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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT: Economic Substance / Substance Over Form

This Field Service Advice responds to your memorandum dated November 8, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

P =
Pp =
S1 =
S2 =

S3 =
U4 =
S4 =
B =
I =

b =

c =
d =
e =
f =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
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Date 10 =
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Date 28 =
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Tax Year 1 =
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$g =

$h =
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$j =
$k =
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Issue #1:

Whether the P consolidated return group should be allowed deductions for losses allegedly suffered when mortgage certificates held by wholly-owned subsidiaries of P matured.

Conclusion #1:

The P consolidated return group should not be allowed deductions for losses allegedly suffered when mortgage certificates held by wholly-owned subsidiaries of P matured.

Issue #2:

Whether the transactions at issue constituted a pre-defined series of steps that reached a tax result lacking in economic substance and not intended by Congress.

Conclusion #2:

The transactions at issue constituted a pre-defined series of steps that reached a tax result lacking in economic substance and not intended by Congress.

Issue #3:

Whether Pp should be recognized for federal income tax purposes.

Conclusion #3:

Pp should not be recognized for federal income tax purposes; alternatively, Pp should be recognized for federal income tax purposes, but essentially treated as a conduit[1] that Pp used to buy back the P stock that P, in form, redeemed from Pp. Additionally, the Service should consider making certain other arguments in this case.

FACTS

P files a consolidated return on a fiscal year-end basis. Each of S1, S2, and S3 are 100% owned subsidiaries of P, which file a consolidated return with P.

Pp is a Delaware limited partnership formed on Date 1 as a holding company by four entities: S1, S2, S3, and U4. Pp is an accrual-basis taxpayer that elected to adopt a fiscal year. U4 is a Delaware limited liability company formed on Date 2. U4 appears to be unrelated to P or the other consolidated group members.

The stated purpose of Pp was "to acquire certain stock, bonds, notes, debentures, puts, calls, options, warrants and other financial instruments…, and to manage, protect, and conserve the assets of the Pp, and to engage in any and all activities related or incidental thereto."

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[1]Conduit, in this context, refers to a conduit in the Court Holding sense. (Note that word, "conduit," can also be used to refer to a any flow-through entity. This latter sense of the word, conduit, (i.e., which would simply see Pp as a flow-through entity) is not the concept to which we are referring.)

Upon the formation of Pp, the partners made the following contributions to capital and received in exchange the following percentage interests in Pp:

PARTNER	CONTRIBUTION	INTEREST	%INTEREST
S1	$ a	General	e%
U4	$ a	Limited	e%
S2	$ b	Limited	f%
S3	$ b	Limited	f%

The conduct of the business and affairs of the partnership would be under the sole direction of the General Partner, S1.

Initial capital contributions and profit and loss sharing were based on the percentage of ownership held by each partner. Profit and loss sharing was subject to further restrictions as defined in the partnership agreement.

Under the terms of the partnership agreement, any limited partner could have requested to withdraw entirely from the partnership, at any time, by giving written notice of such election to the general partner and copies to all limited partners. Approval of such withdrawal was needed from the general partner. However, if the request was made after Date 3, and was denied, the partnership was automatically dissolved. In addition, on one or more occasions, S2 had the option to purchase a portion of U4's ownership interest for S2 and its affiliates to maintain an ownership interest equal to g%.

I, S1 and Pp executed an agreement on Date 1, pursuant to which I loaned $c to Pp. The stated purpose of the loan was to enable the partnership to purchase stocks, bonds, notes, and other securities as specified in the partnership agreement. Originally due Date 4, the loan had a stated interest rate of LIBOR plus b %. The loan agreement further provided that if Pp did not have sufficient funds to pay the investment return, S1 was to loan the money to the partnership for payment of interest. S1 was the guarantor of the investment principal.

The agreement further provided that, the investment principal and any accrued and unpaid investment return could be repaid in cash, or "at the election of [S1], in publicly traded common stock of P or publicly traded debt of P held by Pp.

Certain events required the early retirement of the debt, including failure by Pp to make timely interest payments, deliver required reports to I, or meet certain restrictive covenants. These covenants include limitations on the acquisition and guarantee of debt, the incidence of liens and the distributions of capital to partners. S1 was required to comply with certain restrictive covenants. These covenants included the maintenance of certain asset coverage tests, limitations on debt and liens, and the segregation of its affairs from the Pp. Failure to comply with these covenants could result in the mandatory retirement of the debt.

The partnership could elect to retire the debt at any time prior to Date 5. In this event, a premium would be required to be paid by Pp. To the extent Pp failed or was otherwise unable to pay the debt principal or accrued interest when due, S1 was required to advance funds to Pp in an amount sufficient to permit Pp to pay the principal or interest and cause Pp to make such payment. Pp's obligation to repay any such advances to S1 were subordinate to the repayment of the debt principal and any accrued but unpaid interest on the I debt. The obligations of S1 to advance funds to Pp were also subordinate to the unsecured claims of the general creditors of the general partner.

A first amendment to the agreement, dated Date 5, extended repayment of the principal on the I debt until Date 6, and provided certain assignments of interests. A second amendment to the agreement, dated Date 7, extended repayment of the principal until Date 8, decreased the interest rate, changed the agreement regarding strict confidentiality, and provided another assignment of interest. A third amendment to the agreement, dated Date 9, changed the definition of "applicable LIBOR Rate."

P had announced a share purchase program. The evidence indicates P purchased from B a tax plan in which B would purchase P common stock in the open market as a step in a pre-arranged plan to create the losses at issue in this case. On Date 10, Pp selected B as its agent, in connection with a program to purchase up to c shares of P common stock in the open market.

Between Date 11 and Date 12, B, purportedly on behalf of Pp, purchased d shares of P common stock for a cost of $d. Pp was required to pay a commission of $e, resulting in a total cost to Pp of $f. The average cost per share was $g.

P paid quarterly dividends on its common stock, which amounted to dividend income to Pp of $h for Date 13. Pp paid interest to I of $k during the fiscal year, the source of which appears to have been a combination of the dividend income and a loan from S1.

On Date 14, in exchange for e of the d shares of P common stock owned by Pp, P transferred cash of $n, warrants to acquire its own stock allegedly worth $o,[2] and a newly-executed note in the amount of $p (due Date 15, with a stated interest rate of d%) -- i.e,

[2]It is unclear to us if this amount accurately reflects the fair market value of the warrants.

a total amount of $q. The e shares represented c% of the P shares owned by Pp. The price per share was $i, the market price on Date 14. Pp treated the receipt of cash and P debt in exchange for P stock as a dividend-equivalent redemption under §§302(d), 301, and 316.

On Date 14, Pp and P had entered into a warrant agreement, whereby P would issue to Pp a warrant for the purchase of e shares of P common stock. Pursuant to the warrant agreement, Pp had the right to exercise the warrant, at its election, during the five-year period ending on Date 15. Upon exercise of the warrant, Pp was required to pay $j per share of P common stock purchased. The warrant agreement does not appear to provide for any contingencies on or obstacles to the exercise of the warrant.

The taxpayer stated that, on Date 16, Pp exercised all its warrants for cash.[3] The exercise Price was $l. The closing price on Date 17 was $m. After the exercise, Pp held f shares of P common stock.

On its partnership return for the year ending Date 18, Pp reported dividend income in the amount of $r. Of this amount, $s was considered "regular" dividends and $t was considered the amount in exchange for stock. Pp allocated to each partner its distributive share of the dividend income, and S1, S2, and S3 reported dividend income of $u, and also a dividends-received deduction of $u, on the consolidated return filed by P for the year ending Date 18.

On Date 19, using most of the cash proceeds from the redemption, Pp purchased $v of Mortgage Participation Certificates (Guaranteed), offered by Freddie Mac , allegedly, as an investment. The Certificates bore various interest rates from h% to i% and had monthly maturity dates from Date 20 through Date 21. Freddie Mac guaranteed the payment of both the principal and interest on the mortgage certificates.

From Date 19 through Date 22, Pp received total payments of $w: interest of $x, and principal of $y. From its inception to the end of the period under audit, the partnership operations were essentially receiving dividends on the P common stock, receiving interest on the P Corporation note, paying interest on the I note, and holding the P stock and warrants. S1 also made some short-term loans to Pp, and P made a one-time payment

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[3] [redacted]

of $z on the P note.[4] This $z amount of cash was the exact amount of cash that Pp then used to retire the partnership interests of S2 and S3.

On Date 24, S2 and S4, a wholly owned subsidiary of P, executed a purchase option assignment. On Date 25, pursuant to the purchase option, S4 purchased j% of U4's interest in Pp for $dd. Also on Date 25: a) Pp redeemed k% percent of U4's interest for $ee;[5] b) Pp distributed cash of $ff and mortgage certificates in a principal amount of $gg in liquidation of S3's partnership interest; and c) Pp distributed cash of $hh and mortgage certificates with a principal amount of $ii in liquidation of S2's partnership interest. The amounts of these distributions were equal to the partners' respective capital account balances. Additionally, on Date 26, Pp distributed cash of $jj and mortgage certificates with a principal amount of $kk to U4 in liquidation of U4's remaining partnership interest. The amount of the distribution was also equal to its capital account. Subsequent to the above redemptions, Pp was held l % by S4, as a limited partner, and m% by S1 as a general partner.

S2 and S3 held the mortgage certificates until the securities matured during P's fiscal year ended Date 27. Upon maturity, the S2 and S3 reported ordinary losses in the amounts of $bb and $cc, respectively, on the consolidated return.

The taxpayer submitted the following information regarding the tax treatment to S2 and S3 on the maturing of the mortgage certificates:

P's redemption of Pp's P stock generated dividend income to Pp that passed through to the partners and was reported by them under I.R.C. §702. The dividend income was arguably offset by a 100% dividends-received deduction on the consolidated return. The partners' basis in their partnership interest was increased by the amount of the dividend income reported by the partnership. I.R.C. §705(a). When the two subsidiary partners received liquidating distributions, no gain or loss was reportable. I.R.C. §731(a). The partners' bases in the mortgage certificates equaled their bases in their partnership interests. I.R.C. §732(b). When the mortgages were paid off, ordinary losses were claimed because the mortgages were "natural persons obligations" under I.R.C. §1271.

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[4] [redacted]

[5] The partnership agreement stated, in part, that S2 (or S4 as assignee) may purchase a portion of U4's interest to ensure that the aggregate interest of the subsidiary and its affiliates in the capital and profits of the partnership was equal to g%.

DISCUSSION AND LEGAL ANALYSIS

At issue are losses of $aa that two of P's wholly-owned subsidiaries allegedly suffered in the Tax Year 1, when certain mortgage certificates matured. A summary of the steps the taxpayer took in an attempt to obtain these uneconomic losses is as follows. P, through its subsidiaries, formed the partnership, Pp, which P controlled and directed, and in which P's wholly-owned subsidiaries owned g% of the partnership interests. Pp acquired P common stock on the open market. P redeemed c% of that P stock from Pp using cash, a note, and warrants as consideration. In the transaction, Pp received an equal number of P warrants for the P stock given up, and alleged a dividend-equivalent redemption. Pp reported the cash and the note as dividend income to the partnership, and the partners stepped-up their bases in their partnership interests by the amount of the dividend income. On the consolidated return, the group offset the dividend income with a 100% dividends-received deduction. The partnership used most of the cash to buy mortgage certificates. Shortly thereafter, Pp distributed most of the mortgage certificates to P's two wholly-owned subsidiaries that held p% of the Pp partnership interests in liquidation of their partnership interests. The partners' bases in the mortgage certificates reflected their stepped-up bases in the partnership interests. The subsidiaries then allegedly suffered significant ordinary losses as the certificates matured.

We believe the losses at issue should not be allowed for tax purposes. None of the consolidated group members suffered the losses. The transactions lacked economic substance, apart from their tax consequences. The transactions were merely prearranged steps in a contrived, tax-motivated plan carried out in an attempt to generate approximately $aa of uneconomic tax losses for the P group. See ACM Partnership v. Commissioner, T.C. Memo 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998); Saba Partnership, Brunswick Corporation, Tax Matters Partner v. Commissioner, T.C. Memo 1999-359 (October 27, 1999); Winn-Dixie Stores, Inc. et al. v. Commissioner, 113 T.C. No. 21. (October 19, 1999); Compaq Computer Corporation and Subsidiaries v. Commissioner, 113 T.C. No. 17 (September 21, 1999).

To be respected, a transaction must have economic substance. The economic substance doctrine is applicable where a taxpayer seeks to claim tax benefits not intended by Congress, by means of transactions not economically meaningful, apart from tax consequences. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Weller V. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir.

1959); ACM Partnership v. Commissioner, T.C. Memo 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra.

In determining whether to respect transactions for tax purposes, the courts look at both the objective economic substance of the transactions, as well as the subjective business motivations for the transactions. ACM Partnership, 157 F.3d 231, 247 (3d Cir. 1998); Horn v. Commissioner, 968 F.2d 1229, 1237(D.C. Cir.1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner , 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985).

When parties who are not dealing with each other at arms-length enter into a transaction that gives them tremendous tax savings, the Internal Revenue Service is entitled to be suspicious of the genuineness of the transaction. Transactions among related parties require close scrutiny to ensure that the transactions have substance and reality. Milbrew, Inc. v. Commissioner, 710 F.2d 1302 (7th Cir. 1983), aff'g 42 TCM 1467, 1481 (1981); Scully v. U.S., 840 F.2d 478 (7th Cir. 1988).

When one looks at the series of steps followed by P, as detailed in the tax plan designed by B , it becomes evident the true purpose for the transactions was a reduction of P's income taxes through the creation and deduction of uneconomic losses. P engaged in a series of steps that allowed it to effectively purchase its common stock, and obtain an ordinary loss deduction for most of the costs expended in making the purchase of that stock (in the disguise of consolidated return group members losses "suffered" from the disposal of property received on liquidation of partnership interests).[6] The facts evidence the limited partnership was used as a paper vehicle to facilitate a tax avoidance scheme. The taxpayer characterizes the partnership structure as a MIPS-like entity. However, the transaction does not involve MIPS or any similar security. The purported transactions lack business and economic reality, exposing the transactions as merely steps in a cleverly devised tax-avoidance scheme engineered by P, which dominated the entities involved in

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[6] [redacted]

that scheme. Cf Milbrew, Inc. 710 F.2d 1302 (1983); ASA Investerings Partnership, 76 TCM 325, 333 (1998). The transactions did not have economic substance, and the results were not what Congress had in mind under the Code provisions at issue, including the allowance of losses under section 165. See Gregory v. Helvering, 293 U.S. 465 (1935); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966). Courts should apply the economic substance doctrine, in cases such as these, where taxpayers structure transactions to try to take advantage of apparent loopholes under the tax code. Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988); Northern Ind. Pub. Serv. Co. v. Commissioner, 115 F.3d 506 (7th Cir. 1997), affg. 105 T.C. 341 (1995).

Section §165 states that "a taxpayer may deduct any loss sustained during the taxable year for which the taxpayer is not indemnified by insurance or otherwise." Only a bona fide loss is an allowed tax deduction and an "actual loss" is required. The term "loss" is not defined in the Internal Revenue Code, but it is essentially parting with value of an asset. See Williamson v. Commissioner, 100 F.2d 735 (6th Cir. 1938). The loss must be a bona fide loss representing a real change of position in a true economic sense; substance rather than form governs in determining a deductible loss. Treas. Reg. §1.165(b) A deduction for a loss must be based on an actual economic loss. See, e.g., Scully v. U.S., 840 F.2d 478 (7th Cir. 1988).

In the instant case, P wholly owned the partners which held g% of the Pp partnership interests. The partnership was simply a tax device in P's tax motivated plan to redeem P stock. The artificial losses generated through the transactions should not be allowed since the transactions lacked economic substance.

The lack of economic substance is particularly evident in light of the subsidiaries "loss" of $qq as a result of the transactions. Specifically, on Date 14, P redeemed c% of the P stock held by Pp for a price that was approximately $rr less than the price at which the group had purchased that stock less than just a year earlier. The incoming request for advice indicates Pp sold the stock at almost the lowest price the stock had traded during the years at issue. According to the Examining Team, the price of the P common stock on the open market had been significantly higher prior to P's redemption from Pp of the P common stock.[7] Also, on Date 3, the partnership interests of the two of P's wholly-owned subsidiaries that owned p% of the partnership -- i.e., S2 and S3 -- were liquidated, and

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[7]The incoming request for advice says that the P common stock had a fair market value of $uu per share on Date 14, and cites to Standard and Poor's Daily Stock Price Record, NYSE. However, this appears incorrect since this source indicates the stock was trading at a high of $vv and a low of $ww – and closed at xx -- on Date 14. This source further indicates the stock closed at $yy on Date 28, but also indicates the stock's "30 week moving average" (which was the average of Thursday's close for the 30 preceding weeks) was $zz.

these subsidiary partners received only $ss in liquidation of their interests. This $ss amount was approximately $qq less than the $tt they had contributed to the partnership just one and one-half years earlier.

In comparison to P's tax planning concerns, the amounts Pp got in the redemption of the P stock and the amount the subsidiaries derived in their “investments” in the partnership were irrelevant. Although the unrelated partner ended up obtaining a return on the amounts it advanced to Pp, S2 and S3 “lost” roughly q% of the amounts they “invested” in Pp. The Service can reasonably conclude the redemption and liquidation dates were chosen by P for its own tax planning requirements, and not by Pp and the subsidiaries for their “investment" purposes. Pp’s acquisition of P stock, P’s redemption of that P stock, and Pp’s liquidation of the partnership interests of S2 and S3, were wired and meaningless steps directed by P, which dominated the entities involved. When viewed as a whole, the transactions were undertaken to create artificial basis to generate large, uneconomic losses.

P, in substance, was the party that redeemed from the public the P stock that Pp, in form, acquired. P was controlling and directing the steps of the purchase of its shares, through the partnership, pursuant to the plan to buy back its stock (arguably, using the partnership essentially as a conduit to acquire the stock for it). P also controlled and directed the liquidation of its subsidiaries’ partnership interests, irrespective of the “loss” in value to Pp and the subsidiaries.

Courts will respect transactions imbued with economic substance. <u>Saba Partnership, Brunswick Corporation, Tax Matters Partner v. Commissioner</u>, T.C. Memo 1999-359 (October 27, 1999). However, the transactions in the instant case were not imbued with economic substance. The transactions did not result in meaningful changes in economic position. Neither Pp nor the subsidiaries suffered losses on the mortgage pools. The pools were purchased for $v and were paid off at $v, and even earned $pp of interest income. Rather, the losses at issue resulted from the artificially high basis in the mortgage certificates that S2 and S3 obtained through the contrived series of transactions preceding the purchase of the mortgage certificates. In regard to a similarly uneconomic loss in the <u>ACM Partnership</u> case, the Tax Court stated:

> We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer’s advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance.

ACM Partnership v. Commissioner, T.C. Memo 1997-115, 73 T.C.M. (CCH) 2189, 2215, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998).

Apart from tax consequences, the related party transactions did not meaningfully alter the economic positions of the related parties. The economic consequences of the transactions were minimal in comparison to the significant tax losses the transactions generated, and this indicates the taxpayer entered into the transactions for tax-avoidance purposes. See Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966); ACM Partnership; Saviano v. Commissioner, 765 F.2d 643, 654 (7th Cir. 1985), affg. 80 T.C. 955 (1983).

Namely, as a result of the transactions,

1) The P group (Pp and the P subsidiaries) earned $pp of interest income on the mortgage pools, the principal and interest on which were guaranteed by Freddie Mac. (Moreover, it is reasonable for parties to invest idle cash to make some profit, and this should not drive the determination of whether the transactions meaningfully altered the taxpayer's position.)

2) The P group (the P subsidiaries) reported ordinary losses of $aa, which were paper losses with no economic substance. (Also note that the interest income reported is less than n% of the paper loss.)

3.) The P group additionally paid fees to B to acquire the stock. The P group also may have paid fees (or, have been required to pay additional fees based on a contingency fee arrangement) to B for the tax plan purchased from B.

In Compaq Computer Corporation and Subsidiaries v. Commissioner, 113 T.C. No. 17 (September 21, 1999), the court distinguished minimizing taxes in a business transaction involving a real economic loss from entering into a prearranged loss transaction designed solely for the reduction of taxes on unrelated income. The court viewed Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171 (1988), aff'd. without published opinion 886 F.2d 1318 (7th Cir. 1989) in the first category, and ACM Partnership and Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) in the latter category. The instant case is in the latter category.

[8][9]

Moreover, the taxpayer indicates the fact that Pp could repay the I note with P stock (rather than cash) allowed "the economic interest of such lender [to be] characterized not as a debt instrument in the issuer, but rather as a 'minority interest' in the issuer" for book purposes. (Note that the taxpayer incorrectly states that the I debt could be paid back with either P stock or affiliate stock, but the I note appears to only provide for the payment of the I note using P stock, and not subsidiary stock.) [10] Yet, Pp's payment of the I note with P stock would have been inconsistent with the taxpayer's purported business purpose to buy back the P stock from the public (and thus, not have the P stock outstanding in the hands of I, which would then be a public shareholder). Furthermore, although P's accountants might have treated a possible repayment of the I debt with P stock as if the stock had actually been issued to repay

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8 [redacted]

9 [redacted]

10 [redacted]

the I debt[11] and even though the repayment of the note with P stock presumably would not have occurred in light of P's business purposes[12], it seems inappropriate for P's financial accounting rules to drive (or dictate) unwarranted tax losses derived from transactions without economic substance.

To summarize the economic substance argument, we believe the uneconomic tax losses in this case arose from certain wired and contrived, tax-motivated transactions. Apart from tax consequences, these tax-motivated transactions did not meaningfully alter the taxpayer's economic position. The artificial losses generated by means of these transactions are unwarranted in light of the statutory provisions at issue, and reach a tax result not intended by Congress. The losses should be disallowed.

Disregard the Partnership

We believe the Service should also argue that the partnership should not be respected. A partnership includes "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on." I.R.C. §§ 761(a); 7701(a)(2). A partnership exists for federal income tax purposes if "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." I.R.C. § 761; 7701(a)(2); Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); ASA Investerings Partnership v Commissioner, T.C. Memo. 1998-305. To be considered partners, the parties must "really and truly intend to join together for the purpose of carrying on business and sharing in the profits or losses or both." Commissioner v. Tower, 327 U.S. 280, 287 (1946). Courts examine objective factors in ascertaining the parties' true intent. Culbertson, 337 U.S. at 742; Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964). An arrangement intended and structured solely for tax benefits, between parties with no common business interests and who would not share profits and losses, is not a bona fide partnership. Culbertson, 337 U.S. 733. See Merryman v. Commissioner, 873 F.2d 879, 881 (5th Cir. 1989), aff'g T.C. Memo. 1988-72.

Various Alternative Arguments

Additionally, we believe the Service should advance the following alternative arguments: a.) the partnership anti-abuse rules apply; b.) section 1059 applies,

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12 [redacted]

irrespective of whether the partnership is disregarded or respected; c.) the allocation of dividend income in P's redemption of Pp's P stock does not have substantial economic effect under section 704(b); and d.) various formulations of the substance-over-form doctrine apply (at least two of which are discussed in this memorandum).

Application of Partnership Anti-Abuse Rule

The partnership anti-abuse rule requires that the use of a partnership be consistent with the intent of Subchapter K. Treas. Reg. § 1.701-2(a) sets forth the following implicit requirements of Subchapter K: (1) there must be a substantial business purpose; (2) the form of the transaction must be respected under substance over form principles; and (3) there must be a proper reflection of income. If the results of a transaction are inconsistent with the intent of Subchapter K, and a principal purpose of the transaction is the reduction of tax liability, the Commissioner has authority to undertake a variety of actions to achieve tax results that are consistent with the intent of Subchapter K. In particular, under Treas. Reg. § 1.701- 2(b)(5), the Commissioner can determine that the claimed tax treatment should otherwise be adjusted or modified.

The "loss" claimed by S2 and S3 is generated by the technical application of the partnership rules. The corporate partners are permitted to increase their respective bases in the partnership by the amount of dividend income. When the dividend income is then passed through to the partners, those partners, as members of a consolidated group, are able to ignore it. The corporate partners then receive liquidating distributions of assets to which the increased outside basis is attached. In essence, this transaction is a utilization of the partnership rules to magnify a slight economic loss into a substantial tax loss. Under Treas. Reg. § 1.701-2(b)(5), the Commissioner has authority to determine that the claimed tax treatment should otherwise be adjusted or modified. Therefore, under the present facts, the Commissioner has authority to modify the claimed tax treatment to more clearly reflect the economic substance of the transaction.

Partnership Disregarded -- Section 1059 Applies

Under an argument the partnership is disregarded, S1 and the other two of P's subsidiaries that were partners in Pp may be treated as having purchased the P stock. As discussed in more detail below, S1, rather than Pp, is considered the true debtor on the I debt for tax purposes. Under this view, S1 advanced amounts of the I debt proceeds to S2 and S3. S1, S2 and S3 purchased the P stock. P had dividend income when P redeemed from the P subsidiaries (S1, S2, and S3) c% of the P stock. The dividend income was arguably offset by a 100% dividends-received deduction on the consolidated return. The subsidiaries also bought mortgage pools. However, because the partnership is disregarded, the subsidiaries would not have an artificially high basis in those pools. Additionally, the basis of the redeemed shares would shift to increase the basis the subsidiaries had in the remaining shares of P stock held by the subsidiaries. See Treas. Reg. §1.302-2(c). However, section 1059 should also apply to reduce, at the time of any later sale or disposition, the basis the subsidiaries had in the retained P stock. The basis would be reduced by the nontaxed dividend amount received in the redemption. This is the case notwithstanding the perceived statutory conflict regarding the application of subsection 1059(e)(1)[13] (relating to non pro-rata distributions), as opposed to section 1059(e)(2)[14] (relating to the qualifying dividends exception).

Briefly, certain legislative history of section 1059 indicates that section 1059 can apply to affiliated members that file a consolidated return. Section 1059 can apply to require a basis reduction even though the consolidated return regulations require no basis reduction (as in the instant case) if the results produced under the consolidated return regulations are inconsistent with the purposes and principles of section 1059 (as no basis reduction would be in the instant case). For example, S. Report No. 445, 100th Cong., 2d Sess. 44 (1988) states:

> However, to the extent results produced under the consolidated return regulations are inconsistent with the purposes and principles of the extraordinary dividend provision, it is intended that a basis reduction may be required under this provision notwithstanding the fact that no reduction is mandated under the consolidated return regulations.

Additionally, the perceived statutory conflict regarding the application of subsection 1059(e)(1) (as opposed to section 1059(e)(2)) to non pro rata redemptions was addressed in interpretative regulations, effective after the date of the transaction at issue in the instant case). Treas. Reg. §1.1059 (e) -(1) (T.D. 8724, 7-15-97) provides, among other things, that the exception for qualifying dividends did not apply to redemptions that were not pro rata as to all shareholders. Additionally, the preamble

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[13]The Tax Reform Act of 1986 added section 1059 (e) (1) (B), which provides that "Except as otherwise provided in regulations," any amount taxed as a dividend on a redemption of stock "not pro rata as to all shareholders" is an extraordinary dividend without regard to the 2-year holding period.

[14]Section 1059 (e) (2) stated: "Except as provided in regulations, the term "extraordinary dividend" shall not include any qualifying dividend (within the meaning of section 243 (b) (1))." This exception can be read to apply to non pro-rata distributions that are extraordinary dividends.

to these regulations, when proposed, state that the IRS and Treasury Department believe that applying section 1059(e)(2) is inconsistent with the purpose of section 1059 and may create inappropriate consequences, such as basis shifting that eliminates gain or creates an artificial loss. The preamble states these regulations clarify that section 1059(e)(2) applies to a distribution treated as an extraordinary dividend under section 1059(e)(1) . See 1996-2 C.B. 436.

Partnership Not Disregarded -- Section 1059 Applies

Under a view the partnership is not disregarded, Pp is properly treated as an aggregate of its partners for purposes of applying section 1059.

Subchapter K of the Code is a blend of the “aggregate” and “entity” treatment for partners and partnerships. Moreover, for purposes of interpreting provisions of the Code not contained in Subchapter K, a partnership also may be treated either as an aggregate of its partners or as an entity distinct from its partners. Compare Casel v. Commissioner, 79 T.C. 424 (1982) (treating a partnership as an aggregate for § 267 purposes), with Madison Gas and Electric Co. v. Commissioner, 72 T.C. 521 (1979), aff’d 633 F.2d 512 (7th Cir. 1980) (treating a partnership as an entity for § 162 purposes). The treatment of partnerships in each context must be determined on the basis of countervailing factors applicable to such context. See H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). See also Rev. Rul. 89-85, 1989-2 C.B. 218; Rev. Rul 90-112, 1990-2 C.B. 186. In the present context, given the purpose and intent of § 1059, it is appropriate to treat the partnership as an aggregate of its corporate partners.

Similar to the principles set forth in Example 2 of Treas. Reg. 1.701-2(f), the aggregate concept applies in applying section 1059 to the transaction. As a result, each partner of Pp is treated as owning its own share of the P stock held by Pp. Consequently, the partners must make appropriate adjustments to the basis in their respective interests under section 705 (and Pp must also make appropriate adjustment to the basis of the P stock). Thus, although Example 2 of Treas. Reg. 1.701-2(f) is not effective for the transaction at issue in the instant case, the same principles and results as set forth in that regulation apply to the transaction at issue in the instant case.

Application of Section 704(b) Special Allocation Rules

In general, each partner’s distributive share of partnership items is determined by the partnership agreement. I.R.C. § 704(a). This provision provides a great deal of flexibility to taxpayers who do business in the form of a partnership. Partners have “great latitude in determining themselves by their partnership agreement what their distributive shares will be.” Goldfine v. Commissioner, 80 T.C. 843, 849-50 (1983).

However, the partners' ability to make special allocations of partnership items is not unrestricted. The allocation of partnership interests must have substantial economic effect. I.R.C. § 704(b). If the allocation under the partnership agreement does not have substantial economic effect, the distributive share will be determined in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances. I.R.C. § 704(b). Thus, in the absence of substantial economic effect, the Commissioner can reallocate partnership items in accordance with the partners' interests in the partnership as determined under Treas. Reg. § 1.704-1(b)(3). Arguably, the allocation of the dividend income from the redemption of the P stock in such a way as to allow for the creation of an artificial loss does not have substantial economic effect.

Substance-Over-Form

Various judicial doctrines have been developed by the courts to combat tax avoidance. These doctrines include the doctrine of substance over form, the business purpose doctrine, the sham transaction doctrine, and the step transaction doctrine. It is often difficult to separate these doctrines.

In analyzing the tax consequences of a transaction, the courts look at the substance of the transaction and not the form. Gregory v. Helvering, 293 U.S. 465 (1935). In one of the earliest articulations of the "substance over form" doctrine, the Supreme Court stated that "[t]he incidence of taxation depends upon the substance of a transaction . . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

The step-transaction doctrine is one formulation of the substance-over-form doctrine. Courts have applied three tests to determine whether to apply the step-transaction doctrine. Two of these tests are the mutual interdependence test and the end result test. Under the end result test, a series of formally separate transactions will be stepped together if they appear to be really prearranged parts of a single transaction intended from the outset to reach the ultimate result. Penrod v. Commissioner, 88 T.C.. 1415, 1429 (1987); Redding v. Commissioner, 630 F.2d 1169 (7th Cir. 1980) . The courts determine whether, at the time of the first step, the taxpayer intended to take the subsequent steps to reach a certain end result. King Enterprises, Inc. v. United States 418 F.2d. 511 (Ct. Cl. 1969); Under the mutual interdependence test, the courts determine whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series. McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

These formulations of the step-transaction doctrine should not be viewed as creating fixed requirements for the application of the doctrine in every situation. The step-transaction doctrine must be considered in the light of the purposes at issue. Kass v Commissioner, 60 T.C. 218, 226 (1973), aff'd without published opinion, 491 F.2d 749 (3d Cir. 1974) (" . . . the step transaction doctrine, even when worded consistently and applied to identical facts, may result in integration in one case and "separateness" in another case simply because the legal question to be answered has changed.")

In applying a substance-over-form analysis, S1 is viewed as the debtor of the debt for tax purposes, irrespective of whether the partnership is respected. (This is the case even if P's accountants considered Pp as the debtor on the I note for financial statement purposes.) S1 necessarily guaranteed this debt, and I looked to S1 for repayment. The I note agreement provided that, if Pp did not have sufficient funds to pay amounts, S1 was to advance money to Pp to pay the amounts. The agreement also placed restrictions on the assets and debt of S1, and S1 was required to make quarterly statements to I attesting to the fact that it had not impaired its assets. Additionally, S1 actually advanced amounts to the partnership to pay amounts on the I note. Consistent with the economics, S1 should be treated as the true debtor. Cf. Plantation Patterns, Inc. v. Commissioner, 462 F.2d 715 (5th Cir.), cert. denied, 409 U.S. 1076 (1972).

Additionally, Pp's purported acquisition of the P stock from the public, and P's redemption of that stock should be integrated as they were meaningless, indirect steps, entered into pursuant to a plan to achieve a single end result -- i.e., P's acquisition of the stock from the public. "A given result at the end of a straight path is not made a different result because reached by following a devious path." See Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938); Estate of Schneider v. Commissioner, 88 T.C. 906, aff'd, 855 F.2d 435 (7th Cir. 1988). The preliminary purchase of the P stock by S2 and S3, followed by the redemption of that stock by P, were meaningless, pre-ordained steps incident to the transfer to P of the P stock, all along intended to come into P's hands.[15] These steps were necessary, however, to set up the large artificial tax losses at issue. The steps should be ignored. Rather, P should be treated as if it had directly bought back from the public (using funds advanced by S1, as the true debtor) the P shares that P redeemed from Pp.[16]

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[15]We understand the taxpayer may be citing Esmark in support of its transactions. We believe Esmark is distinguishable from the instant case in various respects (even aside from the transactions' lack of economic substance), including the fact that the instant case includes g% related parties.

[16][redacted]

Under an argument that the partnership should be disregarded, the Service could either argue that P directly redeemed from the public for $fff the P stock that P, in form, redeemed from Pp (i.e., in other words, the c% of the stock that Pp, in form, purchased from the public), and S1 directly acquired from the public the remaining j% of the P stock at issue. Under this approach, Pp's liquidation of the partnership interests of S2 and S3 is also integrated with P's redemption of Pp's P stock and P's redemption of Pp's P stock. Alternatively, the Service could argue that P directly redeemed from the public for $fff the P stock that P, in form, redeemed from Pp, and S1, S2 and S3 directly acquired from the public the remaining j% of the P stock at issue.[17]

For example, under an argument that P and S1 purchased the P stock, S1 advanced most of the amounts it obtained as the true debtor on the I debt to P, and P transferred to S1 a note to pay back to S1 $p, warrants worth $o, and cash of $n. The difference between the amounts P paid to S1 and the $p note amount is a capital contribution P made to S1. Note that other amounts also have to be adjusted to determine the total capital contribution amount that P transferred to S1. For example, P is also treated as transferring to S1 an amount equal to c% of the $s "regular" dividends that P paid, in form, to Pp for the Pp year ended Date 18 since P directly redeemed this stock.[18]

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[17] [redacted]

[18] For example, assume the only amounts at issue in making the determination were the $c debt amount; the $aaa (which represents the j% of the P stock that S1 could be treated as having purchased and retained); the $bbb that U4, in form, contributed to Pp (under an assumption that U4 is treated as a lender and the $bbb that U4, in form, contributed to Pp is treated as a loan that U4 made to S1); and the approximately $ccc million "regular" dividends that P paid, in form, to PP for the Pp year ended Date 18 for c% of the P stock that P is treated as directly redeeming).

Assuming <u>only</u> these amounts were at issue, S1 could be treated as having advanced to P the $c debt amount; less the $aaa; plus the $bbb amount from U4; less the approximately $ccc "regular" dividends that P paid, in form, to Pp. Thus, S1 could be treated as having advanced $ddd to P, in return for P's note to repay S1 $c and $eee of warrants. Additionally, P could be treated as having made a capital contribution for the remainder of the warrants and the cash to P.

However, this analysis is for illustrative purposes only and is not intended to adjust for each and every of the relevant amounts necessary to determine the

P, using the funds advanced from S1, is treated as directly acquiring from the public for $fff the P stock that P, in form, redeemed from Pp (i.e., in other words, the c% of the stock that Pp, in form, purchased from the public). S2 and S3 are treated as having made distributions (i.e., dividend distributions, assuming S2 and S3 had sufficient earnings and profits) of $qq (i.e., the $qq is the difference between the amounts they, in form, received from Pp and the amounts they, in form, contributed to Pp). Additionally, S2 and S3 are treated as having bought an amount of mortgage certificates equal to the amount each received, in form, from Pp in the liquidation of their partnership interests.

Alternatively, under a view that the partnership is not disregarded, the Service could argue that P used Pp as a conduit to redeem from the public for $fff the P stock that P, in form, redeemed from Pp. Cf. Commissioner v. Court Holding Co., 324 U.S. 331 (1945). This approach is similar to the approach under the alternatives to disregard the partnership, except that Pp – rather than S1 or S1, S2 and S3 -- may be viewed as having directly acquired from the public the remaining j% of the P stock at issue (i.e., the P stock that Pp, in form, retained after P's redemption of the c% of the stock it had, in form, acquired). S1, as the true debtor, advanced amounts for Pp to acquire only this j% portion of the P stock. P also made a capital contribution of amounts to either S1 which, in turn, made a capital contribution of the amounts to Pp, or P made a capital contribution of amounts to S1, S2, and S3, which, in turn, made a capital contribution of amounts to Pp.

CASE DEVELOPMENT, LITIGATION HAZARDS, AND OTHER CONCERNS

As you are aware, this case had an extremely short turn-around time period, and due to time constraints, this limited our ability to fully analyze and develop the arguments in this case. We also had insufficient facts to fully develop, as well as to fully assess, the various arguments set forth in this memorandum. However, we wanted to advise you of the various arguments we believe the Service should consider making in this case. Upon subsequent case development, the Service may reconsider what arguments should be made.

[redacted]

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exact amount of the capital contribution P made to S1, or any other appropriate adjustments.

[redacted]

[redacted]

[redacted]

We note that, for the economic substance doctrine to apply, transactions should not have economically meaningfully consequences. Exposure exists in arguing the economic substance doctrine in the instant case because S2 and S3 “lost” amounts of approximately $qq in the transactions. Nonetheless, in light of the arrangement, these $qq amounts should not be viewed as economically meaningful. For example, in the instant case, these $qq “losses” might arguably be viewed as distributions that S2 and S3 made to P. Moreover, note that the Pp subsidiary partners, which purportedly “suffered” the $qq losses in the process of setting up the over $ll uneconomic losses from the mortgage certificates, were the same entities that also “suffered” the over $ll uneconomic losses.

[redacted]

[redacted]

As already indicated, the lack of certain factual development impairs our ability to analyze the transactions and arguments. [redacted]

[redacted]

[redacted]

[redacted]

Application of Partnership Anti-Abuse Rule

An issue does exist as to the effective date of the partnership anti-abuse rule. Treas. Reg. § 1.701-2(g) specifies that paragraphs (a), (b), (c), and (d) are effective for all transactions involving a partnership that occur on or after May 12, 1994. Paragraphs (e) and (f) are effective for all transactions involving a partnership that occur on or after December 29, 1994. In the present case, the partnership was formed on Date 1. The redemption/dividend occurred on Date14. The liquidating distributions occurred on Date 25. Therefore, the formation and dividend/redemption occurred before the effective date of the anti-abuse rule. However, the liquidating distribution, which caused the corporate partners to acquire the investment assets with the artificially inflated basis, occurred after the effective date of the anti-abuse rule. Therefore, the transaction that gave rise to the inappropriate loss, the liquidating distribution, occurred after the effective date of the anti-abuse rule, and should be subject to it.

No Partnership Was Formed

Three subsidiaries of P, as well as U4 (an unrelated limited liability company) joined together in the formation of Pp. To the extent U4 functioned in the capacity of an agent for I, an argument could be made that U4 did not join with the subsidiaries of P in the present conduct of a trade or business. [redacted]

To the extent it can be shown that U4 was an agent for I, a determination must be made as to whether I intended to join with the subsidiaries of P in the present conduct of an enterprise. [redacted]

Disregarding the Partnership -- Section 1059

Litigation hazards exist in making this argument, mainly due to the perceived statutory conflict regarding the application of subsection 1059(e)(1)[19] (relating to non pro-rata

[19]The Tax Reform Act of 1986 added section 1059 (e) (1) (B), which provides that “Except as otherwise provided in regulations,” any amount taxed as a dividend on a redemption of stock “not pro rata as to all shareholders” is an extraordinary dividend without regard to the 2-year holding period.

distributions), as opposed to section 1059(e)(2)[20] (relating to the qualifying dividends exception). We briefly discussed this issue in the base of the memorandum.

Not Disregarding the Partnership -- Section 1059

Litigation hazards exist in making this argument, mainly due to the issue of whether section 1059 applies where a partnership, rather than a corporation, owns the corporation making the distribution at issue. Under the partnership rules, the corporate partners obtain dividends-received deductions under section 243 for the dividends the partnership receives, even though the statute under section 243 provides that the dividends-received deduction applies to amounts of dividends "received" by a corporation (and the dividends were not received by the corporate partners). In essentially treating the corporate partners as having "received" the dividends, it seems consistent with the purposes and application of section 1059 that section 1059 would also apply (where otherwise applicable) to corporate stock owned by a partnership.

Application of Section 704(b) Special Allocation Rules

We recommend that more [redacted]

Substance-Over-Form

Irrespective of whether the partnership is disregarded, we believe it substantially likely the court will view S1 as the true debtor on the I debt.

Concerning the various other substance-over form arguments, additional factual development is necessary [redacted]

[20]Section 1059 (e) (2) stated: "Except as provided in regulations, the term "extraordinary dividend" shall not include any qualifying dividend (within the meaning of section 243 (b) (1))." This exception can be read to apply to non pro-rata distributions that are extraordinary dividends.

In General[21]

Additionally, assuming the transactions undertaken by the taxpayer, when viewed in their entirely as contemplated from the outset, were for the purpose of obtaining a deduction for the cost of redeeming the taxpayer's own stock, section 162(k) provides, in part, that no deduction otherwise allowable shall be allowed for any amount paid or incurred by a corporation in connection with the reacquisition of its stock. Also, if the form of a transaction complies with the Code's requirements for deductibility, but the transaction lacks the factual or economic substance that form represents, then expenses or losses incurred in connection with the transaction are not deductible. Kirchman v. Commissioner, 862 F.2d 1486, 1490 (11th Cir.1989).

Actual costs of redemption should be disallowed as a deduction and capitalized pursuant to section 263. Other tax-motivated transaction costs are neither ordinary nor necessary section 162 expenses. Any claimed losses on the warrants should not be deductible losses under section 165. Interest on the third party loan should also be disallowed on the theory that it was part of the overall tax-motivated scheme. The fact that an enforceable debt exists between the borrower and the lender is not dispositive of whether interest arising from the debt is deductible under section 163. Rather, the overall transaction, of which the debt is a part, must have economic substance before interest can be deducted. Lee v. Commissioner, 155 F.3d 584, 587 (2d Cir. 1998)

Additionally, the analysis in the instant case is controlled by section 165 principles; however, if the Service were unable to establish that the transactions lack economic substance, but were able to establish that the taxpayer had no profit motive, section 183 would then control. Pursuant to section 183, the taxpayer would only be entitled to deductions to the extent of gross income derived from the activity.

If you have any further questions, please call (202) 622-7930.

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[21] We also note that, through the transactions, the taxpayer may also have been attempting to set up a large loss on the shares retained by the partnership (not at issue in this case) since, by means of the related party redemption, the basis of the redeemed P shares would arguably shift to, and increase, the basis of the retained P shares (see Treas. Reg. §1.302-2(c)).

By: ______________________
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