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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR JOHN F. EIMAN
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FROM: David R. Haglund
Senior Technician Reviewer CC:PSI:1

SUBJECT: Loan Transactions

This Chief Counsel Advice responds to your memorandum dated December 21, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

X =

Y =

Z =

Bank =

P1 =

P2 =

Corporation A	=
Corporation B	=
Corporation C	=
Corporation D	=
Corporation E	=
Corporation F	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=
a%	=

b%	=
c%	=
e%	=
f%	=
g%	=
h%	=
i%	=
j%	=
k%	=
l%	=
m%	=
n%	=
#a	=
#b	=
Month A	=
Month B	=
Month C	=
Month D	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

D9 =

ISSUE

What arguments may the Service raise to challenge the following transactions.

CONCLUSION

The Service may argue that the substance of the transactions was a loan from P2 to P1 for which P2 received a b% limited partnership interest in P1 in addition to the monthly interest payments due from P1.

FACTS

Taxpayer is the common parent of an affiliated group of corporations that files a consolidated return. Taxpayer wholly-owns corporation X, and X wholly-owns corporations Y and Z. In Month B and Month C of Year 1, Taxpayer and Bank agreed to a prearranged plan whereby Y and Z would form a partnership (P1), Bank would solicit investors to form a different partnership (P2), Bank would make a loan to P2, and P2 would use the loan proceeds to purchase an interest in P1.

Taxpayer's documentation explains that the objectives of the prearranged transactions, which are more fully described below, were designed to: (1) place approximately $d of limited partnership interests with outside investors in two different offerings; (2) treat the limited partnership interest as traditional equity for legal and tax purposes, and consolidated as "Other Liabilities" for accounting purpose; (3) organize the partnership and limited partnership interest to minimize return requested by the outside investors by designing an attractive [redacted] package, placing environmentally risky assets in a corporate subsidiary, and providing corporate investors with a preferred return and lower share of losses; (4) limit outside investors' (P2's) commitment to #a years, with an opportunity to renew for extended period based on renegotiated terms; (5) allow P2 to maintain control and almost all upside share of profits and value of business assets employed; (6) allow Corporation A complete flexibility on future business ventures and activities without ongoing approval from the outside investor. Additionally, upon examination, X stated that the business objectives for the P1 transaction was to raise cash from third parties without increasing financial statement debt, retain the upside potential of the transferred assets, defer potential losses for financial statement purposes, and leave Taxpayer with the flexibility to pursue other restructuring options.

In accordance with the prearranged plan, on D1, Y and Z formed P1. Y contributed the stock of three of its subsidiaries, including Corporation A, and [redacted] properties to P1 in exchange for a j% limited partnership interest. Y separately transferred other property with an adjusted basis of approximately $e and a fair market value of approximately $b to P1 in exchange for a b% general partnership interest in P1. Y's total adjusted basis in the assets was approximately $o and the fair market value of the assets was approximately $l. Z contributed [redacted] to P1 in exchange for a m% general partnership interest in P1. Z's adjusted basis in the assets was approximately $g and a fair market value of the assets was approximately $m. Z was the managing partner and tax matters partner of P1. Consistent with the parties' expectations, P1 did not realize significant, if any, income from the properties contributed to P1 by Y, but did realize substantial income from the [redacted] contributed to P1 by Z.

In Month D, Year 1, in accordance with the prearranged plan, Corporation A was renamed Corporation F and the [redacted] properties previously transferred from Y to P1 were transferred to Corporation F in a purported § 351 transaction.

In furtherance of the prearranged plan, on D2, Bank approved a Loan Syndication Program in the amount of $k to be accomplished in two phases. Phase 1 involved a #a year term loan in the amount of $i to be made to P2 for the purpose of purchasing an interest in P1, to be fully funded by Bank by D3, and syndicated in Month A, Year 2. Phase 2 involved up to a $f term loan to P2 arranged by Bank on a best efforts basis and expected to be syndicated in Month A Year 2 (concurrent with syndication of Phase 1 of the loan). Bank's documents state that P2 was formed to purchase and own a limited partnership interest in P1 for #a years. Although, Bank's documentation lists P2 as the Borrower, Bank's documentation lists X as the Sponsor of the project and states that Taxpayer engaged Bank to structure and place limited partnership interests and a term loan facility for P2. As a condition of loaning the money, Bank required the execution of a separate security agreement, a debt interest rate swap agreement, and a guaranty by X.

On D4, Corporation B, Corporation C, Corporation D and Corporation E, which were solicited by Bank for the purpose of contributing $c to form P2, formed P2.[1] Although P2's partnership agreement contemplated P2's existence for #b years, the financial models in P2's documents indicates that the parties expected a liquidation of P2's investment in P1 at the end of #a years.

Also on D4, P2 used the Phase 1 loan proceeds and the cash contributed to it by the Corporation B, Corporation C, Corporation D and Corporation E to pay $j to Y for a i% limited partnership interest in P1. Bank transferred the loan proceeds directly to Y. Y transferred the cash to Taxpayer pursuant to a revolving credit agreement among Taxpayer and its subsidiaries. Taxpayer reported a long term capital loss of $n from the purported sale. After the purported sale Y owned a b% general partnership interest and a c% limited partnership interest in P1, Z owned a m% general partnership interest in P1, and P2 owned a i% limited partnership interest in P1. As discussed below, Y purportedly sold its remaining limited partnership interest to P2.

Also on D4, the P1 partnership agreement was amended. The following provisions were among the amendments: (1) the managing partner (Z) could at any time elect to cause all of the limited partner's interest to be retired; (2) the limited partners did not have any right or power to take part in the management or control of the P1; (3) income was to be allocated first to the limited partners' "cumulative priority return" which was defined as e% per annum of the $j "at risk capital" invested by P2 (f% if the distribution was in arrears). Income was allocated next to restore any losses of the limited partners, then to restore any losses of the general partners, and then to expenses of the general partners that exceeded cumulative profits. Any remaining balance was allocated b% to the limited partners and n% to the general partners. Interest on the loans was paid from one of Taxpayer's accounts designated as P1 to Bank as agent.

On D5, P2 purchased Y's remaining c% limited partnership interest in P1 with the $f increase to the loan agreed to by Bank. Taxpayer reported a long-term capital loss from the sale in the amount of $h.

On D6 Y and P2 entered into an agreement, whereby Y acquired an option to repurchase the limited partnership interests from P2.

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[1]The P2 partners were also required to contribute an additional $a to effect P2's purchase D5 purchase of Y's c% limited partnership interest in P1 below described.

Although the facts, with respect to events that occurred between Year 3 and Year 4 are currently under development, the field has ascertained the following: (1) Bank's loan to P2 was repaid in Year 4; (2) on D8, P2 sold its partnership interest in P1 to an entity believed to be unrelated to Taxpayer; (3) P1 did not have an election under § 754 in effect until Year 2; (4) on D7, Z transferred h% of its general partnership interest in P1 to a subsidiary of Taxpayer; (3) by D9, of the entities that owned a partnership interest in P1 in Year 3, only Y, whose interest in P1 was reduced to a%, remained a partner in P1; (5) on D9, X owned l% of P1, and a Taxpayer subsidiary, other than the subsidiary described in number (4) above, owned a k% interest in P1, and the entity that purchased P2's former limited partnership interest in P1 owned a g% interest.

LAW AND ANALYSIS

The Service may argue that the substance of the transactions was a loan from P2 to P1 for which P2 received a b% limited partnership interest in P1 in addition to the monthly interest payments due from P1.

When courts decide whether the parties to a transaction were in a partner-partnership or a debtor-creditor relationship, typically, at issue is whether advances to a partnership are actually loans or contributions to capital. See e.g. Eugene C. Hartman, 17 T.C.M. (CCH) 1020 (1958); Joseph W, Hambuchen, 43 T.C. 90 (1964); Lamar Hunt 59 T.C.M. (CCH) 635 (1990); ASA Investerings Partnership v. Commissioner, 76 T.C.M. (CCH) 325 (1998), aff'd on other grounds, 201 F.3d 505 (D.C. Cir. 2000). In the transactions described above, Taxpayer and Bank agreed to a prearranged plan whereby Taxpayer's subsidiaries, Y and Z formed P1, Bank solicited investors to form P2, Bank loaned $k to P2, and P2 used the loan proceeds to purchase an interest in P1. At issue in this case is whether P2's purported purchase of Y's limited partnership interest was actually a loan by P2 to P1. Consequently, the analysis in this case is identical to the analysis in the cases cited above, in that we must determine whether P2 was in a partner-partnership or debtor-creditor relationship with P1.

Whether parties are in a partnership or a debtor-creditor relationship is a question of fact to be determined from all the facts and circumstances. See Hambuechen 43 T.C at 99.; Dixie Dairies Corp. v. Commissioner, 74 T.C. 476 (1980); ASA Investerings Partnership, 76 T.C.M at 344. In resolving questions of debt versus equity, courts have identified and considered various factors. See, Dixie Dairies, 74 T.C at 493 (citations omitted). Among the factors which have been considered are: (1) the names given to the certificates evidencing the indebtedness; (2) presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payments; (5) participation in management as a result of the advances in relation to regular . . . creditors; (6) intent of the parties; (7) identity of interest between creditor and [partner] . . .; (8) "thinness" of capital structure in relation to debt; (9) ability of [partnership] . . . to obtain credit from outside sources; (10) use to which advances were put; (10) failure of debtor to repay; and (11) risk involved in making advances. See Dixie Dairies 74 T.C. at 493. The identified factors are not equally significant, nor is any single factor determinative. Moreover, due to the myriad factual circumstances under which debt-equity questions can arise, all of the factors are not relevant to each case. See Dixie Dairies 74 T.C. at 493 (citations omitted). Moreover, the ultimate question is whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a loan for which repayment was expected regardless of the success of the venture. See Dixie Dairies, 74 T.C. at 493. We must look to the substance of the transactions rather than the form. See Gregory v. Helvering, 293 U.S. 465 (1935); Hambuechen, 43 T.C at 98; ASA Investerings Partnership ,76 T.C.M. at 348.

Taxpayer and Bank formalized the transactional documents to evidence that the transactions were a loan by Bank to P2 followed by P2's purchase of Y's j% limited partnership interest in P1. We believe that the documents, taken together, support the view that the transactions were in substance a loan from Bank to P2 followed by a loan from P2 to P1 for which P2 received a b% limited partnership interest in P1 in addition to the monthly interest payments due from P1.

Taxpayer and X both stated that a business objective of the transactions was to raise cash from third parties without increasing financial statement debt. In order to accomplish this objective, Taxpayer devised the prearranged plan that would provide Taxpayer with a cash loan without requiring Taxpayer to show the loan on its balance sheet. In addition, the parties structured the transactions to provide Taxpayer with a substantial tax loss. Taxpayer caused its subsidiaries Y and Z to form P1. Y contributed properties with a substantial built-in loss, and Z contributed properties with a built in gain that were expected to provide P1 with substantial income. When P2 purportedly purchased Y's interest in P1, the cash was immediately transferred to Taxpayer pursuant to the revolving credit agreement, and Y's purported loss from its sale of its limited partnership interest in P1 was ultimately recognized by Taxpayer on its consolidated return. It appears that the parties intent from the outset was to provide Taxpayer with a cash loan, and formalize the transactions in a manner that provided Taxpayer with the benefit of omitting the loan from its balance sheet and recognizing a tax loss.

Taxpayer's other stated business objectives for the transactions were to organize the partnership and limited partnership interest to minimize return requested by the outside investors by designing an attractive [redacted] package, placing environmentally risky assets in a corporate subsidiary, and providing corporate investors with a preferred return and lower share of losses and to limit P2's commitment to #a years, with an opportunity to renew for extended period based on renegotiated terms. In furtherance of these stated objectives, on D4, the same day the Phase 1 loan proceeds were distributed to P2 and P2 purportedly purchased i% of Y's limited partnership interest in P1, the P1 partnership agreement was amended. One amendment provided for a special allocation of income first to the limited partners' "cumulative priority return" which was defined as e% per annum of the $j "at risk capital" invested by P2 (f% if the distribution was in arrears). Income was allocated next to restore any losses of the limited partners, then to restore any losses of the general partners, and then to expenses of the general partners that exceeded cumulative profits. Any remaining balance was allocated b% to the limited partners and n% to the general partners. The special allocation of income essentially guaranteed P2 a e% (f% if payment was in arrears) return on $j of the total $k that it paid to Y in the purported sale. It does not appear that the $j was at the risk of the venture considering both the special allocation, and Z's contribution of the [redacted] to P1, which the parties understood would generate a substantial amount of income. It does appear, however, that the allocation of b% of the remaining income was subject to the risk of the venture. This important factor supports our conclusion that the substance of the transactions was a loan from P2 to P1 for which P2 received a b% limited partnership interest in P1 in addition to the monthly interest payments of e% (f% if in arrears) due from P1 to P2.

The parties' intent that P2's interest in P1 would be transitory, limited to only a #a-year term, reinforces the conclusion that the substance of the transactions was a loan by P2 to P1. Taxpayer's documents state that P2's investment commitment was limited to #a years, although P2 did have the opportunity to renew for an extended period based on a negotiation. Bank's documents state that P2 was formed to purchase and own a limited partnership interest in P1 for #a years. Although P2's partnership agreement contemplated P2's existence for #b years, the financial models in P2's documents indicates that the parties expected a liquidation of P2's investment in P1 at the end of #a years. The prearranged #a year term of P2's ownership of the P1 limited partnership interest directly corresponds to the #a year term of Bank's loan to P2. It appears that the P2 was a special purpose partnership, solicited by Bank, and formed only to provide formality to the purported sale transactions.

Other provisions of the D4 amendments to the P1 partnership agreement allowed Z to cause all of the P2 limited partnership interests to be retired, and provided that the limited partners did not have any right or power to take part in the management or control of the partnership. These provisions indicate that P2's economic interest in the partnership was that of a lender and not a partner.

Based on the facts, as currently developed, we conclude that the Service may argue that the substance of the transactions was a loan from P2 to P1 for which P2 received a b% limited partnership interest in P1 in addition to the monthly interest payments due from P1. Because the facts are still under development with respect to years Year 3 through Year 4, we suggest that you request additional advice when the facts are complete.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call if you have any further questions.

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