no check-the box election would be necessary here.

IRS POSITION ON CHECK-AND-SELL STRATEGY

The first pronouncement by the IRS on the check-and-sell technique was a technical assistance memorandum issued in 1999.[14] The fact pattern addressed in the memorandum was substantially identical to the one described above and involved a sale by a CFC (FC 1) of the assets of a former foreign subsidiary (FC 2) following a liquidation of the subsidiary. The memorandum described two situations, one in which the subsidiary was actually liquidated and another in which a check-the-box election was made to treat the subsidiary as a disregarded entity (in both cases immediately before the sale was completed). Largely foreshadowing the arguments made by the IRS in *Dover*,[15] described below, the IRS reasoned that because FC 1 acquired the assets of FC 2 after it entered into a commitment for the sale of those assets, FC 1 did not use or hold the assets for use in its trade or business. Therefore, the gain would not be excludable from FC 1's subpart F income.

Later in the same year, Treasury issued proposed regulations ("the extraordinary transaction rule") amending the check-the-box regulations.[16] The proposed amendments would have invalidated any election to treat a foreign eligible entity as a disregarded entity if

1. a 10 percent or greater interest in the foreign eligible entity is sold, exchanged, transferred, or otherwise disposed of in one or more transactions that occur in the period commencing one day before and ending 12 months after the effective date of the foreign eligible entity's change in classification to a disregarded entity; and
2. the entity was previously classified as a corporation at any time during the preceding 12-month period.

The preamble to the proposed regulations explained that the proposed rule was intended to address inappropriate federal tax consequences that would otherwise

13 If an indirectly US-owned subsidiary is being formed with the expectation that it will ultimately be sold, it might be simpler (subject to provincial tax considerations) to form it as a ULC in the first instance. If corporate treatment is desired for other purposes, the ULC could elect to be treated as a corporation for US tax purposes upon its formation and, in the event of a sale, could elect to be disregarded. (The regulations prohibit an entity that makes a check-the-box election from making a second election to reverse its classification within five years, but this prohibition does not apply to an initial election made effective on the date of the entity's formation.)

14 Technical Assistance 199937038, June 28, 1999.

15 Supra note 2.

16 Proposed Treas. reg. section 301.7701-3(h) was issued on November 29, 1999 (1999-2 CB 670), and was withdrawn by Notice 2003-78, 2003-48 IRB 1172, effective October 22, 2003.

result under a number of international provisions of the Code, including "the disposition of ownership interests under Subpart F."[17] The new rules were proposed to be effective on a prospective basis following publication of final regulations in the *Federal Register*.

The IRS subsequently issued two field service advice memorandums addressing situations in which CFCs had made check-the-box elections for a foreign subsidiary immediately before a sale of the subsidiaries' stock.[18] In both cases, the IRS concluded that the assets deemed to have been sold by the CFCs were not used or held for use by the CFCs in their trade or business and that the gain resulted in FPHCI. Reportedly, Dover Corporation was the subject of one of those memorandums.[19]

The proposed extraordinary transaction rule was widely criticized by commentators.[20] One of the strongest criticisms was that the perceived abuses targeted by the rule are not specific to deemed liquidations under the check-the-box regulations, but would equally arise from the tax treatment of actual liquidations in those situations. Commentators argued that if the IRS believes that such transactions constitute impermissible tax avoidance, it should promulgate rules under the specific provisions so as to shut down abuses for both actual and deemed liquidations. If, however, the IRS believes that the targeted transactions are permissible techniques where the entity to be sold is actually liquidated, there appears to be no policy justification for denying taxpayers access to benefits only in the case of deemed liquidations resulting from a check-the-box election. In the face of this criticism, the IRS, in Notice 2003-46, announced that it would withdraw the proposed extraordinary transaction rule.[21] The proposed regulations were formally withdrawn on October 22, 2003.[22] However, the withdrawal of the proposed regulations did not mean that the IRS had abandoned its views on check-and-sell transactions. In fact, Notice 2003-46 states as follows:

> The IRS and Treasury remain concerned about cases in which a taxpayer, seeking to dispose of an entity, makes an election to disregard it merely to alter the tax consequences of the disposition. The IRS will continue to pursue the application of other

17 Other provisions mentioned in the preamble are the ones governing source of income under sections 861 through 865, foreign tax credit limitation categories under section 904, and outbound transfers under section 367.

18 Field Service Advice 200049002, May 24, 2000 and Field Service Advice 200046008, August 4, 2000.

19 Lowell D. Yoder and Sheri L. Everson, "Check-and-Sell Transactions: Proposed Regulations Withdrawn, But Still Under Attack" (2003) vol. 32, no. 10 *Tax Management International Journal* 515-43, at 524, note 80.

20 See, for example, David S. Miller, "Snake in the Box: The Hazards of Policymaking with 'Anti-Abuse' Rules" (2000) vol. 89, no. 1 *Tax Notes* 107-19.

21 2003-28 IRB 53.

22 See supra note 16.

> principles of existing law (such as the substance over form doctrine) to determine the proper tax consequences in such cases. . . .
>
> In addition, the IRS and Treasury are continuing to examine the potential use of the entity classification regulations to achieve results inconsistent with policies and rules of particular Code provisions or U.S. tax treaties. In contrast to the approach of the extraordinary transaction rule, which would operate to change the classification of an entity if certain conditions are met, this examination will focus on ensuring that the substantive rules of particular Code provisions and U.S. tax treaties reach appropriate results notwithstanding changes in entity classification.

The notice then singles out two transactions that the IRS is considering. One is the use of a check-the-box election that becomes effective immediately after an outbound stock-for-stock transfer of a foreign subsidiary, which converts what would otherwise be a "B" reorganization into an asset (a "C" or a "D") reorganization.[23] One benefit of this technique is that in a B reorganization, the shareholders are required to enter into a gain recognition agreement to avoid gain recognition under section 367(a), but generally no gain recognition agreement is required under the section 367 regulations for an asset reorganization.[24] The second transaction identified in the notice as a source of concern to the IRS is the check-and-sell technique. Thus, the notice made it clear that the IRS had not retreated from its position regarding check-and-sell transactions, as expressed in ITA 199937038,[25] FSA 200049002,[26] and FSA 200046008.[27]

23 The letters "B," "C," and "D" denote reorganizations described in subparagraphs (B), (C), and (D) of Code section 368(a)(1).

24 Treas. reg. section 1.367(a)-3(a). Note that the transaction described in Notice 2003-46 differs slightly from one singled out in the preamble to the proposed extraordinary transaction rule, in which a check-the-box election is made effective immediately *before* the stock of the foreign corporation is transferred by its corporate shareholder in order to enable the transaction to qualify for the active trade or business exception of temp. Treas. reg. section 1.367(a)-2T. Ironically, the preamble to the final section 367(a) regulations states that unless the acquiring corporation intends to dispose of the target assets shortly after the transaction, the use of the check-the-box election to qualify for the trade or business exception is not inconsistent with the purpose of section 367(a) and the form of the transaction will be respected. The willingness of the IRS to bless this technique while rejecting the check-and-sell technique (even though both techniques use the check-the-box election to gain access to the trade or business of the subsidiary) can be explained by the differing roles played by the trade or business in the two techniques. In the check-and-sell technique, the taxpayer seeks to treat the existing shareholder as having conducted the historical trade or business of the subsidiary. In contrast, the section 367 active trade or business exception merely requires that the transferee use the assets in a trade or business in the future.

25 Supra note 14.

26 Supra note 18.

27 Ibid.

DOVER

The check-and-sell strategy came before the Tax Court in *Dover Corporation*,[28] which involved the following facts. During 1997, Dover Corporation was the common parent of an affiliated group of US corporations that filed a consolidated return. Dover also owned (directly or indirectly through its US subsidiaries) a number of foreign corporations including a UK corporation, Dover UK Holdings Limited ("Dover UK"). Dover UK in turn owned a UK operating subsidiary, Hammond & Champness Limited ("H & C"), which was engaged in the business of installing and servicing elevators in the United Kingdom. On June 30, 1997, Dover UK entered into an agreement with a German corporation for the sale by Dover UK to the German corporation of all of the outstanding stock of H & C. The agreement provided that it and related documents would be held in escrow until July 11, 1997, pending the completion of the purchaser's due diligence and the purchaser's determination to proceed with the sale. The agreement provided for the sale to be completed on July 11, 1997, on which date the purchaser was required to deliver the purchase price for the H & C shares. On July 11, 1997, the purchaser notified Dover UK that the escrow conditions had been satisfied and the sale was completed.[29]

By letter dated December 3, 1998, Dover Corporation, on behalf of H & C, requested that the IRS grant an extension of time, pursuant to Treas. reg. sections 301.9100-1(c) and 301.9100-3, for H & C to file a retroactive check-the-box election to be treated as a disregarded entity effective June 30, 1997, immediately before the sale of the stock of H & C by Dover UK. The IRS was initially reluctant to grant the request for relief because of the potential impact the election would have in enabling Dover UK to take the position that the sale of H & C should be characterized as an asset sale from which no FPHCI would result. Ultimately, the IRS agreed to issue the ruling, with the caveat that no inference was to be drawn from the ruling that the sale of H & C did not result in FPHCI. A statement to that effect was included in the ruling.[30] The taxpayer did not report any subpart F income from the sale of H & C, and the IRS issued a notice of deficiency asserting an increase in the taxpayer's subpart F income in the amount of approximately $25 million in connection with the sale of H & C.

The taxpayer made two arguments. First, the taxpayer argued that under the check-the-box regulations Dover UK should be treated not only as having sold H & C's assets but also as having been engaged in H & C's historical business at the time of the sale of the assets. Accordingly, under Treas. reg. section 1.954-2(e)(3)(ii), the assets that were sold should not be treated as "property that does not give rise to income," so the sale should not result in FPHCI.

28 Supra note 2.

29 The Tax Court's opinion notes that the parties' stipulations did not state when the purchase price was paid, but the court assumed that payment occurred on July 11.

30 The ruling issued to Dover appears to be PLR 200027010, March 31, 2000.

Alternatively, the taxpayer argued that Treas. reg. section 1.954-2(e)(3)(ii) goes beyond the plain language of the statute and is therefore invalid. To avoid FPHCI under the regulation, the assets sold have to be used or held for use in a trade or business, but to avoid FPHCI under the statute, an asset must merely not give rise to any income. However, the Tax Court ruled in favour of the taxpayer on the basis of the first argument and, accordingly, did not address the issue of the validity of Treas. reg. section 1.954-2(e)(3)(ii).[31]

In support of its argument that Dover UK should be treated as having been engaged in H & C's historical trade or business, the taxpayer argued that the sale of H & C actually occurred on July 11, 1997, while the check-the-box election approved by the IRS was effective on June 30, 1997. Thus, there was an 11-day intervening period during which the H & C business should be treated as having been operated by Dover UK. However, the court held this issue to be moot because it concluded that Dover UK should be viewed as being engaged in H & C's historical business and as having used H & C's assets in that business even if the check-the-box election were effective immediately before the sale.[32]

At the outset of its analysis, the Tax Court looked to a pair of published rulings issued under former Code section 346(a)(2). The court held that those rulings stand for the proposition that a corporation that receives a distribution of assets from a subsidiary in a section 332 liquidation is treated as stepping into the shoes of the subsidiary with respect to the subsidiary's trade or business, and is therefore treated as having used the subsidiary's assets in its trade or business. Section 346(a)(2) was the predecessor to the provisions that currently appear in Code section 302(b)(4) and section 302(e), which allow capital gain treatment for a partial liquidation of a corporation following the termination of an active trade or business of the corporation.

Rev. rul. 75-223[33] addressed whether the active trade or business requirement of section 346(a) is satisfied in the following three situations where the qualified business was conducted by *a subsidiary* of the distributing corporation:[34]

31 For a discussion of the arguments on the invalidity of Treas. reg. section 1.954-2(e)(3), see Yoder and Everson, supra note 19.

32 In the course of discussing the taxpayer's argument regarding the timing of the sale, the court raised an interesting point. The court noted that both the taxpayer's ruling request for an extension to file the check-the-box election and the ruling issued by the IRS referred to the election's being effective immediately prior to the sale. Given the mutual understanding of the parties that the election was to be effective immediately before the sale, the court suggested that the election might appropriately be treated as effective immediately before the sale even if the sale occurred on July 11, regardless of the date stated on the election form.

33 1975-1 CB 109.

34 Although section 346(a)(2), like section 355(b), did not require that the distributing corporation have been the one conducting the qualified trade or business for the entire five-year period (as long as the business was not acquired by the distributing corporation in a taxable transaction), the statute was interpreted to require that the distributing corporation be engaged in the business immediately before the distribution in order for the distribution to be "attributable to the corporation's ceasing to conduct" the business.

1. the subsidiary is liquidated immediately before the business is sold by the distributing corporation;
2. the subsidiary is liquidated immediately after it sells the business; or
3. the business is not sold at all, but rather the stock of the subsidiary is distributed to the shareholders of the distributing corporation.

In its analysis, the IRS focused on the statutory scheme of Code section 381, under which the parent corporation in a section 332 liquidation succeeds to, among other attributes, the earnings and profits, net operating loss carryovers, and accounting methods of the liquidated subsidiary. The IRS reasoned that for most practical purposes the parent corporation, after the liquidation of the subsidiary, is viewed as if it had always operated the business of the subsidiary, and that consequently there is no meaningful distinction, for the purposes of section 346(a)(2), between a corporation that distributes the assets of a division (or the proceeds of a sale of those assets) and one that distributes the assets of a liquidated subsidiary (or the proceeds of the subsidiary's assets). On the basis of this analysis, the IRS concluded that both the first and the second situations should satisfy the requirements of section 346(a)(2).[35] Rev. rul. 75-223 was followed by the IRS in a second published ruling and in a number of private letter rulings involving partial liquidations.[36]

The Tax Court noted that the IRS has reached similar conclusions in other contexts. Rev. rul. 72-356[37] addressed whether the surviving corporation in a statutory merger must take into account the history of the merged corporation in satisfying the requirements of former Code section 921. In order to qualify as a Western Hemisphere trade corporation, 95 percent of the corporation's gross income for the three preceding years was required to be from foreign sources, and 90 percent of such income had to be derived from the active conduct of a trade or business. By analogy to the rules of section 381 (and the cases preceding the enactment of that section), the IRS ruled that the surviving corporation should be treated not only as having succeeded to the historical gross income of the merged corporation, but also as having earned that gross income in the active trade or business previously conducted by the merged corporation.

The court also discussed a private ruling issued by the IRS under subpart F, in which the IRS followed Rev. rul. 72-356. That ruling involved a CFC that exchanged its shares in a foreign subsidiary for stock and debentures in a newly formed corporation (Newco).[38] The transaction qualified as a reorganization, but the debentures

35 In the third situation, however, the IRS concluded that section 346(a)(2) would not apply because there had been no liquidation of the subsidiary, so the business of the subsidiary could not be attributed to the parent.

36 See Rev. rul. 77-367, 1977-2 CB 193; PLR 200301029, September 30, 2002; PLR 200004029, November 2, 1999; and PLR 8704063, October 29, 1986.

37 1972-2 CB 452.

38 PLR 8019058, February 13, 1980. See also PLR 8017051, January 29, 1980 and PLR 8047056, August 27, 1980.

resulted in a dividend under Code section 356. Other related corporations were also reorganized into Newco. The ruling addressed the consequences of the dividend under the "same country exception" of section 954(c)(3)(A)(i) and Treas. reg. section 1.954-2(e)(1)(i) (the predecessor of Treas. reg. section 1.954-2(b)(4)(i)(A)), under which a dividend paid to a CFC by a corporation that (1) is related to the CFC, (2) is formed under the laws of the same country as the CFC, and (3) has a substantial part of its assets used in its trade or business located in the same foreign country is excluded from FPHCI. This exception applies only if the earnings out of which the dividend is paid were accumulated during a period when all of the three foregoing requirements were satisfied. The IRS ruled that if the dividend paid by Newco is paid out of earnings of a foreign subsidiary to which Newco succeeded under section 381, the dividend would be eligible for the exception from FPHCI as long as the earnings were accumulated during a period in which *the predecessor* of Newco met the three specified requirements. In other words, the IRS viewed Newco as succeeding to the attribute of its predecessor with respect its having been engaged in a trade or business.[39]

The court also discussed a Tax Court case from 1962, *Acro Manufacturing Co.*, which it found to be directly on point.[40] *Acro* involved a corporation that received an offer to buy the stock or assets of a subsidiary. In order to avoid a capital loss on the sale of the subsidiary's stock, the taxpayer liquidated the subsidiary and sold its assets, and reported the loss as an ordinary loss incurred on a sale of inventory, accounts receivable, and depreciable assets used in a trade or business. Finding that the taxpayer acquired the assets from its subsidiary in order to sell them and not to use them in its trade or business, the court rejected the taxpayer's argument that the character of the assets as assets held for use by the subsidiary in its trade or business carried over to the taxpayer following the section 332 liquidation of the subsidiary. The Tax Court's decision in *Acro* was subsequently affirmed by the Sixth Circuit on appeal.[41]

The court agreed that its prior decision in *Acro* supported the position of the IRS that Dover UK should not be viewed as having held the assets it received from H & C for use in a trade or business. However, the court held that by issuing Rev. rul. 75-233 the IRS had conceded that it disagreed with the holding in *Acro*. Accordingly, the taxpayer was justified in relying on the IRS's stated position in Rev. rul. 75-233 that

39 The holdings in PLR 8019058, supra note 38, and Rev. rul. 72-356, supra note 37, could arguably be explained on more narrow grounds—namely, that where a successor corporation in a section 381 transaction succeeds to the earnings and profits of its predecessors, those earnings and profits retain their historical attributes, such as whether they were earned in an active trade or business. It does not necessarily follow that the successor is itself treated as having been engaged in such trade or business for purposes other than determining the attributes of the inherited earnings. The court, however, did not draw such a distinction.

40 39 TC 377 (1962). The court also discussed some other cases cited by the IRS to support its position that Dover UK was not holding the assets of H & C for use in a trade or business, but none of those cases involved a corporation succeeding to another corporation's tax attributes under section 381, and the court found them to be distinguishable on that basis.

41 334 F. 2d 40 (6th Cir. 1964).

a corporation that receives the assets of a subsidiary in a section 332 liquidation is treated as being engaged in the trade or business of the subsidiary and as having used the assets it received from the subsidiary in that trade or business.

The court further held that a careful reading of the language of the check-the-box regulations supported the court's conclusion. Treas. reg. section 301.7701-2(a) provides that if an entity is disregarded under the regulations, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." The court referred to *The American Heritage Dictionary* and *Black's Law Dictionary* to define the terms "branch" and "division" as meaning parts of an operating business. The court interpreted the regulations as providing that the owner of a disregarded entity is treated under the regulations as being engaged in the disregarded entity's business. Because the regulations do not require any minimum period of time after the election is effective for the entity to be treated as a branch or division of the owner, reasoned the court, it follows that the approach adopted by the regulations rejects the holding of *Acro*.[42]

ANALYSIS OF DOVER

The court's reading of the phrase in the check-the-box regulations that if an entity is disregarded "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner" seems overly literal. For example, suppose that the entity was owned by an individual on the effective date of the election and the deemed liquidation was not eligible for tax-free treatment under section 332. Alternatively, suppose that the disregarded entity does not, and never did, conduct a business at all, but simply holds a passive investment. Is it fair to read the regulations as requiring that the entity be treated as a branch that is engaged in a trade or business? A more reasonable interpretation of the language on which the court focused is that the activities of the disregarded entity are treated as activities of the owner *in the same manner that activities of a branch are treated as activities of the owner*; but if the activities would not have constituted a trade or business if they were conducted directly by the owner (whether because the activities are passive or because the owner intends to immediately sell the entity's assets), then the activities should not constitute a trade or business merely because they are conducted by a disregarded entity.

Nevertheless, the court's holding still seems justified in light of the position taken by the IRS in Rev. rul. 75-223. Even though section 346(a)(2) was removed from the Code in 1982, Rev. rul. 75-223 is far from a dead letter and continues to be cited as authority in private rulings issued by the IRS under section 302(b)(4), the successor to section 346(a)(2).[43] The court's decision also seems correct as a policy matter. The difference in treatment under subpart F of a sale of a wholly owned operating subsidiary and a sale of the assets of the subsidiary is purely a matter of form over substance. As a result, it does not seem offensive that taxpayers are able

42 See *Dover*, supra note 2, at 335.

43 See, for example, PLR 200301029, September 30, 2002.

to resort to self-help to adapt the form of their transactions to avoid being trapped by section 954(c)(3)(A). Note that the IRS is not pursuing an appeal in *Dover*.

Impact on Acro

The Tax Court did not overrule its prior decision in *Acro*, but the rationale for the court's decision appears to prevent the IRS from relying on *Acro* in the future unless the IRS issues a regulation or a published ruling concluding that a check-the-box election followed by a sale of a disregarded entity will result in FPHCI. Such a ruling would undermine the basis for the court's holding in *Dover* that taxpayers are entitled to rely on the position of the IRS expressed in Rev. rul. 75-223. As a policy matter, however, it is difficult to see why the trade or business of a subsidiary should be attributed to the shareholder in a section 332 liquidation for the purposes of section 346(a)(2) or 302(b)(4) but not for the purposes of section 954(c). Note that taxpayers should still be able to rely on *Acro* when it leads to a taxpayer-favourable result, though there is a risk that the IRS will seek to have the Tax Court overrule *Acro* in the future.

Substance-over-Form and Step Transaction Issues

It is interesting to note that the IRS did not attempt to argue that the transitory ownership of H & C's assets by Dover UK should be ignored for tax purposes under a substance-over-form analysis or the step transaction doctrine. Treas. reg. section 301.7701-3(g)(2)(i) provides that "the tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of the section is determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine." However, the IRS may have been reluctant to challenge the form of the transaction, because the court might have concluded that H & C should be treated as having sold its business assets to the seller directly, which would of course not have resulted in any subpart F income.[44]

Business Purpose

Dover suggests that in some respects taxpayers may be able to use check-the-box elections to achieve tax results that might not be available if the transactions that are deemed to occur under the regulations were actually undertaken. In particular, there have been a number of cases in which courts have disregarded the tax consequences of a transaction actually undertaken by the taxpayer where the transaction lacked a significant business purpose.[45] The Tax Court in *Dover* noted (albeit in obiter dicta) that the check-the-box regulations require no business purpose for

44 See Lee A. Sheppard, "The Undead Subpart F" (2004) vol. 34, no. 9 *Tax Notes International* 892-98, pointing out that such an approach could be supported by *Commissioner v. Court Holding Co.*, 324 US 331 (1945), which involved a corporation that negotiated a sale of its sole asset, but then liquidated instead to enable its shareholder to sell the asset to the same buyer on a tax-free basis.

45 See, for example, *ACM Partnership*, 73 TCM 2189 (1997); aff'd. 98-2 USTC 50,790 (3d Cir. 1998).

any election under the regulations.[46] Indeed, given the nature of a check-the-box election as purely a creature of the tax law, it is hard to see how any election could ever have a business purpose apart from achieving a reduction in taxes.

EXPANDED CHECK-AND-SELL OPPORTUNITIES FOR NON-WHOLLY-OWNED SUBSIDIARIES

The discussion in this article to this point has dealt with a situation in which the subsidiary being sold is a wholly owned subsidiary of the CFC seller. Suppose instead that a portion of the shares of Opco is owned by a separate foreign subsidiary of USco, as illustrated in figure 2.

If Opco files a check-the-box election to be treated as a passthrough entity, Opco will still be treated as having been liquidated. However, unless Holdco owns at least 80 percent of the voting power and value of Opco's outstanding stock, the deemed liquidation of Opco will be taxable under Code section 331.[47] Moreover, any gain recognized by Holdco on the disposition of its stock in Opco in the deemed liquidation of Opco will result in subpart F income.[48]

Assume that Holdco does own the requisite 80 percent of Opco and the deemed liquidation therefore qualifies for tax-free treatment under Code section 332. Because Opco has more than one owner, rather than becoming a wholly owned disregarded entity of Holdco, Opco will instead become a partnership for US federal tax purposes. If Holdco sells the stock of Opco, then, rather than being treated as having directly sold the assets of Opco (as it would be if Opco were wholly owned by Holdco), Holdco will be treated as having sold a partnership interest. However, under Code section 954(c)(1)(B) gain from a sale of an interest in a partnership would result in subpart F income.

Thus, prior to the enactment of the American Jobs Creation Act, the check-and-sell strategy could not be used where the subsidiary had more than one owner. The Act added a lookthrough rule under which a sale of a partnership in which a CFC is a 25 percent owner is treated as a sale by the CFC of its proportionate share of the assets of the partnership.[49] Although this change was not directed toward check-and-sell transactions in particular, taxpayers should now be able to use the check-and-sell strategy for non-wholly-owned subsidiaries. However, even though the lookthrough rule for sales of partnership interests has a 25 percent ownership threshold, the

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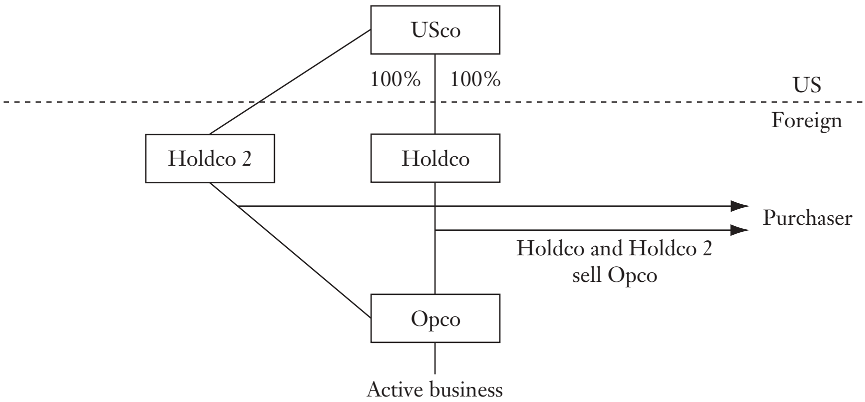
46 *Dover*, supra note 2, at 335, note 19.

47 See Code section 332(b)(1) and section 1504(a)(2). For the purposes of the 80 percent test, certain non-voting preferred stock is not taken into account. Note that ownership by multiple foreign subsidiaries of the same parent is not aggregated. Compare Treas. reg. section 1.1502-34, which aggregates the ownership of members of a US consolidated group for the purposes of the section 332 ownership test.

48 Opco would also recognize gain on the distribution of its assets to Holdco in the liquidation. IRC section 336. That gain, however, would not result in subpart F income because Opco's assets are held for use in its trade or business.

49 Code section 954(c)(4).

FIGURE 2



check-and-sell technique will not be effective unless the taxpayer meets the 80 percent ownership requirement of section 332.

To what extent does *Dover*, which involved a sale of a wholly owned subsidiary, support the position that a check-the-box election that becomes effective immediately before the sale of an 80 percent owned subsidiary avoids subpart F income? The central holding of the court in *Dover* was that a shareholder who receives assets from a subsidiary in a section 332 liquidation steps into the subsidiary's shoes and is treated as having been engaged in the trade or business of the subsidiary and as having used the subsidiary's assets in the trade or business. This rationale applies with equal force to an 80 percent owned subsidiary.[50] Thus, taxpayers should be able to rely on *Dover* even in situations where the subsidiary has more than one owner.

CONCLUSION

The decision of the Tax Court in *Dover* should give taxpayers some comfort in using the check-and-sell strategy to avoid subpart F income on the sale by a CFC of an operating subsidiary. In addition, as a result of the American Jobs Creation Act's amendment to section 954(c)(4), taxpayers will be able to make use of the check-and-sell technique even where the subsidiary that is being sold is not 100 percent owned by the CFC. However, the check-and-sell technique is not a viable strategy unless the target is at least 80 percent owned by the selling CFC.

50 The language in Treas. reg. section 301.7701-2(a) on which the court also relied—namely, the phrase "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner"—refers to a wholly owned subsidiary. However, the court did not appear to rely on this language as an independent basis for its conclusion. Rather, the court merely pointed to that language to support its assertion that the IRS's "acknowledgment that the business history and activities of a subsidiary carry over to its parent in connection with a section 332 liquidation of the subsidiary is also reflected in section 301.7701-2(a)." Supra note 2, at 335.