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Richard J. Kraus
rkraus@pace.edu

Joseph DiBenedetto
jdibenedetto@pace.edu

Roy J. Girasa
rgirasa@pace.edu

BARNES v. COMMISSIONER: USE OF THE STEP TRANSACTION DOCTRINE TO TAX A TRANSNATIONAL REINVESTMENT PLAN

by

Richard J. Kraus *
Joseph DiBenedetto**
Roy J. Girasa***

INTRODUCTION

The Barnes Group Inc. (Barnes) is a Bristol, Connecticut transnational corporation which manufactures industrial and aerospace components, including springs for airframes, machinery and turbine engines, providing repair and logistics support for the aerospace industry. Founded in 1857, this engineering group by 1999 operated three separate business enterprises through its domestic and foreign subsidiary corporations which oversaw significant operations in the United States, Europe, Latin America and Asia. In 2000 and 2001, Barnes and its subsidiaries executed an agreement and plan of reinvestment which sought to reallocate assets from Asia to the United States without incurring tax consequences.

*Professor of Law, Lubin School of Business, Pace University, Pleasantville, New York, e-mail: rkraus@pace.edu
** Professor of Law and Taxation, Lubin School of Business, Pace University, Pleasantville, New York, e-mail: jdibenedetto@pace.edu
*** Professor of Law, Lubin School of Business, Pace University, Pleasantville, New York, e-mail: rgirasa@pace.edu

At the end of 2000, due to aggressive acquisitions of related businesses in the United States and abroad, Barnes had some $230 million of outstanding long term debt and about $50 million due on its revolving credit line for its domestic business. The acquisitions had increased Barnes' cost of borrowing and debt-to-equity ratio, a highly unusual situation for any company within the industrial equipment and component industry[1]. Barnes planned to address its domestic problems through discussions with its Asian subsidiary, Associated Spring-Asia PTE Ltd. (ASA), a highly successful and cash-rich Singapore corporation which was a second tier Barnes subsidiary. This subsidiary conducted operations for Barnes' Associated Spring division, manufacturing and marketing precision, mechanical and nitrogen gas springs in Southeast Asia. As of September 1, 2000, ASA had approximately $12.9 million of existing cash reserves held in short-term accounts and another $26.1 million in cash receivables due from foreign affiliates. ASA possessed more than enough cash for its immediate operating needs. The discussions between the parent and the second tier subsidiary corporations resulted in a reinvestment plan geared to assist the domestic parent without incurring U.S. tax liability. This article will examine the reinvestment plan and its failure to fulfill its desired objective. The United States Tax Court and the Court of Appeals for the Second Circuit[2] indicated that Barnes improperly relied upon its tax advisers. The courts applied the step transaction doctrine procedure used by courts in any number of situations similar to the Barnes plan. The article will conclude with observations for the tax planner, counseling that valid business plans clearly appear in documents and be executed in accord with those documents.

THE SEARCH FOR A PLAN: SECTION 351 AND ITS REVENUE RULINGS; EXPERT ADVICE

Section 351

The United States Internal Revenue Code Section 351 and its Regulations describe the non-recognition of gain or loss for tax purposes if the corporation transferor exchanges its property solely for the stock of another corporation, if immediately after the exchange of stock for property, the transferor is also in control of the transferee corporation, owning at least 80% of its shares.

The section states:

> *§ 351 Transfer to Corporation controlled by transferor*
> *(a) General Rule*
> No gain or loss shall be recognized if property is transferred to a stock corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation
> *(b) Receipt of Property* If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then—
> (1) gain (if any) to such recipient shall be recognized, but not in excess of—
> (A) the amount of money received, plus
> (B) the fair market value of such other property received; and
> (2) no loss to such recipient shall be recognized[3].

Revenue Ruling 74-503 commented upon the Section 351 statements by indicating that if one corporation transfers treasury stock to another corporation and now owns 80% of newly issued stock in the transferee corporation, no gain or loss will occur. In 2006 Revenue Ruling 2006-2 indicated that the 1974 ruling was incorrect; the ruling was revoked because the Internal Revenue Service had recognized that gains or losses could occur even in the mere transfer for stock between corporations. The Service indicated, however, that any decisions made in reasonable reliance upon Revenue Ruling 74-503 before its revocation would be honored and not questioned.[4]

Expert Advice: Barnes' Officers and Accounting Consultants

The Barnes reinvestment plan resulted from a series of events concerning the company's strategy to expand the company through acquisitions. Between 1998 and 2000 Barnes hired an entirely new management team. Its Vice-President for Tax, with the other members of the management team, noted the precarious financial position of Barnes which had resulted from the acquisitions. As already mentioned, Barnes owed more than 230 million dollars to its creditors and 50 million dollars was due to its revolving credit line by the end of 2000. In May 2000, the team noted that the Singapore second tier subsidiary Associated Spring-Asia PTE Ltd. (ASA) had the 12.9 million dollars of existing cash reserves and 26.1 million dollars of cash receivables available. The team discovered that Barnes was earning approximately 3% interest on its investment holdings worldwide but that its domestic debt interest rates range from 7.13% - 9.47%. The Barnes management team sought a solution to this problem by discussing a reinvestment plan which would move ASA's cash reserves to the parent company Barnes Group Inc. The team clearly understood that either a dividend or a loan from ASA to Barnes would incur federal tax liability.[5]

The recently hired vice-president for tax had over 20 years of international tax experience with Pfizer Corp, Johnson & Johnson, ITT Sheraton Corp. Millipore Corp. and Loctite Corp. He approached Ernst & Young (EY) and Deloitte & Touche (Deloitte) for assistance in attempting to solve the interest rate differential problem without incurring federal income tax liability while retaining funds for overseas investment opportunities. After examining the solutions posited by these firms the vice-president rejected them and approached PricewaterhouseCoopers (PwC) with whom he had worked extensively for other international accounting and tax problems. Barnes had been a client of PwC for over 7 years and after receiving the vice president's request for assistance they reviewed their internal Ideasource database for tax solutions submitted by their own professionals to a central network. Ideasource 1365 suggested a structure similar to what would become the reinvestment plan.

PwC issued and executed an engagement letter with Barnes. Its scope included:

> Designing an appropriate…[reinvestment plan]; working closely with personnel of …[Barnes] and its subsidiaries to implement the …[reinvestment plan]; and providing tax opinions in the countries with subsidiaries affected by the …[reinvestment plan] (anticipated to be Singapore, Canada, United States and one other tax jurisdiction)….
>
> Services provided in Singapore will include all tax and legal services needed to implement the … [reinvestment plan]. These services will include preparation of legal documents, share registration documents and a tax and legal

> opinion on the Singapore tax implications of the… [reinvestment plan].[6]

The Barnes management team and PwC spent 3 to 4 months over the summer of 2000 to develop the transaction scheme for the reinvestment plan. PwC professionals from the United States, Singapore, Canada, France and the United Kingdom assisted Barnes, including the tax vice-president and several Barnes' officers and employees to describe a plan in which 1) Barnes would create a domestic financing entity; 2) ASA would create a foreign financing entity; 3) ASA would exchange cash for the foreign entity's stock; 4) the foreign entity would transfer its stock and cash to the domestic entity in exchange for the domestic entity's stock; 5) the plan would then be unwound when the foreign entity purchased the domestic entity stock from Barnes and liquidated the domestic entity. The business purpose of the plan described an international plan for cash management for a multinational manufacturing and distribution company.[7] PwC and the Barnes tax planning team then identified the foreign and domestic entities, their incorporating jurisdictions, prepared representation and opinion letters for execution, and drafted a board of directors' resolution. The Barnes board of directors ratified the plan on October 12, 2000.

REINVESTMENT PLAN SUMMARY

Plan Structure

The Barnes group and three of its subsidiaries, two of which were formed for the execution of the plan, were included: the Singapore ASA second tier subsidiary mentioned above; the newly formed Barnes Group Finance Co. Delaware (Delaware); and the newly formed Barnes Group Finance Co. Bermuda Ltd. (Bermuda). In order to assist in the initial financing of the plan three other Barnes' subsidiaries participated, although they were not mentioned. Barnes Canada, Bowman UK, and Bowman France: the Canadian subsidiary would loan money to the French and UK subsidiaries, which would then pay their receivables due to ASA.[8]

Plan Execution

The reinvestment plan occurred in two parts, both of which had a similar structure. In a Section 351 transaction, ASA and Barnes would exchange foreign currency with Bermuda in exchange for Bermuda common stock; in a second Section 351 transaction, Bermuda and Barnes would transfer foreign currency and Bermuda common stock to Delaware in exchange for Delaware stock. Barnes would receive its common stock and Bermuda would receive its preferred stock. In a final transaction, Delaware would convert its foreign currencies to US dollars and lend the funds to Barnes. The interlocking boards of directors of ASA, Bermuda and Delaware formally approved the plan. The plan itself occurred in two phases:

Phase 1:

(a) 12/7/2000: Bermuda transferred 222,000 shares of common stock to Barnes in exchange for 384,171 Singapore dollars ($222,000);

(b) 12/7/2000: Delaware issued 3,184 common stock shares to Barnes in exchange for Barnes' transfer of 234,000 Bermuda common shares (100%) and 5,137,425 Singapore dollars (2,951,000) to Delaware.

Phase 2:

(a) 12/12/2000: Bermuda issued 39,000,000 Bermuda common shares to ASA in exchange for 67,720,713 Singapore dollars ($39,000,000) to Bermuda;

(b) 12/22/2000: Bermuda transferred 68,204,884 Singapore dollars ($39,222,000) and 2,950,000 Bermuda common shares to Delaware in exchange for Delaware's issuance of 42,172 Delaware preferred shares to Bermuda.

(c) 12/26/2000: Delaware transferred 42,105,000 to Barnes in exchange for Barnes' promise to repay the loan.

Barnes then used the funds to pay off its own outstanding debts, thereby reducing its interest payments.

The Plan and Section 351

In order to justify its conclusion that the reinvestment plan would occur on a tax-free basis, the Barnes management team, after considering the PwC analysis, decided to emphasize the exchanges between Bermuda and Delaware. The team concluded that there are no material factual differences between these exchanges and the exceptional rule promulgated by Revenue Ruling 74-503. Section 351, as already noted, indicated that no gain or loss occurs if property is transferred to a stock corporation by one or more persons in exchange for the corporation's stock, so long as after the exchange, the transferor is in control of 80% of the corporation's stock. The ruling had indicated that, as an example, stock in one corporation could be exchanged for stock in another corporation without realizing any gain or loss for tax purposes in this situation. This rule was later revoked but the Internal Revenue Service had indicated, as already noted, that it would not question and would honor any transaction which occurred before 2005. Since the series of transactions of the plan occurred in 2000 and continued through 2001, the Barnes management team envisioned that no tax would result from the transactions which resulted in the execution of the reinvestment plan.

Section 351 (b) however, indicates that gain would occur if the transferor received money in addition to the stock. The Tax Court noted that Revenue Ruling 74-503, therefore, would not apply to the facts of the case. As noted in *Briarcliff Candy Corp v. Commissioner*[9]and *Anschutz Co. v. Commissioner*[10] both a Tax Court Memo and a Court of Appeals for the 10th Circuit held that Revenue Rulings may only be used to decide tax questions in the limited facts to which the ruling speaks. The 10th Circuit *Anschutz Co.* decision concerned the attempted use by taxpayers to use Revenue Ruling 2003-7 to exempt them from taxation. The ruling, however, envisioned a pledge of stock as security for a loan, whereas the taxpayers used the pledge device to sell the shares to a third party rather than using those shares as security for a loan. The Anschutz Corporation, a Kansas corporation with its principal place of business in Denver, Colorado, was a qualified subchapter S subsidiary of the Anschutz Company. The company initially engaged in the exploration of oil and the development of natural resources. It subsequently expanded its business activities to include railroads, real-estate and entertainment companies. Late in the 1990’s and early in the 2000’s the company sought to leverage its stock holdings through variable pre-paid forward contracts which anticipated the actual delivery of the stock on a specified future date and merely pledged the stock as security for a loan. The contracts, however, permitted the third party lender to use the pledged shares to pay for the third party’s outstanding debts. The Tax Court and the Circuit Court agreed with the Commissioner that ownership rights in the pledged shares had in fact been transferred to the third party in a taxable event. They concluded that Revenue Ruling 2003-7 could not be used to exempt the taxpayers from liability[11].

Revenue Ruling 74-503, then, can only provide guidance where treasury stock is exchanged for newly issued stock of another corporation. The ruling cannot otherwise be used.

The Tax Court noted:

> Specifically, the ruling addresses a situation where treasury stock is purchased by a corporation (corporation X) from its shareholders for less than fair market value and subsequently exchanged for 80% of the newly issued stock of another corporation (corporation Y), in a transaction in which no gain or loss was recognized by either corporation under sections 351 (a) and 1032(a).[12]

The Status of Bermuda and Delaware in the Execution of the Plan

The Tax Court and the Court of Appeals both noted that not only did 351 and Revenue Ruling 74-503 not exempt the reinvestment plan from tax liability. They also noted that the actual execution of the plan only minimally involved participation from Bermuda and Delaware.

In particular, the Tax Court noted that Bermuda declared no income or deductions for 2000 and only $12,000 in revenue and $13,410 in deductions. Bermuda had no paid employees in 2000 and 2001 and noted that the wholly owned Barnes subsidiary listed cash reserves of $12,000 in 2000 and $10,590 in 2001. Bermuda's Board of Directors was interlocked with that of its Barnes parent, including the parents' assistant treasurer, senior vice president for finance.

Delaware declared in a number of 1042 income tax forms for various years from 2002 to 2009 that it paid some $7,471,566 to Bermuda, but it was unclear as to whether Delaware actually paid these preferred dividends to Bermuda.

In addition, the loan from Delaware to Barnes evidenced by various agreements and corresponding notes, which required Barnes to make annual interest payments on the unpaid interest balance on a fixed rate of 7.5% commencing on 12-1-2002 totaled $67,605,000. Once again, it was unclear to the Tax Court whether Barnes ever paid any interest payments on the Delaware loans[13].

The Court finally noted that Barnes did include documents regarding the reinvestment plan with its 2000 and 2001 Federal income tax returns including the series of purported section 351 transactions among Barnes, Delaware, Bermuda and ASA. Barnes did not report any income attributable to the reinvestment plan. Both the Tax Court and the Court of Appeals concluded that the reinvestment plan had no valid business purpose, but merely operated as a conduit, a series of steps, for the transfer of funds from its second tier foreign subsidiary, ASA, to its domestic parent, Barnes.

SUBSTANCE OVER FORM: THE STEP TRANSACTION DOCTRINE

Development of the Doctrine

Smith v. Commissioner[14]described the step transaction doctrine in the following words:

> The step transaction doctrine generally applies in cases where a tax payer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary steps is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken

by the tax payer and the intervening stops may be disregarded or rearranged.

The *Smith* Tax Court and 4th Circuit decisions emphasized the importance of substance over form in determining tax liability. The step transaction doctrine treats the steps in a series of separate transactions as amounting to a single transaction if all the steps are substantially linked. The *Smith* decisions described an agreement between Georgetown University and Harry Smith and a number of other individuals. The University and these individuals entered into a limited partnership agreement concerning ownership of an off-campus housing project. The University had purchased the project from Chase Manhattan Bank, but was operating it at a loss in order to maintain rental parity between on-campus and off-campus housing. The limited partnership agreement transferred a "beneficial ownership" of the project to the partnership in which Georgetown retained a 20% general partnership interest. In return for the other limited partners contribution of $300,000.00, Georgetown promised, among other matters, to make non-recourse loans to the partnership if it needed money for operating expenses. The proceeds of any sale of the project were to be distributed in accordance with the partners' interest, but the agreement was never filed because of Georgetown's concern that the filing would cloud its title to the project. Both courts concluded that substance must prevail over form, and that the step transaction doctrine would apply. Despite its statement of a 20% interest, the University retained all the attributes of ownership. It made all decisions concerning operations management, including the right to sell or re-finance the property. All licenses, insurance leases and property tax returns remained in the University's name without disclosure of the partnership. The required landlord legislation form filed with the District of Columbia bore only Georgetown's name. In addition, the other limited partners did not acquire any equity interest in the project. Georgetown held the sole responsibility to stay the project's $4 million outstanding mortgage and the agreement allowed taxpayers to abandon any debt obligation to the University, other than their $300,000 investment in the partnership. The court concluded, therefore, that Georgetown had not transferred any ownership rights or duties to the other partners, and that the limited partner taxpayers could not claim income tax reductions equaling 80% of the losses accumulating from the operation of the off-campus housing facility. The courts noted that taxpayers are certainly entitled to deduct interest on a debt if the debt is genuine and of economic value, but there was no genuine debt nor economic value, but rather an economic incentive to abandon the collateral and merely forfeit the $300,000.00 investment after having taken substantial write-offs against income unrelated to any ownership in the property itself. The substance of the whole transaction required the collapse of the entire series of transactions so that its individual steps will be disregarded. The step transaction doctrine then must be applied.

Both the Tax Court and Court of Appeals decisions applied the step transaction doctrine to the Barnes reinvestment plan scenario. The court noted that the objective of the plan included a number of steps for no other purpose than to avoid tax liability[15].

One of three alternative tests may be used in deciding whether the step transaction doctrine should apply: 1. The Binding Commitment Test, 2. The End Result Test and 3. The Interdependence Test. Only one of these tests need apply to permit the use of the step transaction doctrine in the reinvestment plan situation[16].

The Binding Commitment Test: This test considers whether, at the time of taking the first step, the parties had made a binding commitment to undertake the subsequent tests. But this test is usually used in situations where a substantial period of time has passed between the steps. In the Barnes reinvestment plan situation, the plan was executed in a matter of days; this test is not appropriate to apply the step transaction doctrine[17].

The End Result Test: The End Result Test may be used if a series of separate transactions are viewed as prearranged parts of a single transaction, set to achieve an ultimate result[18]. The Barnes reinvestment plan would certainly be amenable to the use of this test.

The Interdependence Test: The courts eventually decided to apply the Interdependence test to the Barnes reinvestment plan execution. This test examines whether or not the intervening steps in a transaction are so interdependent that they each depend upon the other for the completion of the later steps[19]. No valid and independent economic or business purpose was served by the inclusion of Bermuda and Delaware in the reinvestment plan: Bermuda could have been established in Singapore under local law and was created merely to add an extra step in the plan. Delaware was created but its form was never respected in the execution of the plan.

In the light of all of the circumstances of the case, the evidence was insufficient to support a finding that either Bermuda or Delaware had any valid business purpose. The various intermediate steps, therefore, are properly collapsed into a single transaction in accord with the Interdependence Test. The reinvestment plan was a device by which ASA transferred a substantial amount of cash to Barnes, which Barnes was able to use to pay its debts. The courts decided that the plan was in substance a taxable dividend payment from ASA to Barnes in 2000 and 2001.

CONCLUSION: THE NEED TO PLAN AND TO EXECUTE WITH A BUSINESS PURPOSE

The introduction to this article indicated that corporate management teams and tax planners should use extreme caution in formulating and executing valid and tax-free reinvestment plans between parents and subsidiaries of transnational corporations. Because of its failure in business planning which envisioned a bonafide profit potential for all interested parties, Barnes was liable not only for a $1,304,352 tax deficiency in 2000 and a $1,807,478 tax deficiency in 2001; the company also had to pay accuracy related penalties under Section 6662(a) of $1,733,084 in 2000 and $307,735 in 2001. The Second Circuit Court of Appeals unpublished opinion firmly indicated that Barnes did not and could not rely upon its tax advisor PwC. This advisor, in fact, clearly stated in its opinion letter that it was not advising as to the tax consequences of the entire series of transactions in the investment plan. The opinion letter examined the stock transfer relationship between Bermuda and Delaware and did not examine any transfer of cash which was planned to occur.

In any plan examining the tax consequences of dealings between transnational parents and subsidiaries, the Internal Revenue Code, revenue rulings and court decisions should be carefully examined and caution should be used in formulating business plans and executing them strictly in accord with the form of the plan. Both the plan and its execution are vitally important. Profit must be planned for all participants and procedures must actually occur which encourage profitability.

In a Checkpoint tax practitioner commentary upon the *Barnes* decision[20], the comment criticizes the decisions of the courts for relying upon the fact that interest was not paid on the notes included in the plan. The courts, it argued, ignored the fact that the interest was accrued, rather than presently and actually paid. But it appears that the courts thoroughly examined the documents for any evidence of intent to treat the interest as accrued; their examinations of the plan and of its execution found a disregard of all form and practice. This disregard amounted to common law fraud. In addition, the commentary criticized the application of penalties for the taxpayer's lack of substantial good faith and reasonable reliance upon substantial authority. The courts, however, and the accountant's tax opinion indicated that reliance would have been misplaced. Prior court decisions implied that Revenue Ruling 74-503, because it did not describe the exact procedures as stated in the plan, could not be the reasonable basis for the taxpayer's decision. In addition, PwC explicitly stated in its opinion letter that it made no decision about the tax consequences of the plan.

The *Barnes* decision and the practice commentary, then, plainly indicate certain essential elements needed in any reinvestment plan or other plan, whether national or transnational, which involves a parent and a subsidiary. Such plans, as already mentioned, must express an explicit business purpose and must be executed in accord with that purpose. In addition, caution is needed: revenue rulings must be strictly construed and expert advisors' opinion letters must be carefully read and used to prevent the penalty levies which resulted in this case.

ENDNOTES

[1] According to Tax Court records, Barnes' debt-to-equity ratio increased from .30 to 1.15. *Barnes v. Commissioner* 2013 Tax Ct. Memo LEXIS 113.

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[2] *Barnes v. Commissioner* 2014 U.S. App. LEXIS 21239., which is an unpublished opinion.
[3] See https://www.law.cornell.edu/uscode/text/26/351
[4] The Internal Revenue bulletin 2006-2 dated January 9, 2006 stated "Section 351 The conclusion in Rev. Rul. 74-503 that a transferor's basis in transferee stock received in exchange for transferor stock…is incorrect….Rev. Rul. 74-503 revoked….Under the authority of section 7805(b), the Service will not challenge a position taken prior to December 20, 2005, with respect to a transaction occurring prior to that date, by a taxpayer that reasonably relied on the conclusions in Rev. Rul. 74-503."
[5] *Barnes v. Commissioner* 2013 Tax Ct. Memo LEXIS 113 at 115.
[6] 2013 Tax Ct. Memo LEXIS 113 at 117.
[7] 2013 Tax Ct. Memo LEXIS 113 at 118.
[8] Due to debt equity considerations however, Barnes itself lent funds to Bowman UK and Bowman France; ASA collected these receivables and thereafter Barnes Canada made the investments in UK and France which were repaid to Barnes. 2013 Tax Ct. Memo LEXIS 113 at 120.
[9] *Briarcliff Candy Corp v. Commissioner*, T.C. Memo 1987-487
[10] *Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Circuit, 2011) Affirming 135 T.C. 78 (2010).
[11] 664 F. 3d 313 at 329.
[12] 2013 Tax Ct. Memo LEXIS 113 at 121.
[13] 2013 Tax Ct. Memo LEXIS 113 at 118-119.
[14] *Smith v. Commissioner* 78 T.C. 350 at 389 (1982), affirmed without published opinion, 820 F.2d 1220 (4th Circuit, 1987).
[15] See *Long-Term Capital Holdings v. United States*, 150 Federal Appendix, 40 (2nd Circuit, 2005).
[16] See *Superior Trading, LLC v. Commissioner*, 137 T.C. 70 (2011).
[17] See *Commissioner v. Gordon*, 391 U.S. 83 (1968).
[18] See *Greene v. United States*, 13 F.3d. 577 (2nd Circuit, 1994).
[19] See *American Bantam Car Co. v. Commissioner* 11 T.C. 397 (1948), 177 F. 2nd 513 (3rd Circuit, 1949).
[20] See commentary entitled "The Tax Court in *Barnes Group* Misapplies the Step Transaction Doctrine, Imposes Penalties" https://checkpoint.riag.com at p.267