Falkoff was a partner in a partnership ("P'ship"). P'ship owned 100% of a corporation ("Corp") that had no E&P. The Corp owned another corporation ("Exchange") that had a substantially appreciated asset that it was planning to sell. Just before Corp's year end, it borrowed from a bank and used the loan proceeds to make a return of capital distribution to P'ship. Just after year end, Exchange sold the appreciated asset and loaned the proceeds of sale to its parent, Corp. Corp then repaid a substantial portion of the bank loan it had taken out days before.

The following is an excerpt from the case:

Congress in enacting the revenue code adopted the annual accounting concept and permitted the wholly-owned corporation to be treated as an entity separate from the shareholder. We believe the taxpayers here did no more than use these characteristics of the tax system to their best advantage. The situation here is an unusual one—a corporation without accrued or current earnings and profits but with substantial assets against which it can borrow to make a cash distribution to its shareholders. Yet, even here the effect is only to delay, not escape, taxation. A distribution reduces a shareholder's basis in his shares and thereby increases taxable gain upon disposition of the stock. The Corporation's future earnings and profits will be taxed as dividends when distributed.

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