Office of Chief Counsel
Internal Revenue Service
Memorandum
CC:PSI:B03:POSTF-154967-03

Number: **200513022**
Release Date: 04/01/2005

UILC: 707.00-00; 752.00-00; 701.00-00

date: November 15, 2004

to: Steven R. Guest, Associate Area Counsel (Large & Mid-Size Business) (Retailers, Food, Pharmaceuticals & Health Care)

from: Christine E. Ellison, Chief, Branch 3, Office of the Associate Chief Counsel (Passthroughs & Special Industries)

subject: **Leveraged Partnership Issues**

This Chief Counsel Advice responds to your memorandum dated November 12, 2003. In accordance with § 6110(k)(3) of the Internal Revenue Code, Chief Counsel Advice may not be used or cited as precedent.

This memorandum is based solely on the facts presented in the November 12, 2003, memorandum, the exhibits received on November 17, 2003, and the exhibit received on December 2, 2003.

LEGEND

A =

B =

Sub 1 =

Sub 2 =

Building =

Limited Liability Company =

State =

Bank 1 =

Bank 1 Sub =

<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>$I</u>	=
<u>$J</u>	=
<u>$K</u>	=
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$V	=
$W	=
$X	=
$Y	=
$Z	=
$AA	=
$BB	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Year 1	=
Term 1	=
Term 2	=
m%	=
n%	=
o%	=
p%	=

ISSUES

1. Are the series of transactions resulting in the transfer of Building from A to Limited Liability Company considered a disguised sale under § 707(a) of the Internal Revenue Code?

2. Does § 1.701-2 of the Income Tax Regulations apply to the transfer of Building between A and Limited Liability Company.

3. Does the anti-abuse rule found in § 1.704-4(f) apply to the series of transactions resulting in the transfer of Building from A to Limited Liability Company?

4. Is A subject to the penalties under § 6662?

CONCLUSIONS

1. The series of transactions resulting in the transfer of Building from A to Limited Liability Company are considered a disguised sale under § 707(a).

2. Section 1.701-2 does apply to the transfer of Building between A and Limited Liability Company.

3. Section 1.704-4(f) does apply to the series of transactions, resulting in the recognition by A of the precontribution gain in Building on the date Building was transferred to Limited Liability Company.

4. A is subject to the accuracy-related penalty for a substantial understatement of income tax under § 6662(b)(1) and (2).

FACTS

In Date 1, A retained a broker to help A sell Building and associated real and personal property.[1] A owned Building through a wholly owned subsidiary, Sub 1, and had an approximate basis in Building of $A.[2] Building was not subject to any liabilities and Sub 1 had no liabilities. After selling Building, A planned to keep its headquarters in Building by leasing the necessary space after the sale.

After reviewing A's Committee's recommendation to sell Building, A's General Counsel advised A's Board of Directors not to enter into a direct

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[1] Unless otherwise indicated, the term Building in this memorandum includes the building, the land building is located on, and the associated real and personal property.

[2] The information provided included two different amounts for A's basis in Building. We used the amount $A in this CCA merely to show how to compute the basis.

sale of Building for $B resulting in a taxable gain of approximately $C and a current tax liability of $D. A's General Counsel recommended against a direct sale based on a plan to defer the $D tax liability. Instead, A's General Counsel recommended that Building be disposed of using a limited partnership structure in which A would retain a m% interest. A would contribute the building to the limited partnership and the buyer would contribute cash to the limited partnership for a n% interest. The partnership then would borrow $B less the cash contributed by the buyer. The amount the limited partnership borrowed would be nonrecourse to A unless the appraised value of the building decreased by more than a specified amount during the first two years of the partnership. The decrease in value of Building below the specified amount would cause A to be liable for up to such specified amount of the borrowing. A's General Counsel also was seeking a way for A to minimize or eliminate this guarantee. At closing on Building, the limited partnership would distribute essentially all of the cash (the loan plus the buyer's contribution) to A. A's General Counsel stated that the purpose of this limited partnership structure was to defer o% of the taxable gain.

In Date 2, A hired a broker to market Building. Following the broker's marketing efforts, A received numerous written bids and asked several of the highest bidders, including B, to submit written best and final bids incorporating a tax structure that would purportedly permit A to defer a significant portion of its unrealized taxable gain in Building. B submitted the highest bid.

B's attorneys proposed the following tax structure. Sub 1 would transfer Building to a partnership in return for a m% common partnership interest and a $E preferred partnership interest, of which $E would be payable upon a capital event. Based on a legal opinion from an outside counsel, B's attorneys believed that the preferred return would constitute an allocation to Sub 1 of a significant item of income and, as such, would allow all of the partnership debt to be allocated to Sub 1. This alternative tax structure would eliminate the need for A to guarantee any of the partnership's debt.

On Date 3, one of A's tax counsel expressed concerns with the proposed alternative tax structure and raised questions regarding the preferred return being a significant item of income. However, despite these concerns, in a Date 4 letter, A's General Counsel requested that the Committee consent in writing to transfer Building to a limited liability company, in exchange for cash of approximately $F, a m% common interest in the limited liability company, and a $E preferred interest. In addition, A would not be required to provide any residual value guaranty in connection with the proposed transaction.

B formed Limited Liability Company under the laws of State and was the only member until Date 5. On that date, Sub 1, B, and Limited Liability Company executed a Contribution and Sale Agreement for the transfer of Building. Also on Date 5, Bank 1 sent B a loan commitment letter for a $G loan.

Effective Date 6, A, through Sub 1,[3] transferred Building to Limited Liability Company in exchange for cash, a m% common interest in Limited Liability Company, and a preferred interest (Member Preference) in Limited Liability Company. The preferred interest allows A to receive the first $E of capital proceeds received by Limited Liability Company on the sale, refinancing, disposition, etc., of any Limited Liability Company property (and any excess will be allocated n% to B and m% to A) plus a return on $E at a rate equal to the lesser of p% per annum or the highest rate of return which would be considered reasonable within the meaning of that term in § 1.707-4(a)(3)(ii). The payment of the Member Preference would be a priority distribution over all other Limited Liability Company distributions, other than payment of interest on loans, if any, that the members make to Limited Liability Company. Further, the base amount of this Member Preference gets reduced by any distributions of any capital proceeds to A after expiration of the Term 1 no sale provision prohibiting Limited Liability Company from selling Building. In addition, after Term 2 from Date 6, A has the right to exercise a put option to cause Limited Liability Company to redeem A's interest for the balance of the preferred interest, any accrued but unpaid preference, and the balance of its capital account.

On Date 6, Bank 1 Sub and Limited Liability Company executed a loan agreement for the $G loan. The loan was a nonrecourse loan, secured by Building to the extent of $H, and recourse as to B for $E. Following the receipt of the funds from Bank 1 Sub, Limited Liability Company made a cash payment of $I to A.

A claimed that of the $I received, $J was consideration for the sale of the land, land improvements, and personal property for which A had a cumulative basis of $J. A also claimed that $K was consideration for the sale of a pro rata portion of the building. The $K was transferred to a trust so that A could enter into a deferred like-kind exchange. Further, A received $H as a partnership distribution from proceeds of the financing, and $L as a reimbursement of pre-formation expenses that A incurred. In addition to receiving the $I, A, through Sub 1, held a m% "common company" interest and the $E Member Preference in Limited Liability Company.

A's common interest in Limited Liability Company entitles A to receive a m% allocable portion of all partnership items. A's preferred interest in Limited Liability Company is defined by the Limited Liability Company Agreement as "the preferred interest in the [Limited Liability Company] entitling [A] to an allocation of Net Income of, and distributions up to, the amount of [$E.]"

[3] Sub 1 acted through its wholly owned subsidiary, Sub 2. Sub 2 is a limited liability company that is disregarded for federal tax purposes under § 301.7701-3.

On Date 7, a law firm provided A with an opinion letter addressing the allocation of the liabilities under the Limited Liability Company Agreement and determined that of the $H Bank 1 loan, $M should be allocated to A under § 1.752-3(a)(2) and the remaining $N should be allocated to A under § 1.752-3(a)(3), in accordance with the allocation of a significant item of other partnership income or gain, assuming that the preferred returns are respected as a significant item. In the opinion letter, the law firm also advised A to file Form 8275, Disclosure Statement.

When A filed its Form 1120, U.S. Corporation Income Tax Return, for the year of the transaction, A did not file a Form 8275.

LAW AND ANALYSIS

Issue I: Disguised Sale Analysis

Section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to the partner (or another partner), and (iii) the transfers discussed in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, the transfers are treated either as a transaction described in § 707(a)(1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

Section 1.707-3(b)(2) provides that the determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitutes a sale, in whole or in part, under § 1.707-3(b)(1) is made based on all of the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under § 1.707-3(b)(1). Among the facts and circumstances that may tend to prove the existence of a sale under § 1.707-3(b)(1) are the following: (i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer; (ii) That the transferor has a legally enforceable right to the subsequent transfer; (iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured; (iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration; (v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations; (vi) That a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt); (vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets); (viii) That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property; (ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and (x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

Section 1.707-3(c) provides that if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

Section 1.707-5(a)(2) provides that a partner’s share of any liability of the partnership is determined under the following rules: (i) Recourse liability. A partner’s share of a recourse liability of the partnership equals the partner’s share of the liability under the rules of § 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section. (ii) Nonrecourse liability. A partner’s share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner’s share of the excess nonrecourse liability under § 1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under § 1.752-1(a)(2) or would be a nonrecourse liability of the partnership under § 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

Section 1.707-5(b)(1) provides that for purposes of § 1.707-3 if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability is allocable under § 1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability.

Section 1.707-5(b)(2)(i) provides that a partner's allocable share of a partnership liability for purposes of § 1.707-5(b)(1) equals the amount obtained by multiplying the partner's share of the liability as described in § 1.707-5(a)(2) by the fraction determined by dividing (A) the portion of the liability that is allocable under § 1.163-8T to the money or other property transferred to the partner, by (B) the total amount of the liability.

Section 1.707-5(b)(2)(ii)(A) provides that except as provided in § 1.707-5(b)(2)(iii), if a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, § 1.707-5(b)(1) is applied by treating all of the liabilities incurred pursuant to the plan as one liability, and each partner's allocable share of those liabilities equals the amount obtained by multiplying the sum of the partner's shares of each of the respective liabilities (as defined in § 1.707-5(a)(2)) by the fraction obtained by dividing (1) the portion of those liabilities that is allocable under § 1.163-8T to the money or other consideration transferred to the partners pursuant to the plan, by (2) the total amount of those liabilities.

Section 1.707-5(b)(2)(ii)(B) provides that § 1.707-5(b)(2)(ii)(A) does not apply to any transfer of money or other property to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under § 1.707-5(b)(1).

Section 1.707-5(b)(2)(iii) provides that for purposes of § 1.707-5(b)(2), a partner's share of a liability, immediately after the partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if (A) it is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer, and (B) the reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale.

Section 1.752-3(a)(3) provides that a partner's share of the excess nonrecourse liabilities (those not allocated under § 1.752-3(a)(1) and (2)) of the partnership is determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners’ interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the § 704(b) regulations) of some other significant item of partnership income or gain.

To calculate the amount excluded from § 707 disguised sale amounts, A's share of liability is determined under § 1.707-5(a)(2)(ii) because it is a nonrecourse liability. To determine A's share of nonrecourse liability, § 1.707-5(a)(2)(ii) requires application of the same percentage used to determine A's share of excess nonrecourse liability under § 1.752-3(a)(3) (third tier allocation regulations). Under those regulations, generally, A's excess nonrecourse liabilities would be allocated according to A's share of partnership profits.

The third tier allocation regulations also allow allocations specified in the partnership agreement if the allocations are reasonably consistent with allocations (that have substantial economic effect under the § 704(b) regulations) of some other significant item of partnership income or gain. A argues that the allocation to A of excess nonrecourse liabilities in the Limited Liability Company Agreement is proper under § 1.752-3(a)(3) because the preferred return is an allocation to A of a significant item of income that allows for all of the Limited Liability Company debt to be allocated to A. Further, A argues that A's transfer of Building to Limited Liability Company is not a disguised sale under § 707(a) because under § 1.707-5(b), the debt financed transfer of consideration is characterized as sales proceeds only if that amount exceeds the partner's share of the partnership liability. A relies on § 1.707-5(a)(2) and the § 1.752-3(a)(3) allocation rules to claim that A's share of the nonrecourse liability exceeds the debt financed transfer of consideration. Thus, A takes the position that the first $E of capital proceeds that A receives on the disposition of Building amounts to a significant item of partnership gain for purposes of § 1.752-3(a)(3).

We believe A's position is flawed. A has a preferred interest in the first $E of capital proceeds (and the excess will be allocated n% to B and m% to A). For A to be allocated 100% of the nonrecourse liabilities under § 1.752-3(a)(3), it is clear that those allocations must be reasonably consistent with allocations of some other significant item of partnership income or gain that must have substantial economic effect under the § 704(b) regulations. We believe the premise for the third tier allocation is to match the excess nonrecourse deductions with the manner in which partners share a significant economic item of partnership income or gain. To consider a single allocation of a preferred return, in isolation, as A argues, does not encompass this concept of sharing in a significant economic item of partnership income or gain. In this case, A's allocation of the $E preferred return does not reflect the overall economic relationship among the parties for that item of partnership gain. Thus, it cannot be what was intended by the third tier allocation permitted by § 1.752-3(a)(3).

We believe that what was intended by the special allocations permitted under the third tier allocation regulations was a determination of significant items of partnership income or gain and then an examination of the manner in which the partners share items of economic significance for the purpose of determining whether the special allocation is consistent with the manner in which the partners share items of economic significance. For example, suppose a 75/25 partnership agrees to allocate the first $100x of net capital proceeds to Partner 1 and the excess net capital proceeds to Partner 2. Assume further that the partnership agreement provides that for purposes of § 1.752-3(a)(3), the allocations will be made in accordance with the manner in which the partners share the first $100x of net capital proceeds. In applying the taxpayer's argument to this example, this allocation would entitle Partner 1 to 100% of the third tier allocations (assuming that the § 704(b) requirement is satisfied). However, if the total amount of net capital proceeds that the partnership was expected to earn in that same year is $500x, Partner 1 is only being allocated one-fifth of the total net capital proceeds, yet Partner 1 is being allocated 100% of the third tier allocations. Because this allocation clearly does not reflect the underlying economic relationship of the partners, the allocation is not consistent with the purpose of the third tier allocation regulations for Partner 1 to be allocated an amount other than 20% of the excess nonrecourse allocations if net capital proceeds is the significant item of partnership income or gain the taxpayer chooses to follow.

Therefore, A has failed to persuade us that A is entitled to the claimed amount of the third tier allocations under § 1.752-3(a)(3). To meet the requirements of allocating excess nonrecourse allocations that are sanctioned under the third tier allocation regulations, the allocation ratio must reflect how the partners are sharing a significant item of partnership income or gain that has substantial economic effect. Here, A's preferred interest in Limited Liability Company does not amount to a significant item of partnership income or gain. As a result, because none of the partnership nonrecourse liabilities are first or second tier liabilities for purposes of § 1.752-3, as § 1.707-5(a)(2) provides, A's share of the nonrecourse liabilities of the partnership is determined under the third tier and most likely is allocated in accordance with A's share of partnership profits. See § 1.752-3(a)(3).

In sum, unless additional facts are presented that can establish otherwise, with regard to the $O ($I less the expense reimbursement of $L) that A received on its contribution of Building to Limited Liability Company, the proper application of the disguised sales rules results in the following: (i) With regard to the $J payment that A properly claimed as received in a sale, the correct calculation of A's basis in the sale is determined by dividing the amount realized ($J) by the total fair market value of Building ($O) and multiplying the quotient by A's basis in Building ($A), yielding a basis of $P, and resulting in a gain to A that should have been recognized of $J less $P, which is $Q; (ii) With regard to the $K payment that A was advised to report as a disguised sale, the correct calculation of A's basis in this portion is determined by dividing the amount realized ($K) by the total fair market value of Building ($O) and multiplying the quotient by A's basis in Building ($A), yielding a basis of $R, and resulting in a gain to A that should have been recognized of $K less $R, which is $S; and (iii) With regard to the $H of loan proceeds A received, n% of it should have been declared as received in a sale, therefore the correct calculation of A's basis in this portion is determined by dividing the amount realized (n% of $H, or $T) by the total fair market value of Building ($O) and multiplying the quotient by A's basis in Building ($A), yielding a basis of $U, and resulting in a gain to A that should have been recognized of $T less $U, which is $V.

Accordingly, A should have recognized a total gain of $W on the sale of Building to Limited Liability Company.[4] Further, A is treated as having contributed the remaining portion of Building to Limited Liability Company in exchange for an interest in Limited Liability Company. Upon the exchange, A will have a basis in its partnership interest equal to $X, which is equal to m% multiplied by $H divided by $O multiplied by $A. Limited Liability Company has a basis in Building equal to $Y, which is equal to the amounts paid in the sales transactions plus the basis on the portion that A transferred in exchange for an interest in Limited Liability Company.

Issue 2: Section 1.701-2 Analysis

Section 1.701-2(a) provides that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements: (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) The form of each partnership transaction must be respected under substance over form principles; and (3) Except as otherwise provided in § 1.701-2(a)(3), the tax consequences under subchapter K to each partner of the partnership operations and of transactions between the partners and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income).

Section 1.701-2(b) provides that 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 § 1.701-2(a). 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,

[4] The $S of gain that was recognized upon receipt of the $K payment from B may have been deferred if, in fact, A entered into the deferred like-kind exchange referenced in your submission.

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 1.701-2(c) provides that whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Sec. 1.701-2(c). Section 1.701-2(c) lists various factors that may be indicative, but do not necessarily establish, that a partnership was used in a manner inconsistent with the intent of subchapter K.

Under the doctrine of substance over form, the courts may look through the form of a transaction to determine its substance in light of economic realities. As explained by the Supreme Court in Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978):

> In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," [Commissioner v. Towers, 327 U.S. 280, 291 (1946)], as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." [Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939); see also Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 266-267 (1958); Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).] Nor is the parties' desire to achieve a particular tax result necessarily relevant. [Commissioner v. Duberstein, 363 U.S. 278, 286 (1960).]

"To permit the true nature of a transaction to be disguised by mere formalisms, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." Court Holding Co., 324 U.S. at 334; see also Gregory v. Helvering, 293 U.S. 465, 469 (1935) (refusing to give effect to transactions that complied with formal requirements for nontaxable corporate reorganization; "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended").

Subchapter K was adopted in part to increase flexibility among partners in allocating partnership tax burdens. See generally Foxman v. Commissioner, 41 T.C. 535, 550-51 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965). This flexibility, however, is limited by the overarching principle that the substance of the transaction is controlling for tax purposes and the form chosen by the parties will only be respected if it comports with the reality of the transaction. See Twenty Mile Joint Venture, PND, Ltd. v. Commissioner, 200 F.3d 1268 (10th Cir. 1999).

The substance of a transaction, and not its form, determines whether a transfer of assets to a partnership is a disguised sale under § 707 or a nontaxable contribution under § 721(a). See §§ 1.707-1(a) and 1.721-1(a); see, e.g., Jacobson v. Commissioner, 96 T.C. 577, 590-592 (1991), aff'd, 963 F.2d 218 (8th Cir. 1992) (corporation, which had attempted to sell property before transfer to partnership and received from partnership cash equal to 75 percent of the value of such property contributed by other partner, treated as selling 75 percent of the property to other partner); Barenholtz v. Commissioner, 77 T.C. 85, 89-90 (1981) (transfer of property to partnership in exchange for 25-percent partnership interest and cash distribution equal to 75 percent of the value of the property to equalize capital accounts deemed to be sale of 75 percent of interest in property to three other partners).

In this case, it was A's initial intent to sell Building outright in Year 1, and it was not until tax savings were discussed that A considered anything other than an outright sale as a means for disposing of Building. In fact, the documents relating to A's negotiations with B and B's presentations to A demonstrate that the form of the transfer of the building to B was done with the primary purpose of reducing A's federal income tax liability. Both parties were aware of the tax consequences. As a result, the purchase price was reduced by B in an effort to take advantage of the reduction in tax to A if the proposed tax structure was used. Further, when A transferred title in Building to Limited Liability Company, A no longer retained the benefits and burdens of ownership, and A no longer managed the building. As a result, the $H distribution to A was merely a disguised payment for Building and the preferred interests were merely another component of the sales price inserted solely in an attempt to bolster A's legal claims for tax avoidance purposes. Therefore, A transferred the title to Building to Limited Liability Company and received cash equivalent to the value of Building and should be taxed in accordance with the substance of this transaction (a sale) and not its form (a contribution and distribution).

Accordingly, we conclude that the transaction was inconsistent with the intent of subchapter K in that it was entered into for the primary purpose of reducing A's tax burden and that the anti-abuse rule in § 1.701-2 should be applied.

Issue 3: Section 1.704-4(f) Analysis

Section 704(c)(1) provides that (A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, and (B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed — (i) the contributing partner is treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under § 704(c)(1)(A) by reason of the variation described in § 704(c)(1)(A) if the property had been sold at its fair market value at the time of the distribution, (ii) the character of such gain or loss is determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and (iii) appropriate adjustments are made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under § 704(c)(1)(B).

Section 1.704-4(f)(1) provides that the rules of § 704(c)(1)(B) and § 1.704-4 must be applied in a manner consistent with the purpose of § 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of § 704(c)(1)(B), the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of § 704(c)(1)(B) and § 1.704-4. Whether a tax result is inconsistent with the purpose of § 704(c)(1)(B) and § 1.704-4 must be determined based on all of the facts and circumstances.

The anti-abuse rule under §704(c)(1)(B), § 1.704-4(f)(1), applies, for example, where a partnership shifts substantially all of the economic risks and benefits of an asset to a partner to avoid the gain that would occur if such asset were actually distributed to the partner. In § 1.704-4(f)(2), example 1, the partners amend the partnership agreement during the 7-year post-contribution period and take steps to provide that substantially all of the economic risks and benefits of the contributed property are borne by the future distributee partner. Thus, before the actual distribution, the future distributee partner essentially owns the property. In such a situation, § 704(c)(1)(B) would call for the contributing partner to recognize gain on the date that the economic risks and benefits of the contributed property are transferred to the future distributee.

Here, A transferred substantially all of the risks and benefits of Building to B, in exchange for $O cash on Date 6 and an additional future payment of $E plus interest (which it could demand, pursuant to its put option, at any point after Term 2 after Date 6). As a result of the formation of Limited Liability Company, A's interest in Building was diluted to m% and A received payment equal to Building's then fair market value. All of this was carried out in an attempt for A to avoid the gain that would otherwise occur if Building was actually distributed to B on Date 6.

As a result, A should recognize gain pursuant to § 704(c)(1)(B) in an amount equal to $O less $A, or $Z.[5]

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[5] Upon the § 704(c)(1)(B) gain recognition, A increases its basis in its partnership interest by $Z, from $A to $O. Then, as a result of the distributions of cash to A, A's basis in its partnership interest decreases by $O (§ 733(1)) and, as a result of the allocation of liabilities to A under § 752(a), A's basis in its partnership

Issue 4: Penalty Analysis

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things, any substantial understatement of income tax. A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies). See § 6662(d)(1).

Section 6662(d)(2)(B) provides that the amount of the understatement is reduced by any portion of the understatement attributable to an item if (1) the tax treatment of the item by the taxpayer is or was supported by substantial authority for such treatment, or (2) the facts relevant to the tax treatment of the item were adequately disclosed in the return or in a statement attached to the return and there is a reasonable basis for the tax treatment of such item by the taxpayer.

Section 6662(d)(2)(C)(ii) provides that § 6662(d)(2)(B) shall not apply to any item of a corporation which is attributable to a tax shelter. The statutory test for determining the existence of a tax shelter is whether the plan, entity, or arrangement at issue had as a significant purpose the avoidance or evasion of Federal income tax. See § 6662(d)(2)(C)(iii). The term "significant purpose" is not defined in § 6662. In addition, the regulations pursuant to § 6662 do not address the meaning of "significant purpose" because they have not been updated since the test was changed from "principal purpose" to "significant purpose" for transactions entered into after August 5, 1997. However, if a transaction satisfies the principal purpose test, it will also satisfy the "significant purpose" test because the latter test is a lower standard.

Section 1.6662-4(g)(2)(i) provides that the principal purpose of an entity, plan, or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose. The regulations further provide the following hallmarks typical of tax shelters: transactions structured with little or no economic purpose; transactions that utilize the mismatching of income and deductions; overvalued assets or assets with substantial uncertainty; certain nonrecourse financing; financing techniques that do not conform to standard business practices; or the mischaracterizing of the substance of the transaction. If, however, the entity, plan, or arrangement claims exclusions from income, accelerated deductions, or other tax benefits consistent with the statute and Congressional purpose, then the principal purpose test is not met. See § 1.6662-4(g)(2)(ii).

After a review of the facts presented in this case, it is clear that the principal purpose for the parties having structured the series of transactions as they did was so

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increases by $AA. Accordingly, as a result of the application of § 1.704-4(f), A's basis in its partnership interest is $AA.

that A would be able to defer a significant amount of gain recognition through the mischaracterization of the substance of the transaction, thus meeting the requirements of the principal purpose test under § 1.6662-4(g)(2)(ii) and qualifying as a tax shelter within the meaning of § 6662(d)(2)(C)(iii). As a result, the next step is to apply § 1.6664-4(f) to determine whether A has reasonable cause sufficient to avoid the accuracy-related penalty for a substantial understatement attributable to tax shelter items.

In the alternative, if it is determined that the transaction entered into was not a tax shelter for purposes of § 6662(d)(2)(C)(iii) and it is determined that there is a substantial understatement of income tax based on A reporting a gain of only $BB on the Sale Portion on its Form 1120, Schedule D, Capital Gains and Losses, when A should have reported a gain which is greater than the greater of 10% of the tax required to be shown on the return or $10,000, then it is still appropriate to assert the accuracy-related penalty for substantial understatement. If this is the case, then there is the potential for there to be a reduction of the understatement pursuant to § 6662(d)(2)(B) if there was substantial authority for the tax treatment of the item or there was adequate disclosure and a reasonable basis for the treatment of the item by the taxpayer. See § 6662(d)(2)(B)(i) and (ii).

In this case, A did not disclose the transfer as required by the regulations under § 707(a)(2)(B). Therefore, A is not able to reduce the understatement on the basis of disclosure. See § 6662(d)(2)(B)(ii). Further, it would be difficult for A to claim substantial authority based on § 707(a)(2)(B) and the accompanying regulations because A did not comply with those regulations.

The Reasonable Cause Exception

Section 6664(c) provides an exception, applicable to all types of taxpayers, to the imposition of any accuracy-related penalty if the taxpayer shows that there was reasonable cause for the underpayment and the taxpayer acted in good faith with respect to the underpayment. Section 1.6664-4(f), discussed below, contains special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all relevant facts and circumstances. See § 1.6664-4(b)(1) and (f)(1). All relevant facts, including the nature of the tax investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, the sophistication of the taxpayer, and the quality of an opinion, must be developed to determine whether the taxpayer was reasonable and acted in good faith.

Generally, the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's effort to assess the proper tax liability. See § 1.6664-4(b)(1); see also Larson v. Commissioner, T.C. Memo. 2002-295. For example, reliance on erroneous information reported on an information return indicates reasonable cause and good faith, if the taxpayer did not know or have reason to know that the information was incorrect. Similarly, an isolated computational or transcription error is not inconsistent with reasonable cause and good faith.

Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication, and education of the taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws, at the time the return was filed, is relevant in deciding whether the taxpayer acted with reasonable cause. See Kees v. Commissioner, T.C. Memo. 1999-41. Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988); cf. Spears v. Commissioner, T.C. Memo. 1996-341, aff'd, 131 F.3d 131 (2d Cir. 1997). In addition, reliance upon a tax opinion provided by a professional tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty.

Section 1.6664-4(f)(2)(i) provides that a corporation is deemed to have acted with reasonable cause and in good faith if the corporation had substantial authority, as that term is defined in § 1.6662-4(d), for its treatment of the tax shelter item, and if at the time of filing the return, the corporation reasonably believed such treatment was more likely than not the proper treatment. The more likely than not standard may be met by the corporation's good faith and reasonable reliance upon the opinion of a tax advisor if the opinion is based on the advisor's analysis of the pertinent facts and authorities in the manner described in § 1.6662-4(d)(3)(ii), and the opinion unambiguously states the advisor's conclusion that there is a greater than 50-percent likelihood the tax treatment of the item will withstand a challenge by the Service. Sec. 1.6664-4(f)(2)(i)(B)(2).

In this case, even if it is determined that A did not enter into a tax shelter for purposes of § 6662(d)(2)(C), one of A's tax counsel expressed concerns about the structure of the transaction and advised A to disclose the transfer. Thus, it would be difficult for A to claim reliance on a tax advisor as the basis for reasonable cause and good faith. Further, A's failure to disclose the transfer, despite the fact that the regulations under § 707 require disclosure, coupled with legal advice to A to disclose, demonstrates bad faith. Cf. § 1.6664-4(d), (f). Therefore, the reasonable cause/good faith exception to the accuracy-related penalty should not apply.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 622-3080 if you have any further questions.