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

OFFICE OF
CHIEF COUNSEL

April 16, 2001

Number: **200128040**
Release Date: 7/13/2001
CC:INTL:Br.4
TL-N-5963-00

UILC: 367.10-01; 701.01-00; 707.00-00; 1491.00-00R97; 1492.01-02R97; 1494.00-00R97; 6038B.00-00.

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR LARGE AND MID-SIZE BUSINESS COUNSEL–NATURAL RESOURCES

FROM: Mike Frankel, Assistant to the Branch Chief, CC:INTL:4

SUBJECT:

This Field Service Advice responds to your memorandum dated Nov. 8, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

## DISCLOSURE STATEMENT

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TL-N-5963-00

LEGEND

| | |
|---|---|
| US1 | = |
| Year1 | = |
| Date1 | = |
| $a | = |
| Seller | = |
| FC1 | = |
| Date2 | = |
| Business1 | = |
| US2 | = |
| Country1 | = |
| FC2 | = |
| Year2 | = |
| Year3 | = |
| US3 | = |
| Business2 | = |
| Date3 | = |
| Date4 | = |
| $b | = |
| $c | = |
| $d | = |

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Province =

FPS =

Holding =

$e =

$f =

$g =

$h =

Date5 =

Period 1 =

$i =

$j =

$k =

$l =

$m =

$n =

$o =

$p =

X =

Year4 =

Product X =

Date6 =

Date7 =

| | | |
|---|---|---|
| $q | = | |
| Date8 | = | |
| Date9 | = | |
| $r | = | |
| $s | = | |
| Y | = | |
| Z | = | |

ISSUES

1. Does US1's "all earnings and profits amount" attributable to its FC1 stock for Year1 include only the earnings and profits that accrued during the period FC1 was a controlled foreign corporation (CFC) as defined in § 957?

2. Under what facts and circumstances can the corporate status of FC1 be disregarded pursuant to § 367(b)?

3. How are principles similar to the principles of § 367 applied to a contribution of intangible property to a foreign partnership where the contributor elected to apply such similar principles under § 1492?

4. Do the penalty provisions in § 6038B apply to a transfer of intangible property to a foreign partnership that is subject to § 1491 where the transferor elected under § 1492 to apply principles similar to the principles of § 367 to the transfer?

5. Does the partnership anti-abuse regulation apply to the transactions described below?

6. Should the deemed contribution of cash and property to FPS, a partnership, followed by the distribution of a portion of the cash to its partners, be recharacterized as part of a sale or exchange of property under the circumstances described below?

CONCLUSIONS

1. FC1 became a CFC when US1 acquired 100% of FC1's stock on Date1. Assuming that FC1 was a calendar year taxpayer prior to this acquisition, and that FC1 continued to be a calendar year taxpayer after the acquisition, US1's all earnings and profits amount attributable to its FC1 stock for Year1 is a proportionate amount of FC1's earnings and profits for Year1 (which includes all items that accrued during FC1's Year1 year) based on the number of days US1 held its FC1 stock during Year1 over the number of days in Year1.

2. Because we conclude that US1's use of the pro rata method to compute its all earnings and profits amount attributable to its FC1 stock for Year1 was proper, and we are unsure about whether US1 included items from other tax years in the calculation of FC1's Year1 earnings and profits, we do not address what the consequences would be if US1 had not correctly computed its all earnings and profits amount with respect to its FC1 stock for Year1.

3. The Agreement (described below) constitutes intangible property for purposes of § 1491 and § 367(d). Applying principles similar to the principles of § 367 to a transfer of intangible property to a partnership, the transfer results in a deemed sale of the property by the transferor to the partnership. See 367(d). Thus, the transferor (US1) is treated as having sold the intangible property in exchange for payments that are contingent upon the productivity, use, or disposition of the property and is treated as receiving amounts that reasonably reflect the amount that would have been received annually in the form of such payments over the useful life of the property. The deemed payments would constitute U.S. source ordinary income to US1. See § 367(d)(2)(C) (as in effect in Year4). The partnership may take a tax deduction for each deemed payment. The deduction should be allocated among the partners in accordance with the partners' loss sharing arrangement (Y% to US1, Z% to Holding).

4. When a transfer of property by a U.S. person to a foreign partnership in Year4 is subject to §1491, and the U.S. person elects to apply principles similar to the principles of § 367 to the transfer, the transfer is subject to the penalty provisions of both § 6038B and § 1494(c). However, Notice 98-18 provides that the amount of the penalty under § 1494(c) will be reduced by the amount of the penalty imposed for failing to comply with the reporting requirement of § 6038B. The penalties may be avoided if the transferor obtains a reasonable cause determination.

5. The partnership anti-abuse regulation does not apply to the transactions.

6. Because more cash was transferred to FPS on its formation than was received in distributions from FPS, the cash distributions that occurred

shortly after the formation of FPS should not be recharacterized as part of a sale or exchange of property under the disguised sale rules.

FACTS

US1, a domestic corporation, was incorporated in Year1. On Date1, US1 used the proceeds of an initial public offering of common stock and long-term notes to purchase for about $a the stock of several subsidiaries of Seller, a U.K. company, including 100 percent of the stock of FC1. As a result of this acquisition, FC1 became a CFC on Date1. Prior to its acquisition by US1, FC1 was not a CFC.

For purposes of this memorandum, we assume that FC1's annual accounting period, the annual period on the basis of which FC1 regularly computed its income in keeping its books, has always been the calendar year, and that therefore, FC1's taxable year has always been the calendar year. See § 1.441-1T(b)(1)(A). We also assume that US1's taxable year is the calendar year, so that FC1's taxable year did not change pursuant to § 898(c) when US1 acquired FC1 on Date1.[1]

From Year1 through Date2, US1 engaged in Business1 in the United States through its wholly owned subsidiary US2, and in Country1 through FC1 and FC1's wholly owned subsidiary FC2. FC1 was incorporated in Year2 and FC2 was incorporated in Year3. FC1 has not made any dividend distributions since it was acquired by US1 on Date1.

US3 is a domestic corporation. Its principal business activity is Business2 in the United States. On Date3, US3 merged into US1.

Calculated in U.S. dollars, on Date4, US1 had a basis in its FC1 stock of approximately $b, and its FC1 stock had a value of approximately $c. Thus, US3 had a built-in-gain in its FC1 stock of $d.

On Date4, there was an amalgamation of FC1 under the laws of Province into a Province unlimited liability company. In connection with this amalgamation, US1 contributed Z percent of its 100 percent interest in FC1 to Holding, its newly organized wholly owned U.S. subsidiary, and FC1 changed its name to FPS. Holding files a consolidated return with US1. Taxpayer asserts that the amalgamation resulted in FC1 converting from a foreign corporation into a foreign partnership for U.S. federal income tax purposes. We assume that FC1 was properly classified as a foreign corporation prior to Date4, and properly classified as

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[1] We also note that it appears that US1 included in the calculation of FC1's earnings and profits for FC1's Year1 tax year items that accrued during Period1. We assume that this inclusion is not the result of FC1 using other than a calendar year as its taxable year prior to its acquisition by US1.

a foreign partnership after the amalgamation and transfer of the Z percent interest to Holding. US1 treated the conversion of FC1 from a corporation into a partnership as a deemed distribution of FC1's assets in connection with its complete liquidation, followed by a deemed contribution of such assets to FPS, a foreign partnership. See Rev. Rul. 63-107, 1963-1 C.B. 71 (where an organization classified as a corporation amends its operating agreement so that thereafter it is classified as a partnership, the change in status is treated as the liquidation of the corporation). At the time FC1 was deemed liquidated, FC1's accumulated earnings and profits in Country1 currency was $e.

Upon the deemed liquidation of FC1 pursuant to the conversion of FC1 from a foreign corporation into a foreign partnership, US1 included $f in its gross income as its "all earnings and profits amount" attributable to its FC1 stock. When computing FC1's earnings and profits for § 1248 purposes for Year1, citing to § 1.1248-2(e)(2), US1 calculated the earnings and profits for FC1's entire Year1 tax year (($g)), and then reduced that amount by the pro rata amount allocated to the portion of Year1 prior to US1's acquisition of FC1 (($h)). Included in these calculations was a prepayment penalty on a loan that FC1 paid on Date5. We assume that the penalty properly accrued in Year1 and not in a prior tax year.

In connection with US1's deemed transfer of property to FPS, US1 filed Form 926 and elected to apply principles similar to the principles of § 367 to the transfer. The information submitted with US1's Form 926 states that US1 transferred the following property (value in US$) to FPS:

| | |
|---|---|
| Cash | $i |
| Accounts receivable | $j |
| Due from FC2 | $k |
| Prepaid expenses | $l |
| Long term receivable-FC2 | $m |
| Investment - FC2 | $n |
| Deferred income tax | $o |
| Deferred foreign exchange loss | $p |

Prior to the conversion of FC1 into a foreign partnership, FC1 and FC2 had entered into long-term supply agreement (the Agreement). The Agreement provides that FC1 will provide Product X to FC2 and FC2 will reimburse FC1 all freight and related costs (and in the case of Product X purchases, FC1's cost plus X cents per barrel) incurred in supplying it Product X.

From Date6 through Date7, FPS distributed a total of $q in cash to US1 and Holding. From Date8 through Date9, FPS distributed a total of $r in cash to US1 and Holding. Accordingly, FPS distributed a total of $s in cash shortly after the conversion of FC1 from a foreign corporation into a foreign partnership.

Finally, it is our understanding that the US1 consolidated group is in a net loss position and has deducted any foreign taxes it is deemed to have paid rather than credit them.

LAW AND ANALYSIS

1. **Calculating the "all earnings and profits amount".**

Generally, the complete liquidation of a subsidiary into its corporate parent is tax-free pursuant to §§ 332 and 337. However, § 367(b) provides that in the case of any exchange described in § 332 in connection with which there is no transfer of property described in § 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary that are necessary or appropriate to prevent the avoidance of Federal income taxes. The liquidation of FC1 into US1 is a transfer described in § 367(b) because the liquidation involves a foreign corporation (FC1) and an exchange described in § 332.

Section 7.367(b)-5(b), which was in effect at the time of the deemed liquidation of FC1, provides that if a domestic corporation that receives a distribution in complete liquidation of a foreign corporation includes in its gross income the all earnings and profits amount attributable to its stock in the distributor foreign corporation, the foreign corporation will be considered to be a corporation for purposes of applying subchapter C of chapter 1 of subtitle A of the Code. The domestic corporation must include the all earnings and profits amount in gross income for the tax year in which occurs the date of distribution (within the meaning of § 381(b)(2) and the regulations thereunder). If the domestic corporation does not include this amount in gross income, for purposes of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the provisions of the Code other than §332 shall apply as if the foreign corporation were considered a corporation.

Section 1.367(b)-2(f) provides that the term "all earnings and profits amount" means the net positive earnings and profits for all taxable years that are attributable to the stock of the foreign corporation exchanged under the principles of § 1246 or § 1248 (whichever is applicable) and the regulations under that section. The determination is made by applying §1246 or §1248 as modified by § 7.367(b)-2 through § 7.367(b)-12 as if there were no distinction in those sections between earnings and profits accumulated before or after December 31, 1962.

Section 1.1248-2(e)(1) provides that except as provided in § 1.1248-2(e)(3), the earnings and profits attributable to a block of stock of a controlled foreign corporation for the period a United States person held the block are an amount equal to–(i) the sum of the earnings and profits accumulated for each tax year of the corporation beginning after December 31, 1962 (computed under § 1.1248-2(d)) during such period, multiplied by (ii) the percentage that (a) the number of shares in the block bears to (b) the total number of shares of the corporation outstanding during such period.

Section 1.1248-2(e)(2) provides that for purposes of computing the sum referred to in § 1.1248-2(e)(1)(i), in case the block was held during a taxable year beginning after December 31, 1962, but not on each day of such taxable year, there shall be included in such sum only that portion that bears the same ratio to (i) the total earnings and profits for such tax year (computed under § 1.1248-2(d)), as (ii) the number of days during such taxable year the block was held bears to (iii) the total number of days in such taxable year. Similar rules are also contained in § 1248-3(c) and (d).

In the instant case, when FC1 was deemed liquidated upon its conversion from a corporation into a partnership, US1 was required to include in its gross income its all earnings and profits amount attributable to its FC1 stock. Noting that US1 owned FC1 stock for only part of FC1's Year1 tax year, and that FC1 did not become a CFC until Date1, the date US1 acquired FC1 stock, the question has been raised as to whether any FC1 items that accrued before Date1 should be taken into account in determining US1's all earnings and profits amount for FC1's Year1 tax year.

US1's all earnings and profits amount should include a proportionate amount of FC1's earnings and profits for FC1's Year1 tax year (which includes any items that accrued during that year, even if prior to Date1) based on the number of days US1 held FC1 stock during that year over the number of days in Year1. See § 1.367(b)-2(f) and § 1.1248-2(e)(2). Accordingly, US1 properly complied with the rules of § 367(b) when it used a pro rata method to compute its all earnings and profits amount for FC1's Year1. However, the information submitted indicates that included in FC1's earnings and profits for Year1 were items that accrued during Period1. If such items were included in FC1's earnings and profits for Year1, US1's all earnings and profits amount for Year1 should be recalculated with those items excluded.

2. **Consequences of failure to properly compute the all E&P amount**

Section 7.367(b)-5 provides that if a domestic corporation that receives a distribution in liquidation of a foreign corporation includes in its gross income the all earnings and profits amount attributable to its stock in the foreign corporation, the foreign corporation will be considered to be a corporation for purposes of applying subchapter C. If a domestic corporation does not include its all earnings and profits amount in its gross income, for purposes of determining the extent to which gain is recognized on the exchange, the foreign corporation will not be considered to be a corporation. However, the provisions of the Code other than § 332 shall apply as if the foreign corporation were considered a corporation. Id. Because we conclude that US1's use of the pro rata method to compute its all earnings and profits amount attributable to its FC1 stock for Year1 was proper, and because we are unsure about whether US1 included items from other tax years in the calculations for FC1's Year1 tax year, we will not address in any more detail what the consequences would be if US1 had not correctly computed its all earning and profits amount for Year1.

3. **Section 1491 and the election to apply § 367 principles**

Prior to its repeal in 1997, §1491 provided that there is imposed on the transfer of property by a domestic corporation to a foreign partnership an excise tax equal to 35 percent of the excess of the fair market value of the property transferred over the sum of the adjusted basis (for determining gain) of such property in the hands of the transferor and the amount of the gain recognized to the transferor at the time of the transfer. Section 1492(2)(B), however, provided that the tax imposed by § 1491 shall not apply to a transfer not described in § 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of § 367.

As noted earlier, the conversion of FC1 from a foreign corporation into a foreign partnership is treated as the deemed liquidation of FC1 followed by the deemed formation of FPS. See Rev. Rul. 63-107, 1963-1 C.B. 71. Thus, US1 is considered to have transferred the property it received in the deemed liquidation of FC1 to a new foreign partnership, FPS. (We assume that the transfer of property to FPS qualified as a § 721 contribution). The transfer of the property by US1 to FPS is subject to § 1491 because it is a transfer by a domestic corporation of property to a foreign partnership. However, because US1 elected to apply principles similar to the principles of § 367 to the transfer, the consequences of the transfer are governed by such similar principles. In particular, principles similar to the principles of § 367(d) would apply to any intangible property transferred to FPS if that property is intangible property with the meaning of § 367(d).

Among the items US1 is deemed to have transferred to FPS is the Agreement. Based on the information submitted, the Agreement, which was entered into before the conversion and was legally enforceable at the time of the conversion, constitutes property within the meaning of § 1491 and intangible property within the meaning of § 367(d). Section 367(d)(1) provides that § 367(d) applies to intangible property within the meaning of § 936(h)(3)(B). Section 936(h)(3)(B) defines intangible property as including any franchise, license or contract. Thus, because the Agreement is a contract, it constitutes intangible property under § 936(h)(3)(B) and hence intangible property for purposes of

§ 367(d). See also § 1.367(a)-1T(d)(5)(ii) and § 1.367(d)-1T(g)(2)(i), which together indicate that a long-term purchase or supply contract can be intangible property for purposes of § 367(d). Therefore, principles similar to the principles of § 367(d) apply to determine the consequences of the transfer of the Agreement to FPS.

Section 367(d)(1) provides that except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of § 936(h)(3)(B)) to a foreign corporation in an exchange described in §§ 351 or 361, § 367(a) shall not apply to the transfer of such property and the provisions of § 367(d) shall apply. Section 367(d)(2)(A) provides that if § 367(d) applies to a transfer, the U.S. person transferring the property shall be treated as (i) having sold such property in exchange for payments that are contingent upon the productivity, use, or disposition of such property, and (ii) receiving amounts that reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of such property. The amounts taken into account under § 367(d)(2)(A)(ii) must be commensurate with the income attributable to the intangible.

Accordingly, US1 is treated as having sold the Agreement to FPS in exchange for payments that are contingent upon the productivity, use, or disposition of the Agreement and receiving amounts that reasonably reflect the amount that would have been received annually in the form of such payments over the useful life of the Agreement. The deemed payments would constitute U.S. source ordinary income to US1. See § 367(d)(2)(C) (as in effect on Date4).

The question has also been raised as to whether FPS is entitled to a tax deduction in the amount of the deemed payment to US1. Section 367(d) provides that for purposes of chapter 1 of the Code, the earnings and profits of a foreign corporation to which the intangible property was transferred shall be reduced by the amount required to be included in the income of the transferor of the intangible property under § 367(d)(2)(A)(ii). Section 1.367(d)-1T(c) provides that for purposes of chapter 1 of the Code, the earnings and profits of the transferee foreign corporation shall be reduced by the amount of the deemed payment, and for purposes of subpart F of Part III of subchapter N of the Code, the transferee foreign corporation may treat such deemed payment as an expense properly allocated and apportioned to gross income subject to subpart F, in accordance with the provisions of § 1.954-1(c) and § 1.861-8. Section 1.367(d)-1T(c) further provides that no other special adjustments to earnings and profits, basis, or gross income shall be permitted by reason of the recognition of a deemed payment under § 1.367(d)-1T(c). To achieve a result similar to that achieved by the adjustments allowed in § 1.367(d)-1T(c), we conclude that FPS is entitled to an annual tax deduction in the amount of the annual deemed payment to US1. The deduction should be allocated among the partners in accordance with the partners' loss sharing arrangement (Y% to US1, Z% to Holding).

4. **Penalty issues**

Section 1494(c), as in effect on Date4, provided that in the case of any failure to file a return required by the Secretary with respect to any transfer described in § 1491, the person required to file such return shall be liable for the penalties provided in § 6677 in the same manner as if such failure were a failure to file a notice under § 6048(a) (i.e., a penalty equal to 35 percent of the gross value of the property transferred plus additional penalties for continuing failure to comply). The § 1494(c) penalty does not apply if failure to report a transfer is shown to be due to reasonable cause and not to willful neglect. See §§ 1494(c), 6677(d).

Notice 96-60, 1996-2 C.B. 227, announced that no § 1494(c) penalty would be imposed if a § 1491 transfer is reported no later than 60 days after issuance of forthcoming guidance. The “forthcoming guidance” was contained in Notice 97-18, 1997-1 C.B. 389, issued on March 10, 1997. Notice 97-18 is effective for transfers of property occurring after August 20, 1996. The notice states that a U.S. transferor that makes an election to apply principles similar to the principles of § 367 must comply with the reporting requirements of § 6038B. Notice 97-18, Section IIIB. The notice further provides that a U.S. transferor is deemed to have satisfied the § 1494 reporting requirements without having to file Form 926 if the transferor is subject to and complies with the reporting requirements of certain other Code sections (e.g., § 6038B). However, if the U.S. transferor has not complied with the reporting requirements of that other Code section, the U.S. transferor will not be treated as having satisfied its reporting obligation under § 1494 and will be subject to penalties under § 1494(c). The amount of the penalty under § 1494(c) will be reduced, however, by the amount of the penalty imposed for failing to comply with the reporting requirement of that other section. Also, the penalty applies only to the extent the transfer is not reported or is reported inaccurately. See §§ 1494(c), 6677(a), and Notice 97-18, Section V.

Section 6038B, prior to its amendment in 1997, provided that each U.S. person who transfers property to a foreign corporation in an exchange described in § 351 shall furnish to the Secretary, at such time and in such manner as the Secretary shall by regulations prescribe, such information with respect to such exchange as the Secretary may require in such regulations. Pursuant to § 6038B(b), any U.S. person that fails to furnish the information described in § 6038B(a) at the time and in the manner required by regulations, shall pay a penalty equal to 25 percent of the amount of the gain realized on the exchange. However, the penalty shall not apply to any failure if the U.S. person shows such failure is due to reasonable cause and not to willful neglect. Section 6038B(b)(2).

Section 1.6038B-1T(b)(1) provides that any U.S. person that is required to report pursuant to § 6038B must attach the required information to Form 926. Section 1.6038B-1T(b)(2) provides that Form 926 and the attachments required under the rules of § 6038B must be filed by each U.S. person that makes a transfer described in § 367(a) or (d). Section 1.6038B-1T(d) states the information that a U.S. person that transfers intangible property to a foreign corporation in a § 351 exchange must provide. The information required by subdivisions (i) through (iii) of § 1.6038B-1T(d) must only be provided if such information was not otherwise provided under paragraph (c) (information required with respect to transfers described in § 367(a)(1)). Additionally, § 1.6038B-1T(f)(2) defines a failure to comply with the requirements of § 6038B as the failure to report at the proper time and in the proper manner any material information required to be reported under the rules of § 6038B, or the provision of false or inaccurate information in purported compliance with the requirements of § 6038B. A reasonable cause exception to the imposition of penalties is contained in § 1.6038B-1T(f)(3).

US1 elected to apply principles similar to the principles of § 367 to its transfer of property to FPS. Therefore, US1 was required to comply with the reporting requirements of § 6038B. US1 filed Form 926 and provided the specific information required by § 1.6038B-1T(c). US1 did not, however, provide the information required to be submitted under § 1.6038B-1T(d) with respect to the transfer of the Agreement. A determination should be made as to whether US1 had reasonable cause for its failure to supply the information required by § 1.6038B-1T(d). If there is no reasonable cause, then the penalty in § 6038B would apply, as would the penalty in § 1494(c), but the § 1494(c) penalty must be reduced by the amount of the § 6038B penalty. The § 6038B penalty, if applicable, would be equal to 25 percent of the amount of gain realized on the transfer of the intangible property to the foreign partnership, i.e., that property with respect to which there was a failure to comply with § 6038B. See § 1.6038B-1T(f)(1)(ii).

## 5. **Partnership anti-abuse regulation**

The partnership provisions of subchapter K are intended to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring any entity-level tax. Section 1.701-2(a). To come within the intent of subchapter K two requirements must be met. First, the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose. Second, the form of each partnership transaction must be respected under substance over form principles.

In general, the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income. Section 1.701-2(a)(1) through (3). If a partnership is formed or availed of in connection with a transaction, a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Section 1.701-2(b). Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Section 1.701-2(c). Section 1.701-2(c) lists various factors that may be considered in making the determination.

In the instant case, by structuring the distribution through a partnership, US1 avoided a distribution to US1 from FC1 that would have been taxable to US1 as a dividend under § 301(c)(1). Therefore, by structuring the transaction as a deemed liquidation followed by a deemed contribution to a partnership, followed by a partnership distribution, US1's federal tax liability may have been substantially reduced, depending on the benefit provided by any foreign taxes associated with the all earnings and profits amount US1 included in its income (as noted earlier, it is our understanding that US1 is in a net loss position and therefore has been deducting rather than crediting foreign taxes). Nevertheless, we conclude that in the present case, the taxpayer's reported tax consequences are consistent with the conversion of a corporation into a partnership and the continuation of the former corporation's business by the partnership. Accordingly, the partnership anti-abuse rule is not applicable.

6. **Disguised sale**

If a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction is considered as occurring between the partnership and one who is not a partner. Section 707(a)(1). Such transactions include the sale of property by the partner to the partnership. Section 1.707-1(a). If a partner transfers property to a partnership, there is a related direct or indirect allocation and distribution to such partner, and the transfer and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such distribution shall be treated as occurring between the partnership and one who is not a partner. Section 707(a)(2)(A); Section 1.707-3(a)(1).

Section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as occurring between the partnership and one who is not a partner, or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

Under the § 707 regulations, a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership if, based on all the facts and circumstances, 1) the transfer of money or other consideration would not have been made but for the transfer of property and, 2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership operations. Section 1.707-3(b)(1). The weight to be given each of the facts and circumstances will depend on the particular case. Section 1.707-3(b)(2).

In the present case, FPS had enough funds in cash to cover the distributions. Because the cash transferred to FPS exceeded the cash that was withdrawn, we conclude that no disguised sale occurred.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any further questions, please call (202) 622-3860.

By: ____________________________

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