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to: Associate Area Counsel
(Large Business & International)

from: Associate Chief Counsel
(Passthroughs & Special Industries)

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subject: Treatment of Leveraged Partnership Transaction

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Plan	=	
X	=	
Select Assets	=	
Line of Business	=	
QSub-X	=	
Y	=	
Sub-Y1	=	
Sub-Y2	=	
Y Affiliates	=	
Partnership	=	
Contributed Assets	=	
Y Notes	=	
Sub-P	=	
Bank	=	
Company	=	
A	=	
a	=	
b	=	

c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=

ISSUES

1. Whether the indemnity by X in connection with its disposition of the Contributed Assets should be disregarded pursuant to section 1.752-2(j).

2. Whether, if the indemnity is disregarded pursuant to section 1.752-2(j), the contribution of the Contributed Assets, and the ensuing distribution, should be recharacterized as a disguised sale by X to the Partnership pursuant to section 707(a)(2)(B) and the regulations thereunder.

3. Alternatively, whether the transaction should be recast under section 1.701-2(b) as Y borrowing from Bank to purchase a% of the Contributed Assets followed by the formation of a partnership.

4. Alternatively, whether, under the judicial doctrine of substance over form, the form of the transaction should be disregarded and the transaction should be recharacterized as a sale.

CONCLUSIONS

1. X's indemnity should be disregarded pursuant to section 1.752-2(j).

2. Because the indemnity is disregarded, the related contribution and distribution will be treated as a disguised sale under section 707(a)(2)(B).

3. Alternatively, the transaction should be recast under section 1.701-2(b) as Y borrowing from Bank to purchase a% of the Contributed Assets followed by the formation of a partnership.

4. Alternatively, the form of the transaction (contribution and distribution) should be disregarded and treated in accordance with the underlying substance (sale).

FACTS

In Year 2, A purchased X using a Plan. X converted from a C corporation to an S corporation effective Date 1.

A had originally planned for X to hold on to Select Assets while selling other assets. However, A changed his mind following a rapid deterioration in X's Line of Business. X began discussions with at least three bidders for the sale of the Contributed Assets. Ultimately, X selected Y as the purchaser. Y outbid several others. Y was willing to accept X's desired structure. Although they generally face no corporate-level tax, S corporations are potentially subject to tax under section 1374(a).

Section 1374(a), as it applies to X, provides that if, for any tax year during a ten-year recognition period, X has a net recognized built-in gain, a corporate-level tax is imposed on the gain for that tax year. (Other section 1374 rules would apply as well). The recognition period begins on the first day of the first tax year for which the corporation operated as an S corporation, or Date 1 in this case.

According to X, the Contributed Assets had a built-in gain of $b. X structured the transaction with Y as a leveraged partnership to try to prevent gain recognition for ten years (and one day) thereby avoiding the section 1374 tax.[1]

The parties consummated the transaction on Date 2, less than prior to X's filing for Chapter 11 bankruptcy relief.

Formation of the Partnership

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[1] When X engaged in the transaction, it is likely X's goal was permanent income exclusion, by deferring recognition of gain until after the end of the recognition period. Post-bankruptcy, X will not continue to be an S corporation, and will in fact be a C corporation. Therefore, accepting X's characterization of the transaction would result in tax deferral of ten years subject to possible gain recognition as the Bank loan is amortized.

On Date 2, QSub-X, a qualified subchapter S subsidiary of X, and Sub-Y2, a subsidiary of Sub-Y1, formed the Partnership. Sub-Y1 is a wholly-owned subsidiary of Y.

QSub-X contributed the Contributed Assets, with a fair market value of $c in exchange for a d% partnership interest. Sub-Y2 contributed the Y Notes, with a fair market value of $e, plus $f in cash in exchange for an a% partnership interest.

The Partnership may not cause or allow the taxable sale of the Contributed Assets for ten years. X has the right to designate one member of a five member board of the Partnership subject to Y's approval. The X member is not required to be present for a quorum.

Y Notes

The Y Notes matured in Year 4. The Y Notes were newly issued at the time of the transaction. They have terms identical to and were issued under the same indenture as Y notes that were issued to the public in Year 1. The Y Notes are actually intercompany debt. The Y Notes were issued by Y and contributed down so that Y owes the Partnership $e.

The Credit Agreement states that the Partnership may not dispose of the Y Notes, except to the extent provided by Section of that Agreement. Section provides that the Partnership may not subordinate the Y Notes except to the extent that any proceeds are received and those proceeds are used to refinance the Y Notes or to invest in cash or cash equivalents. (Such cash proceeds would be subject to restrictions on disposition to the extent of outstanding debt).[2]

Similarly, Section of the LLC Agreement for the Partnership states that any distribution of the proceeds of the Y Notes "

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In an email dated Date 6, an attorney for Y expressed concern about the language of Section of the LLC Agreement. He wanted the Partnership to be able to distribute some of the cash from the proceeds of the Y Notes. An attorney for X responded, "

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[2] Likely referring to Section of the Credit Agreement, the Form 8-K on this transaction filed with the SEC explains,

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In a meeting with X and its representatives on Date 4, X stated that in Year 3, the Partnership refinanced the Y Notes for Y Notes due in Year 7 and Year 8.

Loan and Special Distribution

Also on Date 2, a subsidiary of the newly formed partnership, Sub-P, borrowed $e million from Bank. The Bank debt matured in Year 5. Sub-P used the funds to finance a special distribution to QSub-X in the amount of $g million ($h million plus $i million in prepaid rent for the use of Company facilities). The Partnership is required to maintain $e million of debt for k years, subject to an agreed amortization schedule. In the meeting with X and its representatives on Date 4, X stated that it has refinanced the loan until Year 6.

Collateral

According to an internal X memorandum on accounting for the transaction, dated Date 7, Bank has a perfected first priority security interest in collateral (Collateral) consisting of "i) all the assets of [the Partnership], ii) [Sub-Y1's] equity interest in the [Partnership], iii) the capital stock of [the Partnership's] subsidiaries, and iv) the [Y Notes]."

Guarantees and Indemnity

The Partnership, Sub-Y1, and Sub-Y2 guaranteed the Partnership's borrowing. The guarantees are guarantees of payment, which means that the lender has the right to seek payment from the guarantors of any unpaid, due amounts without having to exhaust other remedies first.

X indemnified Sub-Y1 and Sub-Y2 (together, the Y Affiliates) on their guarantees. The Y Affiliates may only proceed against X for amounts they actually have to pay on their guarantees. The Indemnity Agreement does not impose a net worth maintenance requirement or financial reporting obligations on X. Under GAAP, X disclosed the indemnity but did not record it as a liability or contingent liability.

The Indemnity Agreement provides that if called upon to reimburse one of the guarantors, X could obtain remaining rights in the Collateral (including the Y Notes) on a second priority basis. In the meeting with X and its representatives on Date 4, X's representative confirmed that X could obtain rights—subordinate to Bank's rights—to the Partnership assets.

Bank required an amortization schedule for the loan. The maximum principal amount that could be indemnified by X decreases by the amount of the required amortization on the debt. Moreover, the internal memorandum on accounting for this transaction from Date 7 stated:

Put and Call Options

Beginning on the tenth and ending on the thirteenth anniversary of closing, Sub-Y2 has a call option with respect to X's interest in the Partnership. Beginning after the thirteenth anniversary of closing, X has a put option with respect to that interest. The first of these rights is timed to coincide with the running of the ten-year recognition period and is exercisable at fair market value. Sub-Y2 also has a right of first refusal should X decide to sell its interest once it is permitted to do so.

X's Petition for Chapter 11 Bankruptcy Relief

X filed a petition for Chapter 11 bankruptcy on Date 3, just after executing the indemnity. The Bankruptcy Court entered an order confirming a plan of reorganization for X on Date 5. The plan of reorganization became effective on Date 8.

As stated in Article of X's plan of reorganization, the indemnity was to remain in full force and effect against the reorganized X.

X's Treatment of the Transaction

X reported the contribution of the Contributed Assets as a nontaxable contribution of property under section 721(a) and almost all of the special distribution as a nontaxable distribution of property under section 731(a)(1).[3] Under GAAP, X reported the transaction as a sale.

LAW AND ANALYSIS

1. The indemnity by X of the indebtedness of the Partnership should be disregarded pursuant to section 1.752-2(j).

Section 1.707-5(a)(2) provides that section 752 and the regulations thereunder apply in determining a partner's share of a partnership liability. A partner's share of recourse liability equals the portion of that liability, if any, for which the partner bears the economic risk of loss. Section 1.752-2(a). A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner would not be entitled to reimbursement from another partner. Section 1.752-2(b)(1).

[3] Only the amount that was attributed to rent prepayment ($I million) was taxed; the rest of the special distribution was treated as nontaxable under section 731.

For purposes of determining whether a partner is obligated to make a payment, contractual obligations such as guarantees are taken into account. Sections 1.752-2(b)(3)(i). Furthermore, for purposes of determining the extent to which a partner has a payment obligation and economic risk of loss, it is assumed that all partners who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Section 1.752-2(b)(6).

Section 1.752-2(j) provides additional guidance on circumstances that indicate a plan to circumvent or avoid the obligation. Under section 1.752-2(j)(1), an obligation of a partner to make a payment may be disregarded or treated as an obligation of another person if the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Section 1.752-2(j)(3) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances indicate a plan to circumvent or avoid the obligation.

If X's indemnity were respected, under the section 752 regulations, X probably would bear the economic risk of loss for the Partnership liability and be allocated the full amount of that liability. However, the facts strongly indicate that X's indemnity should be disregarded under section 1.752-2(j). It is appropriate to disregard an indemnity if the indemnity is nothing more than a ". . . guise to cloak" a partner "with an obligation for which it bore no actual economic risk of loss." Canal Corp. v. Comm'r, 135 T.C. 199, 213 (2010).

In Canal Corp., the Tax Court considered the application of section 1.752-2(j) to an indemnity agreement. WISCO, a wholly-owned subsidiary of Chesapeake (the predecessor of Canal Corporation) transferred assets worth $775 million to a new partnership (PRS) in exchange for a 5% partnership interest. Chesapeake wanted to sell a portion of its business but had a low basis in the assets. General Partner (GP) transferred property worth $376.4 million to PRS in exchange for a 95% partnership interest. GP had no interest in Chesapeake's tax deferral but was willing to "buy" at a lower "price" because of the deferral benefit. Subsequently PRS borrowed $755.2 million from a third party lender, all of which was immediately distributed to WISCO in a special distribution. GP served as the guarantor on the note and WISCO agreed to indemnify GP. Neither GP nor the third party lender required the indemnity.

The indemnity agreement was significant in several respects: (1) the indemnification only covered the principal of the debt; (2) it required GP to proceed against the assets of PRS before demanding indemnification; and (3) it provided that WISCO's interest in PRS would increase should WISCO make an indemnification payment. In addition, WISCO was not required to maintain a certain net worth (WISCO's net worth of $157 million represented approximately 21% of the indemnification exposure) and the economic risk of loss of Chesapeake was limited to WISCO's assets, the most valuable of which was an intercompany note that Chesapeake could cancel at any time. Importantly, GP knew that WISCO's assets were limited at the time of the transfers.

In its analysis, the Court considered the purpose of the indemnity agreement and whether WISCO had sufficient assets to cover the indemnity agreement. The Court found that the purpose of the agreement was to limit any potential liability of WISCO's assets. In so finding, the Court took into account the following facts, none of which were dispositive: (1) GP did not require the indemnification; (2) the indemnification did not require WISCO to maintain a certain net worth; (3) WISCO provided the indemnification purposely to achieve tax deferral; (4) the indemnification only covered the principal of the loan; and (5) WISCO stood to receive an increased interest in PRS if required to make indemnification payments. The Court found that WISCO's agreement to indemnify GP lacked economic substance and provided GP no real protection because WISCO's primary asset was an intercompany note that could be cancelled at any time and the indemnity did not require WISCO to retain this note or any other asset (i.e., WISCO was severely undercapitalized vis-à-vis the indemnification exposure). X's indemnity has several similarities with the indemnity that the Tax Court disregarded in Canal Corp. As in Canal Corp., the lenders imposed no net worth maintenance requirement on X. The lack of such a requirement provided X and WISCO an exit strategy. In both cases, neither the lender nor the guarantors required the indemnity. Both X and Chesapeake insisted on the obligations as a prerequisite to the transaction. In Canal Corp., the indemnitor stood to receive an increased interest in the partnership if required to make indemnification payments; in this case, X stands to receive the remaining Collateral if required to make indemnification payments.

One difference is that in Canal Corp., WISCO, an undercapitalized subsidiary of Chesapeake, provided the indemnity whereas in this case, X, the parent corporation, provided the indemnity. However, this difference may be insignificant. Due to the absence of a net worth maintenance requirement and financial reporting obligations imposed on X, X may be able to either sell off assets and make distributions to shareholders or move assets to related entities in order to insulate its assets from its obligation before receiving claims under its indemnity. X may argue that local law prohibiting such transfers in derogation of a creditor's rights, such as fraudulent conveyance laws, restrict its ability to insulate its assets. The absence of net worth maintenance requirements, etc. suggest, however, that the creditor is not concerned about X doing so, and in any case, as the court in Canal Corp. noted, the possibility of creditor causes of action for fraudulent conveyances may be too speculative to take into account in conducting a section 752 analysis. Id. at 216.

There are three compelling arguments for applying section 1.752-2(j) to disregard the indemnity. These arguments are not mutually-exclusive.

First, the indemnity lacks important features typical of an indemnity in a commercially-driven transaction. A typical indemnity expressly includes features such as net worth maintenance requirements, an arms-length fee, an obligation to provide annual financial statements, and evidence that the parties engaged in genuine negotiations over the indemnity. The lack of such features in this case suggests a lack of concern on the part of the lenders and guarantors over X's ability to pay on the indemnity. It also allows X to strategically sell off assets and make distributions to shareholders or shift assets to related entities in order to insulate its assets if X expects the indemnity to be enforced. At the meeting on Date 4, X stated that it did not have plans to sell significant assets. However, reports just later contradict these statements. The reports indicate that X is preparing to sell assets.[4]

Second, the indemnity is specious because there is no practical or commercial risk of it being enforced. As mentioned previously, the Partnership assets include the Y Notes. The Y Notes are also serving as Collateral on the loan. Due to the Y Notes, Y owes the Partnership $e.

In substance, the Y Affiliates are guaranteeing Y's own debt. The reason for this is that if Y cannot pay on the Y Notes, then it follows that neither Y Affiliate will be able to pay on its guaranty. This is because Y and its affiliates are all part of a single economic unit.[5]

If neither of the Y Affiliates is able to pay on its guaranty, then X will not have to pay on its indemnity. This is because X's indemnity to the Y Affiliates is only for payments actually made on their guarantees. If the Y Affiliates default on their guarantees, then X has no obligation under its indemnity even if Bank has yet to be repaid. X has no obligation to Bank under its indemnity.

Third, Y merely used the Partnership as a conduit to borrow $e million from Bank in order to accommodate X's structure. The Y Notes and Bank loan are similar to back-to-back loans. The principal amounts of the Y Notes and Bank loan were equal. The Y Notes were issued and contributed at the same time that the Partnership took out the loan. The maturity date of the Y Notes was Year 4, while the maturity date of the loan was Year 5.

X's own internal memo on accounting for the transaction states, " ." This arrangement is another indication that X planned to avoid any realistic possibility that it would have to make any payment on its indemnity, and, as discussed below, that the Bank debt is not even "partnership debt" to be allocated for tax basis purposes among the partners. The Date 6 email exchange between attorneys for X and Y reinforces this notion. It demonstrates that X intended, and acted, to ensure that the Partnership maintained sufficient

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4 , available at .

5 Y has no operations outside of Sub-Y1.

collateral (the Y Notes or the proceeds thereof) to repay the Bank without exposing X to meaningful liability on the indemnity.

Indeed, the motivation for the debt-financed distribution exception to the disguised sale rules is absent in this case. The Conference Committee Report on section 707(a)(2)(B) describes a set of facts that Congress intended to exempt from disguised sale treatment: the case in which a partner contributes property to a partnership, the partnership borrows against that property, the proceeds of the loan are distributed to the contributing partner, and the contributing partner retains liability for the repayment of the borrowed amounts.[6] Congress intended equivalent treatment for such a situation and a situation where a partner borrows against the property outside of the partnership and contributes the encumbered property to a partnership.

We believe that Congress assumed in the example in the legislative history that the partner would economically bear the liability, and that the debt was economically a partnership level debt. That is not the case here. Here, X neither borrowed against the Contributed Assets before they were contributed to the Partnership nor afterward. The Contributed Assets are not the property that was borrowed against. Instead, the Y Notes that Y contributed to the Partnership were borrowed against. Moreover, normally in a leveraged partnership that is effective for tax purposes, the cash flow of the business is used to service the debt, while in this case, the debt is being serviced by the partner, Y, through back-to-back loans. In short, it is Y, not X, that is exposed to the economic burden of the liability on the debt.

Although we have identified what we believe are persuasive arguments for disregarding the indemnity under section 1.752-2(j), we expect X to make at least three arguments in response.

First, we anticipate that X will argue that the survival of the indemnity post-bankruptcy combined with X's anticipated net worth of $j upon emerging from bankruptcy demonstrate that X, in contrast to the undercapitalized WISCO, has the ability to pay on its indemnity.

However, we believe this argument is a red herring. Unlike in Canal Corp., the indemnitor's ability to pay is not relevant in this case. As explained above, X has carefully structured the transaction to eliminate any commercial or practical risk that its indemnity will be called. In addition, as explained above, this transaction should be

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[6] "The conferees wish to note that when a partner of a partnership contributes property to a partnership and that property is borrowed against, pledged as Collateral for a loan or otherwise refinanced and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provisions to the extent the contributing partner, in substance retains liability for repayment of the borrowed amounts (i.e., to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership." H.R. CONF. REP. NO. 98-861, at 862 (1984) (Emphasis added).

viewed as Y using the Partnership as a conduit to borrow from the Bank. The Partnership must hold Y Notes or the proceeds thereof at least equal to its own borrowings. These circumstances were not present in Canal Corp.

Second, we expect X to argue it faces some practical risk on its indemnity due to the Partnership's purported refinancing risk. According to X's representative, the Partnership is required by the transaction documents to reinvest the proceeds of the Y Notes in other Y Notes. As a result, according to X's representative, in the event that X had been unable to refinance the Year 5 Bank loan, the cash proceeds of the Year 4 Y Notes would not have been available for repayment of the Bank loan in Year 5. Therefore, the Partnership would have defaulted.

However, we do not agree that the transaction documents *require* the Partnership to refinance the Y Notes at all. Instead, refinancing of the Y Notes appears to be one of several permitted actions the Partnership can take with respect to the Y Notes. Furthermore, this argument minimizes the role of Bank. The Loan Agreement contains restrictions on what the Partnership may do with the Y Notes and the proceeds thereof. If the Y Notes were not refinanced, in Year 4, the Partnership would have had $e in cash from the proceeds of the Y Notes to fully repay Bank in Year 5 when the Bank debt matured. If the Y Notes were refinanced, then Bank would need to approve of the terms of the refinancing. Bank would have been unlikely to approve the refinancing of the Y Notes if it believed there was a refinancing risk on its own loan. Therefore we do not see any real "refinancing risk" in this case.

Third, X will likely argue that because the Y Affiliates' guarantees are guarantees of payment and not of collection, it means that Bank can and will seek payment on the guarantees as a first step in the event of a Partnership default before taking possession of the Collateral—thus triggering X's indemnity obligation. X will further argue that the Y Affiliates actually have an incentive to repay the Bank debt through their guarantees since those payments are reimbursable by X.

However, these arguments overlook the fact that the Partnership would not default unless Y defaults on the Y Notes. In that case, neither of the Y Affiliates would be able to pay on its guaranty, and X's indemnity obligation would not be triggered. Furthermore, even if the Partnership somehow did default without a default by Y on the Y Notes, Bank likely would take possession of the Collateral, including the Y Notes, before bothering to seek payment from the guarantors. Taking possession of the Collateral would be convenient for Bank because it would not have to resort to judicial action. In addition, it is not true that the Y Affiliates have an incentive to pay on their guarantees. X stands to acquire the remaining Y Notes in the event payments are required on its indemnity. The Y Affiliates would end up in the same place whether 1) they pay on their guarantees (in which case X would reimburse them and stand to acquire the remaining Y Notes) or 2) Bank takes possession of the Y Notes directly. In either situation, the Y Affiliates would be out the Y Notes at the end of the day.

If Y defaults on the Y Notes, neither of the Y Affiliates will be able to pay on its guaranty, therefore X faces no practical or commercial risk on its indemnity.

For the many reasons stated above, the facts and circumstances indicate a plan by X to circumvent or avoid its indemnity, and thus, its indemnity should be disregarded under section 1.752-2(j).

2. Because the indemnity is disregarded, the related contribution and distribution will be treated as a disguised sale under section 707(a)(2)(B).

Sections 721 and 731 generally provide for nonrecognition treatment of contributions to, and distributions from, respectively, a partnership. However, nonrecognition treatment does not apply in the case of a disguised sale.

Under section 707(a)(2)(B), if a partner transfers property to a partnership and receives a related transfer of money, the transfers may be treated as a sale. Section 1.707-3(a)(1). Such transfers constitute a sale only if based on all the facts and circumstances, (i) the transfer of money would not have been made but for the transfer of property; and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. Section 1.707-3(b)(1).

However, transfers that occur within a two-year period 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 1.707-3(c)(1). Section 1.707-5(b)(1) provides that 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 are allocable to a transfer of money to the partner made within 90 days of incurring the liability, the transfer of money is taken into account only to the extent that the amount of money transferred exceeds that partner's allocable share of the partnership liability.

In the present case, X's transfer of the Contributed Assets (treated by the parties as worth approximately $c) to the Partnership and its receipt of an $h distribution within a two-year period meets the literal definition of a disguised sale under section 707(a)(2)(B) and section 1.707-3(c)(1). However, the parties purposefully designed the transaction to fall within the debt-financed distribution exception in section 1.707-5(b)(1). X's indemnity is an obligation for purposes of section 1.752-2(b)(3)(i), and, if respected, would result in allocating the entire amount of the liability under section 1.752-2(b)(1) to X. Accordingly, if the transaction is respected, X would qualify for non-recognition treatment under section 731 for almost all of the distribution.

However, if the Service disregards X's indemnity based on the anti-abuse provisions in section 1.752-2(j), the Service would not consider X as the partner who bears the economic risk of loss for the underlying debt for purposes of section 1.752-2(b)(1) and X's basis would not reflect the allocation of that liability. None of the facts indicate that

X could rebut the two-year presumption in section 1.707-3(b)(1). Therefore, the disguised sale provisions would apply. As a result, all or a portion of X's distribution would be taxable under section 731 because the distribution would exceed its basis in the partnership.

3. Alternatively, the transaction should be recast under section 1.701-2(b).

Under the partnership anti-abuse rule in section 1.701-2(b), the IRS can recast part, or all, of a transaction where a partnership is used or availed of with a principal purpose of reducing the partners' federal tax liability in a manner that is inconsistent with the intent of subchapter K. Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity level tax. Implicit in this intent are three requirements: 1) the partnership must be bona fide and used for a substantial business purpose; 2) the transaction must be respected under a substance over form analysis; and 3) the resulting tax consequences must clearly reflect income (or else the distortion must be clearly contemplated by the applicable provision). Section 1.701-2(a). Whether there is a principal purpose of reducing the partners' federal tax liability is determined under all facts and circumstances. Section 1.701-2(c).

Several aspects of the transaction are unusual and were designed for tax rather than business purposes. The absence of common features of a commercial indemnity, and the potential unwinding of the transaction after the end of the section 1374 recognition period indicate that this transaction was entered into with the principal purpose of reducing a partners' federal tax liability. The contribution of the Y Notes with a value equal to the amount of the Bank debt compel us to conclude that the Bank debt was not "partnership debt" for purposes of section 752. The Bank debt is, in substance, the obligation of Y, and the Partnership is a mere conduit through which the debt service flows. The unusual fact that the Bank loan is secured by Sub-Y1's equity interests in the Partnership but not by X's partnership interest buttresses the argument that the Bank debt is, in substance, Y's debt. In addition, as explained previously, X's indemnity is specious.

X does not have a substantial business purpose in forming the Partnership. The partnership form was adopted primarily as a way to avoid or defer a significant tax liability.

In substance, this transaction is a sale of a% of the Contributed Assets on a tax-free basis. X monetized its equity in the Contributed Assets while transferring a% of the benefits and burdens of those Assets to Y. The memo on accounting for the transaction makes a determination that the incidents of ownership have in substance been transferred to the "buyer." X's treatment of the transaction as a sale under GAAP is consistent with this view.

X's treatment of this transaction for tax purposes as a contribution and distribution do not clearly reflect income and the distortion is not clearly contemplated by the applicable provisions. The section 707 and 752 regulations (especially the debt-financed distribution exception) do not clearly contemplate nonrecognition treatment for a distribution from a partnership to a partner who has a payment obligation that lacks substance or in situations in which notes contributed by the other partner are providing liquidity for repayment of the debt. As mentioned above, we read the legislative history of the disguised sale rules to support sale treatment in this case.

We recommend that the transaction be recast under section 1.701-2 as Y borrowing from Bank to purchase a% of the Contributed Assets followed by the formation of a partnership.

4. Alternatively, the form of the transaction (contribution) should be disregarded and treated in accordance with the underlying substance (sale).

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 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. Nor is the parties' desire to achieve a particular tax result necessarily relevant.

See also, e.g., Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) ("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"); 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. Twenty Mile Joint Venture, PND, Ltd. v. Commissioner, 200 F.3d 1268 (10th Cir. 1999), aff'g in part and appeal dismissed in part, T.C. Memo. 1996-283. Thus, there is ample precedent applying the substance over form doctrine to partnership transactions. See, e.g., Coven v. Commissioner, 66 T.C. 295, 305 (1976), acq. 1976-2 C.B. 1; Miller v. U.S., 181 Ct. Cl. 331, 337-341 (1967) (both involving a substance over form analysis to determine whether a partner has, in substance, sold a partnership interest or received a liquidating distribution).

Cases involving the issue of substance over form are inherently factual, and the reluctance of some courts to look beyond the form of the transaction prompted Congress to add section 707(a)(2)(B). See, Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793, 813-14 (1988). The circumstances that motivated Congress to act should not be interpreted as a deficiency with the doctrine. There is precedent for the application of the doctrine to transactions that were structured as contributions and distributions, but were more appropriately treated as sales. See, id.; Jacobson v. Commissioner, 96 T.C. 577, 587-88 (1991), aff'd, 963 F.2d 218 (8th Cir. 1992).

X has effectively parted with a% of the benefits and burdens of the Contributed Assets while receiving cash equal to the value of a% of the Contributed Assets. The restriction on the Partnership from transferring its assets prior to the end of the recognition period and the put and call options are features that allowed the parties to achieve the tax benefit associated with a non-sale and immediately thereafter create the effects of a sale.

We recommend that the form of this transaction be ignored and that the transaction be treated as a sale of a% of the Contributed Assets under the judicial doctrine of substance over form.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

To the extent time permits, we recommend [redacted].

From X, we recommend [redacted]. More generally, we recommend [redacted]. Finally, we recommend [redacted].

From Bank, we recommend [redacted].

From the Partnership, we recommend [redacted]

From Y, we recommend [redacted].

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.