INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 25, 2005

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-146625-04/CC:FIP:B03

Taxpayer's Name:
Taxpayer's Address:
Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Company B =
Company C =
Company D =
Company E =
Company F =
Company G =
Company H =
Company I =
Counterparty =
Bank =
Fund 1 =

State A =

Country X =
Country Y =

Year 1 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Year 14 =
Year 15 =

<u>a</u> =
<u>b</u> =
<u>c</u> =
<u>d</u> =
<u>e</u> =
<u>f</u> =
<u>g</u> =
<u>h</u> =
<u>i</u> =
<u>k</u> =

<u>aa</u> =
<u>bb</u> =
<u>cc</u> =
<u>dd</u> =
<u>ee</u> =
<u>ff</u> =
<u>gg</u> =
<u>hh</u> =
<u>ii</u> =
<u>kk</u> =

A Certificate =
B Certificate =
C Certificate =

ISSUE(S):

1. Did the contractual arrangement result in a full and complete transfer in the ownership of the underlying money market mutual fund shares for federal tax purposes?

2. Does the contractual arrangement create an entity separate from Company B?

3. Assuming that the contractual arrangement is treated as an entity separate from Company B, do the A Certificates and B Certificates create multiple classes of ownership in the assets of the contractual arrangement so that the contractual arrangement is classified as a business entity under §301.7701-2?

4. What are the consequences of treating the contractual arrangement as a business entity under §301.7701-4(c)(1)?

CONCLUSION(S):

1. The contractual arrangement did not result in a full and complete transfer in the federal tax ownership of the underlying money market mutual fund shares.

2. The contractual arrangement created an entity that was separate from Company B.

3. Assuming that the contractual arrangement is treated as an entity separate from Company B, the A Certificates and B Certificates create multiple classes of ownership interests in the underlying assets of the contractual arrangement so that the contractual arrangement is classified as a business entity under §301.7701-2.

4. The contractual arrangement will initially be treated as a disregarded entity and then will be treated as a partnership when Company B transferred the A Certificates to the Counterparty. As a result of the partnership formation, the transfer of the A Certificates to the Counterparty will be treated as constituting a transfer of a proportionate (by value) share in all of the contractual arrangement's/partnership's assets.

FACTS:

Taxpayer is part of a complex corporate structure. Taxpayer, a State A corporation, owns 100 percent of Company B, a Country X corporation. Taxpayer is wholly owned by Company C, a Country X corporation. Company C is a wholly owned subsidiary of Company D, a Country Y corporation. Company E, a State A corporation, is wholly owned by Company F, a Country Y corporation. Company F is a wholly owned subsidiary of Company D. Company G is a subsidiary of Company E.

As described below, the transactions in question occurred primarily between various parties and Company B. Taxpayer is involved in this case because it filed a consolidated US income tax return for Year 1 with Company B.

In Year 1, Company E approached the Counterparty with an offer to buy and sell certain financial products. At the time, the Counterparty was the owner of C Certificates maturing on Date 3. Company E offered to purchase the C Certificates from the Counterparty, and the Counterparty would purchase from Company B newly created A Certificates that matured at approximately the same time as Date 3. The assets underlying both the C Certificates and the newly created A Certificates were money market mutual fund shares.

Counterparty agreed to sell C Certificates related to money market mutual fund shares with an aggregate face value of $a and purchase A Certificates related to money market mutual fund shares with an aggregate face value of $a. The prices for the C Certificates and A Certificates were based upon a discounted cash flow method used to price zero-coupon debt.

Under the agreements, Company B paid Company E $b for structuring the deal. Company B also paid a $c fee to Counterparty by reducing the sales price of the A Certificates by $c.

On Date 4, Company H wired $d directly to Company B. The Taxpayer and Company B both treated this money as a loan of $d from Company H to the Taxpayer, and then as a capital contribution of $d from the Taxpayer to Company B.

On Date 5, Company I transferred $e to Company B. On Date 6, the Bank purchased $a of money market mutual fund shares through its custodial department on behalf of Company B. $f was invested in each of four different money market mutual funds from three different fund sponsors.

On Date 7, Company B replaced $f of shares in one of the money market mutual funds with an equal amount of money market mutual fund shares from a different fund sponsor. No gain or loss was reported on this transaction.

According to the prospectuses for the four money market mutual funds, the underlying assets include: U.S. government agency obligations, foreign government obligations, obligations of U.S. and foreign banks and corporations, repurchase agreements, reverse repurchase agreements, asset-backed securities, taxable municipal obligations, high grade commercial paper, and other short-term corporate obligations. All four funds had investment grade or better ratings from major rating agencies in Year 1.

On Date 7, Company B and Counterparty entered into a letter agreement providing that on Date 8, Company B agreed to deliver four A Certificates, four Custody Agreements and four Termination Agreements to the Counterparty. In exchange, Counterparty agreed to wire transfer $g to Company B's account at the Bank. On Date 7, Counterparty faxed an acknowledgement to Company B confirming the terms of the transaction. Company G served as the broker for Company B.

Also on Date 7, Company B entered into a purchase agreement with the Counterparty, under which Company B agreed to sell, and the Counterparty agreed to buy, four A Certificates for $g. Each A Certificate was related to the shares of one of the four money market mutual funds held by the Bank as custodian for Company B. Under each A Certificate, the Counterparty was entitled to receive the underlying money market mutual fund shares after Date 9, but was not entitled to either the underlying shares nor any dividends paid until after Date 9.

On Date 7, Company B entered into a contractual arrangement with the Bank for the Bank to act as custodian, paying agent, and registrar for Company B. Company B was charged an acceptance fee, an annual administration fee, and various out-of-pocket fees by the Bank. Subsequent annual invoices were sent to Company B and covered the fees for both the A Certificates and the B Certificates.

On Date 8, Company B and the Bank entered into four separate custody agreements, each one relating to the shares in one of the four money market mutual fund purchased on Company B's behalf. Each Custody Agreement set forth the duties to be performed by the Bank as custodian of the money market mutual fund shares. The Bank agreed to issue A Certificates and B Certificates to Company B. In addition, the Bank, as custodian, is to receive payment of dividends from the mutual funds and pay the dividends over to the holder of the B Certificates. The money market mutual fund shares are to be held in book-entry credit form by the Bank custody department only and are to be shown on the books and records of the Bank. The agreement required that Company B was to furnish the Bank with written instructions as to the names in which the A Certificates and B Certificates were to be registered, the number of shares, and the persons and addresses of the persons to whom the receipts were to be delivered. These written instructions were never produced by either Company B or the Bank, and it is not clear that the written instructions were ever delivered to the Bank. Each agreement also provided that the Bank was to keep a register in which the Bank would provide for the registration of the receipts, but no such register was prepared until a number of years after the transaction began. (The registers were apparently prepared in Year 14 or Year 15.) Section aa of each custody agreement provides that prior to the delivery of all documents and fees required by the Bank to register a transfer of ownership, the Bank may treat the holder listed in its register as the owner of either A Certificates or B Certificates as the legal owner for all purposes.

The custody agreements also defined the rights represented by the A Certificates and B Certificates. Each B Certificate represents the right to receive dividends paid on the underlying money market mutual fund shares through Date 9. Each A Certificate represents the right to receive the underlying money market mutual fund shares on Date 9, any payments characterized by the issuer of the underlying money market mutual fund shares as return of capital, and all dividends paid on the underlying money market mutual fund shares after Date 9. On Date 9, the B Certificates will cease to be valid and will be cancelled, the underlying money market mutual fund shares will be transferred to the holders of the A Certificates, and the custody agreement will terminate.

The holders of the A Certificates do not have the right to redeem the underlying money market mutual fund shares prior to Date 9 and the Bank is not permitted to take any actions to request redemption of the underlying money market mutual fund shares. However, if a person holds both A Certificates and B Certificates related to the same underlying money market mutual fund shares, that person may request distribution of the underlying money market mutual fund shares represented by the A and B Certificates prior to Date 9. Further, if the issuer of the underlying money market mutual fund shares chooses to liquidate, the Bank is permitted to deliver the underlying money market mutual fund shares to the issuer.

The holders of the A Certificates have the right to instruct the Bank how to vote the underlying money market mutual fund shares, except that they may not instruct the Bank to vote in favor of dissolution of the underlying money market mutual fund, nor may they instruct the Bank to vote in favor of any changes in investment objectives, policies, or restrictions that would cause the underlying money market mutual fund to fail to qualify as a money market fund under Rule 2a-7 of the Investment Company Act of 1940, as amended.

On Date 8, the same day that Company B entered into the custody agreements with the Bank, Company B also entered into four Termination Agreements with the Counterparty, paying the Counterparty $h for each agreement. Under the Termination Agreements, the Counterparty agreed to purchase the B Certificates from Company B if a purchase event occurred. Under the Termination Agreements, a purchase event occurs if: a) an issuer of an underlying money market mutual fund liquidated the fund, b) an underlying money market mutual fund failed to maintain its status as a money market fund under Rule 2a-7 of the Investment Company Act of 1940, as amended, or c) an issuer of an underlying money market mutual fund redeemed bb% or more of the shares held by the Bank. If a purchase event occurs, the holder of the B Certificate receives an amount equal to the face value of the underlying money market mutual fund shares multiplied by a formula which, in essence, divides the proceeds from the redemption between the holders of the A Certificates and the holders of the B Certificates. The formula basically provides that the Counterparty gets to keep roughly the present value of the A Certificates and must pay over most of the rest of the redemption proceeds. The amount of principal to be received by Company B decreases over time because the holder of the A Certificates gets to retain the present value of the A Certificates, which increases as the termination date of Date 9 approaches.

Copies of a number of transactional documents were submitted with the request for technical advice. With respect to the transaction involving Fund 1 shares, certain documents appear important. The new account application to establish account number cc, the Fund 1 account in issue, lists Company B as the registered owner with an EIN of dd. A letter dated Date 10 from Company B to Fund 1 instructs and authorizes Fund 1 to transfer the shares owned by Company B from account number cc to an account with Bank as custodian. The documents contain an acknowledgement dated Date 8, from Fund 1 that the shares were re-registered from “Company B” to “the Bank as Custodian for Company B” and referencing account number cc. The acknowledgement also has attached a registry listing the new name under tax number dd/ee.

A Fund 1 report numbered ff is dated Date 11 and relates to account number cc. This report lists a Date 7 trade date as the date f shares were purchased by wire at $i per share and lists dividend receipts on such shares from Date 12 to Date 13. The date the account was established is listed as Date 7, not Date 8. The tax number on the account is dd/ee, which is Company B’s tax number. Company B’s tax identification number appears on all subsequent Fund 1 account statements. There is no indication on this report of any information related to the Counterparty.

On Taxpayer’s consolidated income tax return for Year 1, Company B reported dividend income from the four money market mutual funds and also deducted a short-term capital loss in the amount of $k, which was calculated by subtracting Company B’s entire $a basis in the underlying money market mutual fund shares from the $g amount received for the A Certificates.

LAW AND ANALYSIS:

Issue 1: Did the contractual arrangement result in a full and complete transfer in the ownership of the underlying money market mutual fund shares for federal tax purposes?

Taxpayer’s primary argument is that the assignment of income doctrine requires Company B to allocate its entire basis to the A Certificates that were sold to Counterparty. According to Taxpayer, no portion of the basis is allocable to the B Certificates because the B Certificates represent only the right to future income. Therefore, under this argument, each A Certificate represents the entire ownership interest in the underlying money market mutual fund shares.

In support of its position, Taxpayer cites Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Helvering v. Horst, 311 U.S. 112 (1940); and Estate of Stranahan v. Commissioner, 472 F.2d 867 ($6^{th}$ Cir. 1973). Taxpayer interprets these cases as directing a finding that no basis is allocated to the right to dividend income. These cases, however, are distinguishable from the instant case.

In Horst, a father who owned a bond attempted to transfer taxable interest income to his son by detaching a negotiable interest coupon before the maturity date and giving it to his son, who ultimately collected the interest payment. The Court held that the father was the owner of the coupons, notwithstanding his assignment of the interest, and his son's ultimate receipt of the cash paid as interest. In P.G. Lake, Inc., a corporate taxpayer paid off a debt owed to its corporate president through an assignment of an "oil payment right" to him, and it reported that disposition as a capital-gain-producing transaction. The "oil payment right" entitled the holder to payment of $600,000 out of a portion of oil revenues due to the corporation, plus an additional 3% per year on the unpaid balance. The Supreme Court held that the corporate taxpayer did not convert a capital asset but instead received what was "essentially a substitute for what would otherwise be received at a future time as ordinary income." 356 U.S. at 265. Finally, In Estate of Stranahan, the taxpayer sold the right to future dividend income to his son in an attempt to accelerate income to the taxable year of the sale so as to offset a large unused interest deduction. The taxpayer claimed the entire amount realized as ordinary income without any basis recovery. The court upheld the taxpayer's characterization of the transaction and treated the sale of dividend rights as generating ordinary income in the year of sale.

All three cases described above involve a taxpayer's assignment of future income without a transfer of any rights in the underlying asset. As discussed below, in the instant case, both the interests retained and the interests disposed of by Company B include rights in the underlying assets, and, therefore, the facts of Horst, P.G. Lake, and Estate of Stranahan are distinguishable.

a. The Termination Agreement is an integral part of the transaction.

The Taxpayer argues that Company B transferred all rights to the underlying assets because it believes the terms and conditions of the custody agreements and the A Certificates and the B Certificates reflect a complete transfer of the underlying assets to the Counterparty. The Taxpayer argues that the Termination Agreements are independent side agreements that should be ignored when evaluating the overall transaction. We disagree with the Taxpayer and believe that the Termination Agreements are integral parts of the overall transaction that must be considered in evaluating whether there was a full and complete transfer of the underlying assets to the Counterparty.

The analysis of whether and to what extent property has been transferred depends upon a determination of the rights and obligations concomitant with ownership of the two different types of receipts issued by the custodian. In identifying these rights and obligations, we have considered the rights and obligations of Company B and the Counterparty provided under the Termination Agreements. Although each Termination

Agreement was documented separately from the corresponding contractual arrangement, the facts and circumstances of the overall arrangement compel the conclusion that the Termination Agreement should be included as part of the contractual arrangement and purported purchase transaction, including: a) each Termination Agreement was executed between the same parties and on the same date that the parties executed all other documents relating to the contractual arrangement; b) each Termination Agreement specifically references the purported purchase and contractual arrangement under which the related fund shares are held; and c) the payments under the Termination Agreement relate to distributions on the fund shares held in the custodial account.

Each Termination Agreement has been formalized using the terminology of a put option. Pursuant to each Termination Agreement, in the event of a purchase event and upon proper notice by Company B, the Counterparty will purchase the B Certificate from Company B (or subsequent holder or holders of the B Certificates). A purchase event includes a complete or partial redemption by the issuer of the underlying money market mutual fund of bb% or more of the initially issued shares held by Bank. A triggering event also includes the liquidation of the issuer of the underlying money market mutual fund or the failure of the issuer to maintain its status under Rule 2a-7 under the Investment Company Act of 1940, as amended, as a money market fund (or any similar entity under any successor to such Rule).

Upon written notice from Company B, the Counterparty must pay to Company B an amount determined under a formula that effectively allocates non-dividend distributions received from an issuer due to a triggering event between Company B and the Counterparty based upon the remaining term of the purchase transaction. Under the formula, Company B receives gg% of the $i per share face value of the underlying money market mutual fund shares less the estimated value of the A Certificate on the date of the purchase event. Therefore, upon a triggering event, Company B will receive a portion of any non-dividend distribution paid to the Counterparty, which effectively is a distribution representing a return of principal. As part of the formula, the value attributed to the A Certificates increases over time. Ultimately, upon the termination of the contractual arrangement, Company B will not receive any payment upon the occurrence of a trigger event because the value attributed to the A Certificate will accrete to eliminate the amount due under the Termination Agreement. It is important to note, however, that up until the day before the termination of the contractual arrangement, Company B is still entitled to receive at least some small amount representing a return of principal upon the occurrence of a specified triggering event.[1]

[1] Taxpayer may assert that because return of principal is distributed first to Counterparty and then from Counterparty to Company B, the payments under the Termination Agreements are not direct interests in the underlying money market mutual fund shares. However, under the terms of the A and B Certificates and section hh of the custody agreements, the holders of both the A Certificates and B Certificates must agree as to the distribution of any amount that “on its face is not a dividend in connection with a return of capital of shares.” If the holders do not agree, Bank will institute an action in court to determine the parties’ relative rights to such payments.

Taxpayer argues that the likelihood of an occurrence of a triggering event, and hence payment under a Termination Agreement, is remote and should be disregarded for tax purposes. There is nothing in the record to show the remoteness of an occurrence of a triggering event. To the contrary, for each of the four B Certificates, Company B and Counterparty entered into a Termination Agreement, indicating that the likelihood of a triggering event was not considered so remote that a Termination Agreement was considered unnecessary. Thus, Company B's own actions indicate that the Termination Agreements were necessary and integral parts of the overall transaction.

We conclude that the Termination Agreements are not separate transactions, but are integral parts of the overall transaction. We also find that under the terms of the Termination Agreements, Company B, and any subsequent holder or holders of the B Certificates, is entitled to receive an amount representing a return of principal on the underlying money market mutual fund shares.

b. <u>Other factors indicate that Company B has not transferred all rights related to ownership of the underlying money market mutual fund shares.</u>

In addition to the fact that the contractual arrangement did not result in a full and complete transfer of the underlying money market mutual fund shares, there are serious questions whether Company B actually transferred any ownership interest in the underlying money market mutual fund shares.

The key to identifying a tax owner is determining who has the substantial benefits and burdens of ownership of the property. In making this determination, legal title or legal form is a relevant starting point, but is not determinative. <u>Coleman v. Commissioner</u>, 87 T.C. 178, 201 (1986). The benefits and burdens of ownership include the power to dispose of the property and the ability to exercise rights attendant to ownership of the property.

The Custody Agreement and the B Certificates give Company B the power to proceed against the issuer of the underlying money market mutual fund shares for nonpayment. The Custody Agreement and the A Certificate give the holder of the A Certificate the power to proceed against the issuer of the underlying money market mutual fund shares for nonpayment. Under the Custody Agreement, Company B has the power to remove the custodian and appoint a successor with the consent of a majority of the holders of the B Certificates and a majority of the holders of the A Certificates. The Counterparty, however, has the power to remove the custodian and appoint a successor only with consent of all the holders of the A Certificates and the consent of Company B.

Further, with respect to all of the underlying money market mutual fund shares held by Bank as custodian, the documentation supplied indicates that Company B is obligated to pay, and indeed did pay, to Bank all charges, expenses, and fees related to Bank's role as custodian during the restricted dividend period. If Company B did indeed transfer away its entire ownership interest in the underlying money market mutual funds, it is unlikely that Bank's charges for custody duties related to the underlying assets would be assessed to a non-owner.

Few aspects of the record appear to support Taxpayer's contention that Company B effected a transfer of complete ownership of the Fund 1 shares to the Counterparty on Date 8. The only document that appears to support this contention is the A Certificate held by the Counterparty, which purports to represent ownership of the underlying shares to which the A Certificate relates, exclusive of the right to receive dividend distributions on those shares.

We note that the documents and other evidence offered in connection with this Technical Advice Request do not consistently describe the asserted transfer of the shares. The new account application to establish account number cc, the Fund 1 account in issue, lists Company B as the registered owner with an EIN of dd. Although a letter dated Date 10[2] from Company B to Fund 1 instructs and authorizes Fund 1 to transfer the shares owned by Company B from account number cc to an account with Bank as custodian, other documents show that the shares were retained in the cc account under Company B's federal tax identification number, dd. The documents contain an acknowledgement dated Date 8, from Fund 1 that the shares were re-registered from "Company B" to "the Bank as Custodian for Company B" and referencing account number cc. The acknowledgement also has attached a registry listing the new name under tax number dd/ee.

A Fund 1 report numbered ff is dated Date 11 and relates to account number cc. This report lists a Date 7 trade date as the date f shares were purchased by wire at $i per share and lists dividend receipts on such shares from Date 12 to Date 13. The date the account was established is listed as Date 7, not Date 8. The tax number on the account is dd/ee, which is Company B's tax number. Company B's tax identification number appears on all subsequent Fund 1 account statements. There is no indication on this report of any information related to the Counterparty.

In light of all the facts and circumstances, we find that, for federal tax purposes, the contractual arrangement did not result in a full and complete transfer of the entire ownership of the underlying money market mutual fund shares.

Issue 2: Does the contractual arrangement create an entity separate from Company B?

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

2 It appears that the letter may be misdated because Company B did not purchase the Fund 1 shares until Date 8.

Section 301.7701-1(a)(2) provides that joint undertakings or other contractual arrangements may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. Thus, a separate entity may result from an organization, arrangement, or other undertaking of investors grouped to carry out an investment program. The arrangement need not be cast as any particular form. See North American Bond Trust, 122 F.2d 545 (2nd Cir. 1941), cert. denied, 314 U.S. 701, and Brooklyn Trust, 80 F.2d 865 (2nd Cir. 1936), cert. denied, 298 U.S. 659 (1936). Section 301.7701-1(a)(2) also provides that mere co-ownership may not create a separate federal tax entity. For example, if an individual owner, or tenants in common, of farm property lease the property to a farmer for a cash rental or share of the crops, the owners do not necessarily create a separate entity for federal tax purposes.

In general, the term “co-ownership” means “tenants in common” or other ownership arrangements in which each owner has a right to, and the responsibility for, an undivided fractional interest in each asset that is owned.[3] For example, Rev. Rul. 75-374, 1975-2 C.B. 261, describes as co-ownership the situation where the two owners each own an undivided one-half interest in the underlying asset. Rev. Proc. 2002-22, 2002-1 C.B. 733, describes Bergford v. Commissioner, 12 F.3d 166 (9th Cir. 1993), as a case involving seventy-eight “co-owners;” the court in Bergford describes the facts as involving “ownership interests as tenants-in-common” and refers to return positions taken by an individual investor in the transaction as stemming from the “co-ownership interest” in the underlying assets. 12 F.3d at 167-168. Rev. Rul. 99-5, 1999-1 C.B. 434, describes a situation where an unrelated person B purchases a 50% ownership interest in a LLC from A and then A and B continue to operate the business of the LLC as co-owners of the LLC. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets.

The contractual arrangements in this case do not result in mere co-ownership interests in the underlying money market mutual fund shares. The A Certificates and the B Certificates do not merely represent the rights to differing fractional amounts of the undivided underlying money market mutual fund shares. Rather, the B Certificates together with the Termination Agreements represent rights to all dividends on the underlying money market mutual fund shares through Date 9 and a decreasing right to any non-dividend payments received through Date 9. In contrast, the A Certificates together with the Termination Agreements represent rights to an increasing amount of any non-dividend payments made through date 9 and the entirety of the underlying

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[3] The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property §§ 50.01-50.07 (Michael Allan Wolf ed., 2000).

money market mutual funds after Date 9. Because the contractual arrangements in this case result in ownership interests that are not mere co-ownership interests, the contractual arrangements form a separate entity under §301.7701-1(a)(2) which must be classified for federal tax purposes.

Issue 3: Assuming that the contractual arrangement is treated as an entity separate from Company B, do the A Certificates and B Certificates create multiple classes of ownership in the underlying assets of the contractual arrangement so that the contractual arrangement is classified as a business entity under §301.7701-2?

The conclusion that the contractual arrangements form a separate entity under §301.7701-1(a)(2) which must be classified for federal tax purposes is further supported by regulations under §301.7701-4 and related case law. Sections 301.7701-4(a) and (b) provide a general discussion of the meaning of the term "trust" for purposes of the Code, Income Tax Regulations, and Procedure and Administration Regulations. A business trust is excluded from the category of trust because joint enterprise and other arrangements for the conduct of business are to be treated as associations or partnerships, even if technically cast in a trust form.[4] See §301.7701-4(b).

Section 301.7701-4(c)(1) of the Procedure and Administration Regulations provides, in part, that an investment trust that has multiple classes of ownership interests is ordinarily classified as a business entity under section 301.7701-2. An investment trust that has multiple classes of ownership interest, however, is classified as a trust for tax purposes if (1) there is no power under the trust agreement to vary the investment of the certificate holders, and (2) the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interest is incidental to that purpose.

In the instant case, there are two classes of certificates. Under the B Certificates, Company B is entitled to all dividend distributions until the receipts are terminated or retired and a declining percentage of any unscheduled distributions representing a return of principal while the receipts are outstanding. Under the A Certificates, the Counterparty is entitled to receive payments of dividends only after the A Certificates have been retired and an increasing percentage of any unscheduled distributions representing a return of principal while the receipts are outstanding. There are no subordination rights as between the two receipts.

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[4] See also Peaslee & Nirenberg, The Federal Income Taxation of Mortgage-Backed Securities (Revised Edition, 1994), page 34, footnote 10 (whether an organization exists for tax purposes is normally subsumed in the question of how the organization would be classified under the regulations if it was assumed to exist); Howell & Cosby, "Exotic Coupon Stripping: A Voyage to the Frontier between Debt and Option," 12 Virginia Tax Review 531, footnote 44 (the limitations contained in the Sears regulations will apply to a multiple-class investment arrangement, even if the arrangement does not otherwise create a trust for federal income tax purposes.)

The contractual arrangements thus serve to create investment interests with respect to the underlying money market mutual fund shares that differ significantly from direct investment in the underlying money market mutual fund shares. As a result, the existence of multiple classes is not incidental to any purpose of the arrangement to facilitate direct investment in the assets, and therefore, the contractual arrangement is classified as a business entity under §301.7701-2.

Issue 4: What are the consequences of treating the contractual arrangement as a business entity under §301.7701-4(c)(1)?

Based on the default classification rules of §301.7701-3(b)(1), the contractual arrangement, as a business entity, will be disregarded for the period in which it has one owner, and will be treated as a partnership for the periods in which it has multiple owners. In addition, we conclude that through retention of income rights coupled with the Termination Agreement, benefits and burdens of ownership associated with the principal interest in the underlying money market mutual fund shares continue to reside with Company B even after Company B has transferred the A Certificates to the Counterparty. The identity of a partner for federal tax purposes is not dependent on legal title; rather it is dependent on an analysis of the benefits and burdens of ownership. See, e.g., Red Carpet Car Wash, Inc. v. Commissioner, 73 T.C. 676 (1980), acq., 1980-2 C.B. 2 (dummy corporation held partnership interest as nominee for true partner). Because benefits associated with the principal of the underlying money market mutual fund shares flow to Company B, we conclude that this right to a portion of the principal of the underlying money market mutual fund shares actually serves to define the nature of Company B's partnership interest.

Because the contractual arrangement is treated as a business entity, the transfer of the interest to the second owner should be analyzed in accordance with the holding of Situation One of Rev. Rul. 99-5. That ruling describes the federal tax consequences when a single member limited liability company that is disregarded becomes an entity with more than one owner that is then classified as a partnership. Where the contractual arrangement is treated as a business entity, then by definition it has to be a single member business entity when it is formed by Company B. When the A Certificates are transferred away by Company B, a partnership is created such that the contractual arrangement has been effectively converted into a partnership.

Situation One of the ruling addresses a fact pattern where A transfers a portion of the ownership interest in the disregarded entity to B for consideration. The ruling concludes that in such a situation, the disregarded entity is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50 percent of A's ownership interests in the LLC is treated as the purchase of a 50 percent interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership. Under §1001, A recognizes gain or loss from the deemed sale of the 50 percent interest in each asset of the LLC to B. Under §721(a), no gain or loss is recognized by A or B as a result of the contribution of their separately held assets to the partnership.

The present transaction falls within Situation One of the ruling. When interests are transferred away from Company B, it is equivalent to the sale to B in the ruling. Accordingly, Company B is treated as disposing of an appropriate proportion of the underlying assets in a §1001 transaction. Company B is treated as if it disposed of some, but not all, of the right to principal payments on the underlying money market mutual fund shares as well as the rights to later year income payments. Thus, the Company B is treated as retaining the rights to the first kk years of income with regard to the underlying money market mutual fund shares as well as some, but not all, of the rights to any principal redemption payment of these instruments.

Where the underlying assets consist of $a worth of the underlying money market mutual fund shares, and Company B receives $g in consideration, Company B is treated as transferring a ii% interest in the undivided underlying money market mutual fund shares (rights to principal and interest payments), that portion transferred having a basis equal to the $g amount Company B received as consideration. To the extent that Company B has a fair market value basis in the underlying money market mutual fund shares, it will recognize no gain or loss on the deemed sale.

As a caveat, while Rev. Rul. 99-5 treats B as purchasing a 50 percent interest in each of the entity's assets, we do not believe that the analysis of the ruling requires proportionate sales in all cases. We draw this conclusion from the policy determinations that were expressed in the finalization of the §707 disguised sale regulations.

When the disguised sale regulations were proposed (PS-163-84), they contained a rule addressing the treatment of part-sales and part-contributions for contributions of multiple properties. To avoid "cherry picking" of high basis asset sales, the rule required a sale of a proportionate amount of each property.[5] Commentators criticized this provision as inconsistent with authorities under §§ 351 and 453 where taxpayers could plan for divergent treatment for certain assets. The preamble to the final regulations acknowledged the comments and the rule was not included in the final regulations. Thus, in the disguised sale context, it appears that taxpayers have some residual ability

[5] The provision, §1.707-3(e), read as follows:
*Multiple properties transferred pursuant to a plan.* If a partner transfers more than one item of property to a partnership pursuant to a plan, the amount realized from any transfer of money or other consideration made by the partnership pursuant to the plan that is treated as part of a sale of property under paragraph (a) of this section is allocated among each item of property transferred pursuant to that plan based upon the relative fair market values of the properties. For purposes of applying the preceding sentence, the fair market value of an item of property transferred to a partnership is reduced by the amount of any qualified liability with respect to that property. See §1.707-5(a)(6) for the meaning of qualified liability of a partner. The allocation rules of this paragraph do not apply to consideration transferred in the form of the assumption of or taking subject to a qualified liability

to identify the assets that will be treated as sold, and the assets that will be treated as contributed. There is no sound policy rationale for providing for a different treatment in scenarios that fall under Situation One of Rev. Rul. 99-5.

Based upon an examination of the authorities identified in the context of §§351 and 453, it appears that the ability to identify assets for divergent treatment is not unfettered. The case law appears to require both a business purpose for the different treatment, and factual indicia that the different treatment was understood and intended by the parties. See, Brown v. Commissioner, 27 T.C. 27 (1956), acq. 1957-2 C.B. 4; Collins v. Commissioner, 48 T.C. 45 (1966), acq. 1967-2 C.B. 2. We believe that a similar result is appropriate in the present context. Where there are not strong indications of different treatment, we believe that the appropriate treatment is a proportionate transfer of all underlying assets.

Company B claims that it transferred to the Counterparty the entire interest in the principal payments of the underlying money market mutual fund shares. However, Company B retained rights to principal redemption payments under the Termination Agreement; this fact undercuts Company B's argument. Thus, the present case lacks the strong factual indicia of an intended and understood outright transfer of the entire interest in the principal of the underlying money market mutual fund shares. Under the circumstances, it is appropriate for the Service to treat the transfer as a transfer by the Company B to the Counterparty of a proportionate interest (based on value) of the underlying money market mutual fund shares.

CAVEAT(S):

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.

No opinion is expressed herein as to any other issues that were raised in the incoming technical advice request or that may be raised based on the facts of this case. For example, the Service is not ruling on whether: (1) the arrangement between Company B and Counterparty can be characterized as a financing arrangement or sale of a future interest in the underlying money market mutual fund shares; and (2) section 165(a) applies to the arrangement to eliminate the losses claimed by Taxpayer.