DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSISTANT DISTRICT COUNSEL

FROM: ASSISTANT CHIEF COUNSEL(FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated January 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.

LEGEND:

A:
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Date 1:
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Date 3:

ISSUES:

1. What is the proper classification of A for federal tax purposes?
2. What are the proper classifications of B and C for federal tax purpose?
3. Are D and E qualifying organizations eligible to elect out of Subchapter K pursuant to Internal Revenue Code § 761?
4. Are B and C eligible to elect out of Subchapter K pursuant to section 761?
5. Is F subject to the partnership basis provisions of Subchapter K and, if so, is the loss from D and E reduced by any basis limitations?

CONCLUSION:

1. A should be classified as an association taxable as a corporation for federal tax purposes.
2. B and C should be classified as associations taxable as corporations for federal tax purposes.
3. D and E are not a eligible to elect out of Subchapter K.
4. B and C are not eligible to elect out of Subchapter K.
5. F as a partner in D and E is subject to the basis provisions of Subchapter K and has the burden of proving its right to deduct losses.

FACTS:

G is a closely-held corporation incorporated on Date 1. It comprises a group of interrelated companies whose primary function is the distribution of H products and related J services to dealers in K states.

F is a wholly owned subsidiary of G and provides L primarily to customers of M , another wholly owned subsidiary of G involved in the distribution of N. F also provides third party servicing.

F owns limited-purpose finance subsidiaries and limited-purpose partnerships. All subsidiaries own their respective assets and are separate entities with creditors who own a security interest in their assets.

The consolidated group includes, but is not limited to, F, O, and P. The consolidated group through its subsidiaries, owns S percent of D and E. E acts as a grantor of two trusts, B and C. D is the grantor and beneficiary of A. A's purpose is to take assignment of contracts and related Q originated through dealers in the G network of dealers. F services these contracts.

The taxpayer has treated A as a security arrangement and therefore has not filed any income tax returns for it. Depreciation on A's assets has been claimed by D. Depreciation on A's assets has been claimed by E, because of the transaction described below. As these two entities have filed a section 761 election, the depreciation is reflected on F's return.

In Date 2, F became involved in two transactions. The transaction at issue begins when F related dealers assign contracts and the underlying to A. A's interest in all contracts and titles is perfected by registration in the name of its trustee, R. A then issues an interest representing the entire beneficial interest in the assets of A to D.

A's trustee then allocates a separate portfolio of within A and issues to D a

trust.

D then sells its entire interest in the to E. E in turn transfers T percent of its interest to either B or C, the For tax purposes, E treats this transaction as merely to secure debt. On its books it is treated as a sale.

The trust issues two classes of investor certificates, senior Class A certificates and subordinated Class B Certificates. E sold the Class A certificates in a public offering and the Class B certificates through a private placement. E used the proceeds to pay D, which in turn gave the monies to A.

Class A certificate holders possess a U percent interest in the trust and Class B certificate holders possess a V percent interest. The remaining V percent is held by E.

Although the taxpayer asserts that the trust is not to be treated as a tax entity, but as a security arrangement, the trust elected under section 761(a) to be excluded from the application of Subchapter K of the Internal Revenue Code. E also made this election. It is the taxpayer's position that E owns S percent of the equity of B and C; however, due to the election, on a look-through basis the tax owners would be considered F and P. B and C have also elected out of the provisions of Subchapter K.

The Date 3 returns of G are currently under examination. The taxpayer has executed an extension of the period of limitations for these returns. This extension may be withdrawn by the submission of a Form 872-T.

LAW AND ANALYSIS

ISSUE 1: CLASSIFICATION: A

Section 7701 sets forth definitions to be used in determining the classification of an organization for federal tax purposes. The regulations under section 7701 in effect for these transactions pre-date the "check the box" regulations currently in effect. The check-the-box regulations provide that for certain business entities that were in existence before January 1, 1997, the entity's claimed classification will be respected for all periods before January 1, 1997, if (i) the entity had a reasonable basis (within the meaning of section 6662) for its claimed classification; (ii) the entity and all members of the entity recognized the federal tax consequences of any change in the entity's classification within the sixty months before January 1, 1997; and (iii) neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination). Treas. Reg. § 301.7701-3(f)(2). It is not clear whether A, B, C, or any of their members were notified in writing before May 8, 1996, that the entity's classification was under examination. If no one was notified, the entity's classification may be respected. If any of the trusts or any of their members were property notified, the classification of that entity is determined under examination by applying the regulations effective for the years at issue.

Organizations may be classified as trusts or as associations taxable as a corporation or as a partnership. Taxpayer asserts that A should be taxed as a partnership. District counsel asserts that A is an association taxable as a corporation. The following discussion refers to the Treasury Regulations under section 7701 in effect for the years at issue.

A was set up as a W business trust. D is the grantor and R is the trustee. Nonetheless, A's designation as a trust alone does not ensure its status as a trust if it is not simply an arrangement to protect or conserve property for beneficiaries. Treas. Reg. § 301.7701-4(b).

First, we will turn to the issue of whether this is a trust or an association. Treas. Reg. § 301.7701-4 states that the fact that an "organization is technically cast in the trust form . . . will not change the real character of the organization if . . . the organization more nearly resembles an association or a partnership than a trust." In order for an entity to be treated as an association taxable as a corporation, it must possess certain characteristics. Under Treas. Reg. § 301.7701-2(a)(1) the characteristics of a corporation include the presence of: 1) associates; 2) an objective to carry on business and divide the gains therefrom; 3) continuity of life; 4) centralization of management 5) liability for corporate debts limited to corporate property 6) free transferability of interests. This is a facts and circumstances test. Treas. Reg. § 301.7701-2(a)(2) clarifies, "[S]ince centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom." Taxpayer admits the common traits of centralization of management, and continuity of life and also admits there are associates and an objective to carry on business. Therefore, this entity is not a trust.

Taxpayer, however, disputes that the appropriate classification is as a corporation. The differentiation between a partnership and a corporation depends upon the existence of centralization of management, continuity of life, free transferability of interests and limited liability. Although other characteristics are included in the definition of a partnership and a corporation, since they are shared characteristics they are ignored for the purposes of this test. As noted above, taxpayer admits centralization of management and continuity of life but asserts that A lacked limited liability and free transferability of interests. Therefore we will concentrate our analysis on these last two attributes.

Treas. Reg. § 301.7701-2(d) states that "an organization has the corporate characteristic of limited liability if under **local law** there is **no member** who is personally liable for the debts of or claims against the organization." [Emphasis added.] Although section 4.03 of the trust agreement generally provides that D will be liable for the obligations of the trust, W state law provides otherwise: "No assessment shall be made against the interest of any owner, and no owner shall be personally liable for any debts or liabilities incurred by the trustees or by the D is the grantor and the sole beneficiary of the trust under the agreement. Moreover, section 4.03 of the agreement further provides that "[t]o the extent the Grantor . . .shall have paid or suffered any liability or expense with respect to the Trust Assets or the operation of the Trust, and to the extent that the liability or expense was not caused by the willful misconduct or bad faith of the Grantor . . . the Grantor shall be indemnified, defended and held harmless out of the Trust Assets against any such liability or expense . . . ."

Further, D's actions reflect its limited liability. Under section 4.83 of the trust agreement, D's liability with respect to any financing secured by a or any assignee of a is as set forth in those financing agreements. The Certificate Purchase and Sale agreement at 2.01 provides: "D does hereby absolutely sell, assign and otherwise convey to E , without recourse" the certificates. [Emphasis added.]

Moreover, it is our understanding that under the financing agreements, the lenders who provided financing to D for the transaction, have recourse limited to the Therefore, D, de facto has limited liability as grantor and beneficiary of A and the laws of W further support this.

The second issue concerns free transferability of interests. An organization has the corporate characteristics of free transferability of interests if each of its members or those members owning substantially all of the interest in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. This must include a transfer of all rights. Treas. Reg. § 301.7701-2(e)(1). Moreover, there is no free transferability where under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization. Under W law, free transferability of interest exists with respect to a business trust.

There is also other evidence that transferability exists in that the original grantor was O and D was substituted for O. It is not clear from the trust agreement if D can now substitute anyone for itself. Under the trust agreement, D cannot sell the It can sell the but only to E "or any similar special purpose vehicle created for the purpose of a financing." Section 4.02(c). We must look into what is actually transferred with the The is an equitable claim on a designated portfolio of contracts and Q owned by the A. District counsel argues that by creating the D is essentially transferring its interest, because once a is cut out, there is nothing left in the Further, under this argument, the represents D's interest in the trust.

Although the argument that there is free transferability of interests is not as clear cut nor as strong as the argument for limited liability, with the presence of limited liability, A still has more corporate characteristics than partnership characteristics and accordingly should be classified as an association taxable as a corporation.

ISSUE 2: CLASSIFICATION OF B AND C

The B and C trusts are set up as common law trusts under X law. Taxpayer asserts that B and C should be treated as security arrangements and not tax entities. The following discussion assumes that the Trusts are not treated as security arrangements for federal tax purposes.

As a default position, the taxpayer asserts that they should be treated as partnerships not corporations. To this end the taxpayer has filed section 761(a) elections for both entities. Under Treas. Reg. § 301.7701-2(a)(2), the determination of whether an organization is a partnership or a corporation depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

Taxpayer asserts that the trusts lack limited liability and free transferability of interests. As noted above, Treas. Reg. § 301.7701-2(d) states that "an organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization." Under X law, exculpatory provisions inserted into a trust are generally held effective. Thus, it was possible to create limited liability in this entity under X law.

The agreements for the B and C trusts, however, do not indicate whether the Class A or Class B certificate holders are, or are not, liable for debts or claims against the trusts. Moreover, the trust agreement does provide the following as to E:

> a) The Seller shall be liable in accordance with this agreement only to the extent of the obligations in this Agreement specifically undertaken by the Seller in such capacity under this Agreement and shall have no other obligations or liabilities hereunder.
>
> b) The Seller agrees to be, and shall be, liable without limitation for all liabilities (including taxes), contracts, expenses, indemnity payments and other charges of the trust, other than distributions to Certificate holders.

Although there are other provisions limiting the Seller's liability, this provision generally makes E liable. Therefore, this entity does not have the characteristic of limited liability.

As to free transferability of interests, Treas. Reg. § 301.7701-2(e) provides that "an organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization." Class A certificates which represent U percent of the beneficial interest in the trust, are transferable and are in fact transferred on a secondary market. As this represents substantially all of the interests, there is free transferability. Despite a lack of limited liability, B and C have more corporate characteristics than not and they should be classified as associations taxable as corporations for federal tax purposes.

ISSUE 3: D AND E'S ELIGIBILITY TO ELECT OUT OF SUBCHAPTER K

Section 761(a) provides, in part, that under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of Subchapter K, if the organization is availed of (1) for investment purposes only and not for the active conduct of business; (2) for the joint production, extraction, or use of property, but not for the purposes of selling services or property produced or extracted; or (3) by dealers in securities for a short period for the purposes of underwriting, selling, or distributing a particular issue of securities, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

Treas. Reg. § 1.761-2(a)(1) provides, in general, that under conditions set forth in the regulations, an unincorporated organization described in Treas. Reg. § 1.761-2(a)(2) and (3), relating to investing partnerships and operating agreements for the joint production, extraction, or use of property, may be excluded from the application of all or a part of the provisions of Subchapter K.

Treas. Reg. § 1.761-2(a)(2) provides:

> Investing partnership. Where the participants in the joint purchase, retention, sale, or exchange of investment property -
>
> (i) Own the property as coowners,
>
> (ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and
>
> (iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

> such group may be excluded from the application of the provisions of Subchapter K under the rules set forth in paragraph (b) of this section.

D and E are limited partnerships formed pursuant to the Y Revised Uniform Limited Partnership Act. Generally, the Service does not allow entities formed under a state's partnership or limited partnership laws to elect out of Subchapter K. Under Y state law:

> Except as provided in the partnership agreement, a partner, regardless of the nature of the partner's contribution, has no right to demand and receive any distribution from a limited partnership in any form other than cash. . . .

Thus, the partners in D and E do not have the right to take their share of partnership property. In addition, the agreement itself must provide that the partners can take their share of property. Thus the partners of D and E cannot take their share of the property at will and dispose of it, as is required for the election.

Moreover, the active conduct of business has been found where the parties entered into complex transactions to achieve a profit. The parties here have entered into a complicated series of transactions to achieve their goal. Accordingly, D and E cannot elect out of Subchapter K. See Arthur B. Willis et al., Partnership Taxation, 1.02[8] (6th ed. 1998).

ISSUE 4: B AND C'S ELIGIBILITY TO ELECT OUT OF SUBCHAPTER K

As determined above these entities should be treated as associations taxable as corporations. Treas. Reg. § 1.761-2(a) provides that "Any syndicate, group, pool or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions." Also, as noted above, Treas. Reg. § 1.761-2(a)(2) provides, among other things, that the participants in an entity seeking to elect out of Subchapter K must own the property as co-owners. The certificate holders are not co-owners of the trust property and cannot take their share of the property. Therefore, B and C cannot elect out of Subchapter K.

ISSUE 5: IS F SUBJECT TO THE PARTNERSHIP BASIS PROVISIONS OF SUBCHAPTER K?

F owns P, and the two of them respectively hold a T percent and Z percent partnership interest in E. The losses from the assets flowed through E to the consolidated group. Also, F owns O, and the two of them respectively hold T percent and Z percent partnership interest in D. The losses from the **non-** assets flowed through D to the consolidated a group.

Section 702(a) provides that in determining its income tax, each partner must take into account separately its distributive share of the partnership's (1) gains and losses from sales or exchanges of capital assets held for not more than one year, (2) gains and losses from sales or exchanges of capital assets held for more than one year, (3) gains and losses from sales or exchanges of property described in section 1231, (4) charitable contributions, (5) dividends with respect to which there is a deduction under part VIII of Subchapter B, (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States, (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of section 702(a).

Section 704(d) provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which the loss occurred.

Treas. Reg. § 1.704-1(d)(2) provides that if a partner's distributive share of the aggregate items of loss specified in section 702(a)(1), (2), (3), (8), and (9) exceeds the basis of the partner's interest, the limitation on losses under section 704(d) must be allocated to the partner's distributive share of each such loss. See Arthur B. Willis et al., Partnership Taxation, 1.02[8] (6th ed. 1998).

D and E did not maintain books and records or file Form 1065 tax returns and therefore taxpayer's basis in the partnerships cannot be determined. The burden of proving its right to a deduction is on the taxpayer. United States v. Wisconsin Power and Light Co., 38 F.2d 329,337 (7th Cir. 1994). Accordingly unless or until taxpayer can prove its adjusted basis in the partnerships, it should not be allowed to deduct the losses.

Please call if you have any further questions.

By: ______________________________
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