Part III - Administrative, Procedural, and Miscellaneous

Distressed Asset Trust (DAT) Transaction

Notice 2008-34

The Internal Revenue Service (Service) and the Treasury Department are aware of a type of transaction, described below, in which a tax indifferent party, directly or indirectly, contributes one or more distressed assets (for example, a creditor's interest in debt) with a high basis and low fair market value to a trust or series of trusts and sub-trusts, and a U.S. taxpayer acquires an interest in the trust (and/or series of trusts and/or sub-trusts) for the purpose of shifting a built-in loss from the tax indifferent party to the U.S. taxpayer that has not incurred the economic loss. This notice alerts taxpayers and their representatives that this transaction (referred to as a distressed asset trust or DAT transaction) is a tax avoidance transaction and identifies this transaction, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 6111 and 6112 of the Internal Revenue Code. This notice also alerts persons involved with these transactions to certain responsibilities that may arise from their involvement with these transactions.

BACKGROUND

The Service and Treasury Department are aware that, prior to October 23, 2004, taxpayers used partnerships improperly to engage in variations of the distressed asset transaction described in this notice. The Coordinated Issue Paper, "Distressed Asset/Debt Coordinated Issue Paper," LMSB-04-0407-031 (Apr. 18, 2007) describes the variation of the distressed asset transaction involving partnerships (DAD). The American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418) (AJCA), amended §§ 704, 734 and 743 effective after October 22, 2004, for contributions of built-in loss property to a partnership, for basis adjustment rules in the case of a distribution for which there is a substantial basis reduction, and for basis adjustment rules in the case of a transfer of a partnership interest for which there is a substantial built-in loss. The revisions to §§ 704, 734 and 743 generally (1) require that a built-in loss may be taken into account only by the contributing partner and not other partners, and (2) make the basis adjustment rules mandatory in cases with a substantial basis reduction or substantial built-in loss. Thus, the statutory changes to §§ 704, 734 and 743 under AJCA prevent taxpayers from shifting a built-in loss from a tax indifferent party to a U.S. taxpayer through the use of a partnership. The Service and Treasury Department have learned that a variation of the distressed asset transaction using a trust is being promoted in an attempt to avoid these revisions made by AJCA. Consequently, this notices identifies the DAT variation of the transaction as a listed transaction under § 1.6011-4(b)(2) for transactions that are entered into after October 22, 2004.

FACTS

In a DAT transaction, a tax indifferent party creates a trust (Main-Trust) with X as trustee. The tax indifferent party contributes distressed assets directly or indirectly (through a partnership or otherwise) to Main-Trust, and is described as the grantor and beneficiary of Main-Trust.

A U.S. taxpayer (Taxpayer) transfers cash or a note to Main-Trust in exchange for certificates evidencing units of beneficial interest in Main-Trust. The cash or note approximately equals the fair market value of the distressed assets. Under the terms of the Main-Trust agreement, Taxpayer thereby becomes a beneficiary of Main-Trust.

The parties contend that Main-Trust is a trust for tax purposes with the stated purpose of preserving and protecting assets. Thus, the parties contend that Main-Trust is to be taxed as a trust under the Internal Revenue Code, and not as a business entity described in § 301.7701-2 of the Procedure and Administration Regulations. As a result, the parties contend that under § 1015(b), Main-Trust's basis in the distressed assets is the same as the grantor's basis in the distressed assets (in this case, the tax indifferent party's basis).

Under the Main-Trust agreement, X, the trustee, is permitted to establish one or more sub-trusts of Main-Trust, each for a separate beneficiary of Main-Trust who will then be the sole beneficiary of that sub-trust. The Main-Trust agreement further provides that each sub-trust for a beneficiary constitutes a separate and distinct sub-trust of Main-Trust with beneficial interest certificates issued and separate records maintained for each sub-trust.

As permitted under the Main-Trust agreement, the trustee creates a separate sub-trust (Sub-Trust), transfers certificates evidencing units of beneficial interest in Sub-

Trust (Sub-Trust Certificates) to Taxpayer, and allocates the distressed assets to Sub-Trust for the sole benefit of the beneficiary of the Sub-Trust. The Main-Trust agreement entitles the holder of Sub-Trust Certificates to various rights including the right to direct the trustee to vest the holder's ratable share of the corpus or the income of Sub-Trust in the holder. The Taxpayer contends that the existence of these rights causes the Taxpayer to be considered the owner of Sub-Trust under § 678, and that Sub-Trust is a grantor trust. As a result of being treated as the owner of Sub-Trust, the Taxpayer takes into account those items of income, deductions, and credits against tax, which are attributable to Sub-Trust, to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual. Section 671. The Taxpayer contends that Sub-Trust's basis in the distressed assets is the same as the grantor's basis in the distressed assets (in this case Main-Trust's basis). Section 1015(b). Within a short period of time, the distressed assets held by the Sub-Trust are written off as wholly worthless under § 166. Alternatively, the distressed assets are sold, and Taxpayer claims a deduction under § 165.

DISCUSSION

The transaction described in this notice attempts to shift built-in losses from a tax indifferent party to a U.S. taxpayer who has not incurred an economic loss so that the U.S. taxpayer may claim a deduction of the built-in losses from the distressed assets. The built-in loss purportedly transferred to Main-Trust and Sub-Trust and improperly shifted to the Taxpayer is not an allowable loss for the Taxpayer. The Service may assert one or more arguments that may include, but are not limited to, asserting that the Taxpayer's transfer of cash or a note to Main-Trust in exchange for certificates of

beneficial interest is a transfer of the distressed assets under § 1001; asserting that Main-Trust does not meet the trust requirements of § 301.7701-4; asserting that Main-Trust is not a taxable trust; asserting that one or more of the entities is properly classified for Federal tax purposes as a partnership subject to §§ 704(c)(1)(C), 734(b) and 743; asserting that the claimed loss deduction under § 165 was not incurred in a transaction undertaken for profit; asserting the judicial doctrines, including substance over form, lack of economic substance, and step transaction; and asserting that, in the case of distressed debt, the distressed debt was worthless under § 166 at the time of contribution to Main-Trust and Sub-Trust.

Transactions that are the same as, or substantially similar to, the transaction described in this notice that are entered into after October 22, 2004, are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) and §§ 6111 and 6112 effective February 27, 2008, the date this notice was released to the public. Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the requirements of § 6011, § 6111, § 6112, or the regulations thereunder. However, the variations of this transaction described in the Coordinated Issue Paper, "Distressed Asset/Debt Coordinated Issue Paper," LMSB-04-0407-031 (Apr. 18, 2007), that are subject to the AJCA changes to §§ 704, 734 and 743 are not being identified as "listed transactions" for purposes of this notice, § 1.6011-4(b)(2), § 6111 and § 6112.

Persons required to disclose these transactions under § 1.6011-4 who fail to do so may be subject to the penalty under § 6707A, which applies to returns and statements due after October 22, 2004. Persons required to disclose these transactions

under § 1.6011-4 who fail to do so may be subject to an extended period of limitations under § 6501(c)(10). Persons required to disclose these transactions under § 6111 who fail to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who fail to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose other penalties on persons involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662 or § 6662A.

A person that is a tax-exempt entity within the meaning of § 4965(c), or an entity manager within the meaning of § 4965(d), may be subject to excise tax, disclosure, filing or payment obligations under § 4965, § 6033(a)(2), § 6011, and § 6071. Some taxable entities may be subject to disclosure obligations under § 6011(g), that apply to "prohibited tax shelter transactions" as defined by § 4965(e) (including listed transactions).

The Service and Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should take appropriate corrective action and ensure that their transactions are disclosed properly.

DRAFTING INFORMATION

The principal author of this notice is Eric Ingala of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Ingala at (202) 622-3070 (not a toll-free call).