INTERNAL REVENUE SERVICE 200004 03 6
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index (UIL) No.: 707.01-00

CASE MIS No.: TAM-I 10546-99

OCTOBER 13, 1999

CC:DOM:P&SI:B2

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

P =

P1 =

P2 =

P3 =

P4 =

P5 =

M =

H =

A1 =

A2 =

200004036

Partnership	=
Bank	=
Bonds	=
Note	=
D1	=
D2	=
D3	=
D4	=
D5	=
D6	=
D7	=
D8	=
D9	=
$A	=
$B	=
$C	=
$D	=
$F	=
$E	=
$G	=
$H	=

ISSUE(S):

(1) Whether the transfer of Note by P1 to Partnership was a disguised sale under § 707(a)(2)(B)?

CONCLUSION:

(1) The transfer of Note by P1 to Partnership was a disguised sale under § 707(a)(2)(8) of Note by P to Partnership for federal tax purposes,

FACTS:

P is a parent company that owns numerous other corporations. On D1, P sold its interest in certain corporations to H. For the stock sold, P received cash and Note from H. The face amount of Note was $A. Note was due on D9, but the terms of the Note provided that it could be prepaid at up to $F per year following the first anniversary date, or prepaid in larger amounts with 12 months written notice to P. Note was secured by an irrevocable letter of credit dated D1. The letter of credit was in turn secured by mortgages on certain property owned by H. P elected to report the sale on the installment method. The entire $A is a deferred gain, taxable in the year of receipt of payment.

H, in order to remove the mortgages on the property securing the letter of credit, approached P in D5 about prepaying Note. On D6, H and P entered into an agreement pursuant to which H transferred $A to Bank. As a result, the letter of credit securing Note was now secured by a compensating cash deposit with Bank, as opposed to mortgages on H's property.

On D2, approximately 3 years later, P, in the first step for transferring Note to Partnership, transferred Note and the underlying letter of credit to P1, a newly formed subsidiary of P. Approximately a week later: on D3, PI transferred Note and the underlying letter of credit to a newly formed partnership, Partnership. The partners of Partnership were PI, M, Al, and A2. Al and A2 each contributed $B to Partnership for their respective partnership interest. Also on D3, the following transactions occurred: Partnership contributed $C to P2, a newly formed corporation, in exchange for all the stock in P2; P2 loaned the $C to P3, a wholly-owned subsidiary of P; P3 loaned $D to

P, and also loaned $E to P4, a wholly-owned subsidiary of P. P3 subsequently contributed the P4 loan to the capital of P4. P4 used the $E received from P3 to pay off an inter-company debt it had to P. Accordingly, eight days after the cash contribution to Partnership by Al and A2, and on the same day that the Note and the letter of credit were contributed to Partnership, the $C that Partnership had transferred to P2 as a purported equity contribution ended up with P.

Following the contribution of $C by Partnership to P2, the assets of Partnership consisted of Note, the underlying letter of credit, $G invested in Bonds, and an equity interest in P2. Partnership's sole activity has been collecting the payments made on Note and the interest payment from Bonds.

For the 5 years following Partnership's contribution to P2, through the tax year D7, P2 conducted no activity and had no earnings. Partnership received no economic benefit from its investment in P2. Partnership's earnings through D7 were derived solely from Note and the investment in Bonds.

On D4, 5 years after the formation of Partnership, Note and the underlying letter of credit were distributed to Al and A2 in liquidation of their respective interests in Partnership. Also in the same year, M's interest in Partnership was liquidated and a new partner, P5, a wholly-owned subsidiary of P, was admitted to Partnership. At the end of D7 the partners of Partnership were PI and P5, wholly-owned subsidiaries of P. At the end of D7, the only assets held by Partnership were its investment in P2 and an investment account with a brokerage firm with a value of $H.

The intent of the parties that formed Partnership, as evidenced by the action of the parties and by the partnership agreement, was to minimize the economic risk of Al and A2 and to provide the $C that would ultimately be transferred to P.

Under Article I of the first amended and restated agreement of partnership for Partnership (Agreement) Al and A2 are entitled to a first priority return on their respective contributions of to Partnership.

Under Article VI of Agreement, net cash flow is to be distributed semiannually, in an amount equal to the net taxable income of Partnership for the previous quarter, first to Al and A2 in proportion to their respective positive capital account balances in an amount equal to the sum of their respective annual priority return.

Under section 5.02 of Article V of Agreement, losses are allocated first, 99% to PI and 1% to M, Al, and A2 collectively. The intent of the arrangement between the partners of Partnership was that Al and A2 could suffer an economic loss only if the bank that provided the letter of credit securing Note failed.

Section 8.01(a) of Article VIII of Agreement provides that following the formation of Partnership, the Partnership shall contribute $C to the capital of P2.

LAW AND ANALYSIS:

Section 721 of the Internal Revenue Code provides that no gain or loss is recognized by a partner or a partnership when the partner contributes property to the partnership in exchange for a partnership interest.

Section 707(a)(2)(8) of the Code provides that if there is a direct or indirect transfer of money or other property by a partner to a partnership, there is a related direct or indirect transfer of money or other property by the partnership to such partner, and the transfers when viewed together are properly characterized as a sale or exchange of property, then such transfers shall be treated either as a partner engaging in a transaction with a partnership other than in his capacity as a member of such partnership, or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

Section 1.721-1 (a) of the Income Tax Regulations provides, in part, that § 721 does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by § 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form.

As noted by the Tax Court in Jacobson v. Commissioner, 96 T.C. 577, 588 (1991), the legislative history of § 707(a)(2)(8) indicates that

> "[I]n the case of disguised sales, the committee is concerned that taxpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership or another partner. The committee believes that these transactions should be treated in a manner consistent with their underlying economic substance."

Staff of the J. Comm. on Taxation, General Explanation of the Revenue Provisions of the 98th Cong., 2d Sess., Deficit Reduction Act of 1984, at 231-233 (J. Comm. Print).

In order to re-characterize a transfer of property to a partnership as a sale of the property to the partnership or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership, § 707(a)(2)(8) requires that three elements must be satisfied:

First, there must be a direct or indirect transfer of money or other property by a partner to a partnership. P1, AI, and A2 each transferred money and property to Partnership. P did not directly transfer money or property to Partnership. Therefore, in order to satisfy the first requirement of § 707(a)(2)(8) it must be shown that the transfer of property by P1 to Partnership was in substance a transfer by P to Partnership.

Second, it must be shown that there is a related direct or indirect transfer of money or other property by the partnership to such partner. The parties to Partnership carefully structured the transfer of money from Partnership to avoid a direct transfer of money from Partnership to P. Therefore, to satisfy the second requirement of § 707(a)(2)(B) it must be shown that the transfer of money from Partnership to P2 was intended by the parties to be an indirect transfer of money to P.

Third, it must be shown that the transfers to the partnership and the transfer from the partnership to the partner when viewed together, are properly characterized as a sale or exchange of property between P and Partnership. Therefore, to satisfy the third requirement of § 707(a)(2)(8) it must be shown that the transfer of the property by PI to Partnership and the transfer of money from Partnership to P2 was in substance a sale or exchange between P and Partnership.

Clearly, the form chosen by P in structuring the investment in Partnership and the transfer of money from Partnership to P2 was intended to insure that § 707(a)(2)(8) did not apply to the transfer of Note to Partnership.

P created a new subsidiary, P1, with the transfer of Note and the underlying letter of credit, solely to ensure that P1 and not P was considered the partner in Partnership.

Partnership transferred $C ($C was 80% of $A) to P2, a newly created corporation on the same date as the contribution by P1 to Partnership, followed immediately by P2 loaning the $C to P3, which in turn loaned $D to P and $E to P4, with P4 using the $E to pay an inter-company loan to P, was intended to result in P receiving $C from Partnership and still avoid the application of § 707(a)(2)(8) to the transaction.

In interpreting § 707(a) the Tax Court noted that "in order to fit within a particular provision of the statute a transaction must comply not only with the letter of the section, but must have a business purpose (other than to avoid taxes) that falls within its spirit as well." See Jacobson, supra at 590.

Although the form selected by the partners in the formation of Partnership was intended to avoid the application of § 707(a)(2)(8) to the transfer of Note to Partnership on D3, the Service is not required to follow this form. The Tax Court in Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793, (1988), noted that although the statutory scheme under subchapter K gives partners great latitude in selecting the form the partnership takes and in allocating economic benefits and tax burdens of partnership transactions among partners, this flexibility is not unlimited. The court also noted that labels, semantics, technicalities, and formal documents do not necessarily control the tax consequences of a given transaction. The form of the transaction must be in keeping with its true substance and the intent of the parties. In this regard, the provisions of written documents are not necessarily conclusive for tax purposes. Hiqhland Hills Swimmino Club, Inc. v. Wiseman, 272 F. 2d 176 (10" Cir. 1959). Nor will a "label" attached by a tax-conscious litigant control the proper characterization of a transaction. Jupiter Corp. v. United States, 2 Cl. Ct. 58, 79 (1983).

Partners may attempt to structure the substance of their transactions choosing the form of the transactions. Otev v. Commissioner, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980). Ordinarily, "the taxpayers are . ** bound by the form of their transaction while the Government can attack that form if it does not represent the substance of the transaction." Newhall Unitrust v. Commissioner, 104 T.C. 236, 243 (1995). Mere formalisms arranged by the parties are not binding in the application of the tax laws. Cozzi v. Commissioner, 88 T.C. 435, 445 (1987) (citing Commissioner v. Court Holdinq Co., 324 U.S. 331 (1945). The form chosen by P allowed P to receive from Partnership 80% of the cash contributed by Al and A2 to Partnership, immediately following p's transfer of Note to Partnership, without the recognition of gain on the transaction. The Seventh Circuit stated, in Saviano v. Commissioner, 765 F.2d 643,654 (7th Cir. 1985), affg 80 T.C. 955 (1983) "The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substances and to apply the tax laws accordingly." Clearly, the form chosen by P: the contribution by P of Note and the letter of credit to P1, followed shortly thereafter by PI transferring Note and the letter of credit to Partnership, served no economic purpose other than to avoid having P considered a partner in Partnership.

y 3 c

Although P is not formally identified as a partner in Partnership, the formation of P1 with the contribution of Note by P to P1, followed by PI transferring Note to PA, served no purpose other than to avoid the application of § 707(a)(2)(8). Furthermore, although Partnership did not transfer money directly to P, the transfer of $C to P2 served no economic purpose other than to avoid a direct transfer of money from Partnership to P. The tax statutes apply only "to transactions entered upon for commercial purposes and 'not to • * transactions entered upon for no other motive but to escape taxation."' Weller v. Commissioner, 270 F.2d 294, 297 (3d Cir. 1959) (quoting Commissioner v. Transport Tradino & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949). The only acknowledged business purpose for p's and P1's involvement in the transaction was to enable P to receive cash from Partnership. P could not directly transfer Note to Partnership and then take the cash out of Partnership, for this would clearly fall within the ambit of § 707(a)(2)(8). Therefore, P1 was formed to be the "partner" that contributed Note and P2 was formed to receive the $C from Partnership as a purported equity contribution. However, the economic substance of the transaction was that P contributed Note to Partnership in exchange for $C. The sole business purpose for the creation of P2 was to allow the transfer of $C out of Partnership without the cash going directly to P.

Further, although the $C contributed to P2 represented 80% of the cash contributed by Al and A2 to Partnership, and although the "investment" in P2 never generated any economic return to the Partnership, neither P nor Al or A2 acted in a manner consistent with normal business practices concerning the "investment" in P2. Whether P2 ever generated a return on the "investment" was irrelevant to P, Al, and A2; Al's and A2's investment in Partnership was secure because of the Note and letter of credit, and p's investment in Partnership was also secure because it already withdrew $C on the day it contributed the Note, and the balance was held by Partnership in the form of the Bonds, which in time (when Al and A2 withdrew from Partnership) was owned by P through its subsidiaries P1 and P5. Thus, even if Partnership's investment in P2 never generated any return, no partner would suffer any true economic loss.

Therefore, based upon the economic substance of the transaction and not the form adopted by the parties to the transaction, we conclude that for purposesof the disguised sales rule under § 707(a)(2)(B), the transfer of Note to Partnership is properly characterized as a transfer by P of Note to Partnership, followed by a transfer of $C by Partnership to P.

Accordingly, the transfer of.Note to Partnership was a sale of Note by P to Partnership in exchange for $C on D3. No opinion is expressed regarding whether P should recognize gain on the $A, the amount remaining in Partnership in D7 when Al and A2 withdrew from Partnership.

Appeals also requested guidance regarding the application of § 451 to this transaction. This issue will be addressed in a separate Technical Advice Memorandum.

CAVEAT(S)

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Code.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent