



Economic Substance, Promissory Notes and Partnerships
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The IRS Goes After Partnership Liquidation Transaction

In the case of *Countryside Limited Partnership v. Commissioner*, TC Memo 2008-3, the IRS attempted to apply the general concepts of economic substance, the specific anti-abuse partnership provisions found in Reg. §§1.701-2 and 1.731-2(h) and a claimed side agreement that, in the IRS's view, changed promissory notes into marketable securities per §731(c)(1)(B) to impose tax on a partnership interest redemption that the taxpayers contended resulted in no recognized gain per the general provisions of §731(a).

The IRS was unsuccessful on all counts, and the case provides some interesting insights into the application of the various provisions regarding tax motivated transactions and partnership liquidation provisions.

Partnership Distribution Provisions

The general rules for taxation of a distribution to a partner is governed by §731, which provides at its beginning:

(a) Partners

In the case of a distribution by a partnership to a partner--

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

At first glance that rule appears very simple—we look to see if a taxpayer received cash and, if not, we have no gain issue. But, as is often true, the Code complicates matters with a couple of definitional issues that tell us that “money” isn’t necessarily limited to what we generally think of as money.

Of key importance generally for partnership taxation is the overriding rule of §752 that establishes a definition that ties debt to “money” for these purposes. For distributions, a key provision is §752(b) which provides:

(b) Decrease in partner's liabilities

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

In addition, §731(c) provides an expansion of the definition of “cash” to include marketable securities in most cases:

(c) Treatment of marketable securities

(1) In general

For purposes of subsection (a)(1) and section 737--

(A) the term "money" includes marketable securities, and

(B) such securities shall be taken into account at their fair market value as of the date of the distribution.

And, to continue, our definition of what is marketable securities also isn’t quite so simple. A provision will come into play in this case is a special expansion of the definition of marketable securities found at §731(c)(2)(B)(ii) that provides for these purposes that marketable securities will include:

(ii) any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities,

But even transactions that literally comply with the Code and regulations may run afoul of various anti-abuse rules in the partnership regulations. Reg. §1.701-2 provides a broad set of anti-abuse rules where transactions are structured to avoid the “intent” of Subchapter K. Reg. §1.701-2(b) specifically provides:

(b) Application of subchapter K rules.

The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (INTENT OF SUBCHAPTER K). Accordingly, 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. Thus, *even though the transaction may fall within the literal words of a particular statutory or regulatory provision*, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K --

- (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
- (2) One or more of the purported partners of the partnership should not be treated as a partner;
- (3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;
- (4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or
- (5) The claimed tax treatment should otherwise be adjusted or modified.

Section 731(c) has its own specific anti-abuse provision in Reg. §1.731-2(h) which provides:

(h) Anti-abuse rule.

The provisions of section 731(c) and this section must be applied in a manner *consistent with the purpose of section 731(c)* and the substance

of the transaction. Accordingly, if a *principal purpose* of a transaction is to achieve a tax result that is *inconsistent with the purpose of section 731(c)* and this section, the Commissioner can *recast the transaction* for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h) --

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

Finally, the IRS has the ability to make use of the more general economic substance doctrine to remove tax benefits if the underlying transactions, taken as whole, do not have any economic substance—that is, the only thing happening from an economic perspective is that taxes are being reduced.

In this case, the IRS looks to the 1965 Second Circuit's affirmation of the Tax Court's holding in the case of *Goldstein v. Commissioner*, 364 F.2d 734. In this case, the Tax Court summarizes the *Goldstein* facts as follows:

In the *Goldstein* case, the taxpayer (Mrs. Goldstein, the wife in a joint return filing) won over \$140,000 in the Irish Sweepstakes. In an effort to mitigate the tax impact of having to report all her winnings in the year of receipt, her advisers constructed a plan pursuant to which, before the end of that year, she borrowed \$945,000 from two banks, purchased \$1 million face amount Treasury 1.5-percent notes, and prepaid 4 percent interest for 1.5 years on one bank loan and for approximately 2.75 years on the other. The total interest prepayment was over \$81,000, which the Goldsteins claimed as a deduction in the year of payment under section 163(a). We denied the deduction on the ground that "there was no genuine indebtedness established between * * * [Mrs. Goldstein] and * * * [the banks]." *Goldstein v. Commissioner*, 44 T.C. at 298. The Court of

Appeals for the Second Circuit affirmed, but on a different basis. It agreed with the dissenting opinion in this Court that the bank loans were "indistinguishable from any other legitimate loan transaction contracted for the purchase of Government securities", *Goldstein v. Commissioner*, 364 F.2d at 737 (quoting *Goldstein v. Commissioner*, 44 T.C. at 301 (Fay, J., dissenting)), and it found that we were in error in concluding that those loans "were 'shams' which created no genuine indebtedness", *id.* at 738. It agreed, however, with our finding that Mrs. Goldstein entered into the two bank loans "without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction * * * [to offset her sweepstakes winnings]." *Id.* at 740. The court found that Congress intended to limit interest deductions under section 163(a) to interest on debt incurred for "purposive activity", and it held that that section did not permit a deduction for the interest paid by Mrs. Goldstein where the sole purpose of her borrowings was to generate tax deductible interest. *Id.* at 740-742

Because Mrs. Goldstein could not profit from this transaction (it served merely to shift income into a later year), there was no substance to the transaction aside from accomplishing the goal of reducing taxes. That is true even though, as the Second Circuit effectively found, Mrs. Goldstein had complied with all the literal requirements of the law necessary to obtain the deduction.

Partnership Transactions

While the case is a bit involved, they can be roughly summarized as noted below. The partnership had an appreciated piece of real estate that it was planning on selling. Two of the partners (Mr. Winn and Mr. Curtis) did not wish to pay tax currently on the gains when the property was sold. So to accomplish that goal, the following plan was put in place.

Mr. Winn had two corporations under his control form new LLCs, CLP Promisee L.L.C (CLPP) and Manchester Promisee L.L.C. (MP), acquiring a 1% interest in each for cash. The other partner in CLP's case was Countryside Limited Partnership. Countryside borrowed \$8.55 million from Columbus Bank & Trust and contributed that to CLPP in exchange for 99% interest. CLPP then contributed \$8.5 million in cash to MP in exchange for the remaining 99% interest in that LLC.

MP then borrowed an additional \$3.4 million from Columbus Bank & Trust. Both Columbus Bank & Trust loans were guaranteed by Mr. Winn, and the loan to Countryside was secured by the Manchester property (the appreciated piece of real estate described earlier). The Countryside loan had a due date of May 1 of the following year, while the MP loan was due two years and eleven months after it was taken out.

MP (which, remember, now actually has most of the cash) used it to buy four promissory notes issued by AIG Matched Funding Corp of \$11.9 million. Each of the notes paid an interest rate that was lower than the rates being paid on the bank notes, and provided that if the holders of more than 50% of the note principal agreed, the terms could be modified by the parties. A security interest was given to Columbus Bank & Trust in two of the notes that totaled \$3.4 million, to secure MP's note with the bank.

At December 26, 2000, Countryside distributed its 99% interest in CLPP to Mr. Winn and Mr. Curtis in complete liquidation of their partnership interests. While there was relief from debt as part of that transaction, Mr. Winn and Mr. Curtis recognized the new debt to Columbus Bank & Trust they took on as part of the overall transaction, and thus they were not deemed to receive a distribution of cash in the form of reduction in debt in excess of their basis in the Countryside (though they now had very basis remaining). In January of 2001, Countryside the Manchester property to a buyer with whom the partnership had been negotiating with since May or June of 2000. Following that sale, Countryside repaid its loan to Columbus Bank & Trust.

AIG redeemed its notes from MP in April 2003, and the MP loan to Columbus Bank & Trust was repaid in early 2004.

Mr. Winn & Mr. Curtis treated the distribution of the LLC member interests to them as a distribution of property in liquidation of their partnership interests. As such, they recognized no gain on the receipt of these interests pursuant to the general rule of §731(a) and took a carryover basis in the membership interests tied to their ending basis just before redemption in Countryside pursuant to §732(b).

Countryside treated the liquidating distribution as a distribution triggering the application of §734, thus stepping up the partnership's basis in the assets of the partnership.

IRS Says There's No Substance Here

The IRS objected to this transaction in total which, as reported on the respective tax returns, had the partnership reduce its reported gain through an addition to basis, but had no recognition of gain by the departing partners. The IRS viewed the entire device as a mechanism meant to avoid taxation. In the alternative, the IRS viewed the notes from AIG as "window dressing" for which there was an agreement that the notes were redeemable in cash whenever the outgoing partners wanted the funds via an understanding that existed at the time the transaction was entered into.

The taxpayers admitted that the exact structure they used to accomplish their goal was selected due to the tax effect it gave them, but claimed that there was an

underlying change in circumstance for the departing partners (whose taxation is the matter in question here) that both stops the IRS from being able to carry a general economic substance attack on the transaction and making use of either partnership anti-abuse regulation they cite.

Economic Substance Issue

The IRS starts out by observing that, in their view, the partnership borrowed funds and then used them effectively to purchase debt obligations that paid a lower interest rate than that due on the underlying notes—a transaction that had no possibility of being profitable. Thus, the IRS argued, as in the case of Mrs. Goldstein cited above, the transaction had no purpose other than to delay the payment of tax and was totally lacking in economic substance.

The Tax Court did not agree. The Court indicated that the IRS made a fundamental mistake in its use of the *Goldstein* case, noting:

Respondent's reliance on *Goldstein* founders on the fact that Countryside, rather than Mr. Winn and Mr. Curtis, occupies Mrs. Goldstein's position (paying more interest on the borrowings than was received on the investment purchased with those borrowings). The comparable issue in this case would be whether Countryside is entitled to deduct the interest paid on the loans from CB&T. Respondent has not raised an interest deductibility issue in this case, and there is nothing, on that score, for us to resolve.

However, the Court notes that this alone doesn't resolve the matter—there is still the issue of, regardless of the fact that *Goldstein* isn't directly applicable, whether Mr. Winn and/or Mr. Curtis “engaged in any ‘purposive activity’ other than tax avoidance.” Failing to find such an activity would present circumstances that “negate the application of sections 731(a)(1) and 752(a) and (b) to provide nonrecognition of gain to Mr. Winn and Mr. Curtis on the liquidating distribution.”

In Note 20 to the case, the Tax Court outlines the two prongs, one of which must be met, in order for a transaction to found to have economic substance:

1. Objective Prong: there is a change in the taxpayer's economic position following the transaction (other than via tax savings alone);
2. Subjective Prong: the taxpayer has a legitimate nontax reason for entering into the transaction

However, the Court found that there was something that fundamentally changed in the economic interests aside from solely tax impacts. The Court noted:

In this case, what "occurred" was a distribution of nonmarketable notes in redemption of limited partnership interests. Countryside undertook the

distribution in order to eliminate Mr. Winn and Mr. Curtis as limited partners. Mr. Winn and Mr. Curtis agreed to the redemption in order to convert their interests in Countryside into interest-bearing promissory notes. All of the parties to the transaction had legitimate business purposes, and the manner in which those parties accomplished those purposes cannot be disregarded and converted by respondent into a transaction (an exchange of Mr. Winn's and Mr. Curtis's interests in Countryside for cash) that never occurred simply because the transaction that did occur was tax motivated or, as we stated in *Hobby v. Commissioner*, supra at 98523 "had a collateral favorable tax effect." Moreover, that transaction changed Mr. Winn's and Mr. Curtis's economic positions, thereby satisfying both prongs of the economic substance doctrine. See *supra* note 20. Likewise, the transaction changed the economic positions of Countryside and its remaining partners, CLP Holdings, Inc., and Mr. Wollinger, who, through Countryside, increased their collective percentage ownership in the Manchester property to 100 percent.

As noted, the mere existence of tax motivation isn't enough to trigger the application of the economic substance doctrine. Rather, to carry an economic substance position there needs to be an absence of both a change in the taxpayer's economic position and a legitimate nontax business reason for undertaking the transaction.

Were the Notes Marketable Securities?

The IRS also attempted to claim the AIG notes were marketable securities as defined by §731(c)(2)(B)(ii). The IRS claimed that the AIG promissory notes were readily convertible into cash or other marketable securities at the exiting partners request. The IRS was concerned with that "renegotiation" option, though the hearing IRS counsel agreed that a mere right to renegotiate isn't enough to convert such notes into marketable securities, since otherwise any note that did have a provision prohibiting renegotiation would fall into this trap—a position the IRS did not advance.

Rather, the Court interpreted the IRS position to be as follows:

On the basis of his posthearing submissions, we interpret respondent's position to be that the right to seek to renegotiate the terms of the AIG notes does not, in and of itself, render the AIG notes marketable under section 731(c)(2)(B)(ii) but, rather, indicates the presence (or, at least the possibility, requiring further factual inquiry) of an "arrangement" to modify the notes in accordance with participating partner's desires, including the desire to "readily exchange the AIG * * * notes for cash."

The IRS noted that correspondence between AIG and the parties indicated that AIG was “willing to structure the BP-AIG notes in accordance with instructions received from the prospective client's representative” and down the line that AIG would be “willing to modify those notes in accordance with the purchaser's wishes, even at a possible financial loss.” The Tax Court did not find any of this demonstrative of a prearrangement to allow cashing out the notes.

The Court noted:

AIG's willingness to "consider" a modification or repurchase of the AIG notes does not constitute evidence of an "arrangement" to convert the AIG notes into cash or marketable securities at MP's request, as it would be no more than standard business practice for a bank or financial institution to at least consider a customer's request to modify the terms of its notes. Moreover, respondent's counsel has made no representations to the Court that she is able to get Mr. Nelson or anyone else on behalf of AIG to testify that it was AIG's "practice" to renegotiate the terms of or to repurchase its notes.

Nor did AIG's willingness to structure and, subsequently, restructure the BP-AIG notes in accordance with the customer's wishes at a probable overall loss (on account of transaction costs) indicate that the parties were not operating at arm's length then or later in connection with the AIG notes. An e-mail from Mr. Nelson makes clear that that willingness (and, in particular, the willingness to modify the note terms) was a business decision in that he hoped it would assure the customer's purchase of a second note from AIG.

The Court also did not find that the fact that these notes were used to secure a line of credit give credence to the theory that they were effectively marketable. The Court noted:

Here again, the line of credit and the collateral therefor, including the pledge of the BP-AIG notes, were all transactions negotiated between parties operating at arm's length. There is no evidence of any prior arrangement between BP and AIG that the BP-AIG notes would be used to secure the line of credit, and, even if there had been, we do not agree that such an arrangement would have justified treating the BP-AIG notes (and, by implication, the AIG notes) as marketable securities. It is common to use property, including a personal residence, to secure a bank loan or line of credit, but that fact does not lead to the conclusion that such property "is readily convertible into, or exchangeable for, money or marketable securities" within the meaning of section 731(c)(2)(B)(ii).

Anti-Abuse Regulations

The IRS was now down to its final argument—that it should be able to use the anti-abuse provisions of Reg. §§1.701-2 and/or 1.731-2(h) to recast these transactions.

As far as Reg. §1.701-2 is concerned, the Tax Court indicated that, given its holdings on the economic substance matter, the only issue remaining was whether the transaction violated the “intent” of Subchapter K. The Court held that:

Respondent, by attributing gain to Mr. Winn and Mr. Curtis on the deemed receipt of the AIG notes in exchange for their interests in Countryside, takes the position that their reporting of no gain on that transaction did not clearly reflect their income. Under section 1.701-2(b), Income Tax Regs., in cases in which there is not a clear reflection of income, the Commissioner may "recast the transaction for federal tax purposes" if the partnership has been "formed or availed of in * * * 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". Because we find that the transaction (1) was imbued with economic substance and (2) did, in fact, result in Mr. Winn's and Mr. Curtis's receipt of nonmarketable securities, we find that their reporting of no gain on the receipt of the AIG notes, pursuant to section 731(a)(1), clearly reflected their income from that transaction. Therefore, petitioner's reporting of the liquidating distribution as a distribution of property other than money may not be "adjusted or modified" pursuant to section 1.701-2(b)(5), Income Tax Regs.

The Tax Court also refuses to use Reg. §1.731-2(h) to allow the IRS to tax the transaction, holding that:

Participating partner argues, on the basis of the illustrative examples contained in section 1.731-2(h), Income Tax Regs., that "the provision should not have any application to a partnership that owns no marketable securities at all, either directly or indirectly". Respondent describes that argument as expressing "the untenable position" that section 1.731-2(h), Income Tax Regs., does not apply "to situations where partnerships create purportedly nonmarketable securities to distribute in lieu of marketable securities, or cash, to avoid section 731(c)."

We interpret respondent's statement as expressing tacit agreement with participating partner that if, in fact, the AIG notes were not marketable securities, as defined in section 731(c)(2), then section 1.731-2(h), Income Tax Regs., is inapplicable to Countryside's deemed distribution of

the AIG notes to Mr. Winn and Mr. Curtis. Because we have concluded that the AIG notes did not constitute marketable securities, we assume that respondent would concede that section 1.731-2(h), Income Tax Regs., is inapplicable to the distribution of those notes.

Explicitly, the Tax Court did not find the examples in Reg. §1.731-2(h) which the IRS cited as showing why this transaction should be recast, applicable to this situation:

In any event, we agree with participating partner that each of the three examples contained in section 1.731-2(h), Income Tax Regs., the first of which involves a change in partnership allocations or distribution rights with respect to marketable securities, the second, a distribution of substantially all of the partnership assets other than marketable securities, and the third, a distribution of multiple properties to one or more partners at different times, involves circumstances that are not present in this case. We also note that, in the preamble to the final regulations under section 731(c), the Commissioner, in response to a taxpayer request that there be "examples illustrating abusive transactions intended to be covered by * * * § 1.731-2(h)", stated that "the text of the regulations adequately describes several situations that would be considered abusive * * *, and * * * additional examples are unnecessary." T.D. 8707, 1997-1 C.B. 128, 130. Thus, the examples contained in the regulation, which are the only portion of the text of the regulation describing "situations that would be considered abusive", presumably illustrate the universe of circumstances considered abusive for purposes of section 731(c).