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The M&A Tax Report

February 2013 Volume 22, Number 7

The Monthly Review of Taxes, Trends & Techniques

Disguised Sales Revealed and Obscured

By Jonathan Van Loo • Wood LLP • San Francisco

Tax-free is occasionally bad, but only rarely. Like most things that are free, tax-free is usually good. In the M&A context, tax-free is especially good. Qualifying a transaction as tax-free is the primary tax goal in a myriad of corporate and M&A transactions.

With the increasing prevalence of LLCs, check-the-box tax planning, publicly traded partnerships and other passthroughs, however, the tax-free corporate reorganization rules can seem downright anachronistic. These days, one of the ways to achieve tax-free goals is through joint ventures and partnership transactions. This has the potential to avoid the difficulties of qualifying a transaction for tax-free treatment under the challenging and sometimes byzantine rules of Internal Revenue Code Section ("Code Sec.") transactions, much less the spin-off rules of Code Sec. 355.

For example, an exchange of voting stock of an acquiring corporation for control of the target corporation can potentially qualify for tax-free treatment under Code Sec. 368(a)(1)(B). However, a B reorganization is easily busted through the use of nonvoting preferred stock or a mere peppercorn of boot. Spin-offs are notoriously challenging to qualify as tax-free given the business purpose and other requirements, and the possible "device" taint. Qualifying a transfer of property to a corporation as tax-free under Code Sec. 351 tends to be easier.

The use of nonvoting stock is permissible in a Code Sec. 351 incorporation, and boot will not bust the transaction. Nonqualified preferred stock is treated as boot, but it is far easier to plan around nonqualified preferred stock than the restriction against any boot in a B reorganization. Moreover, a Code Sec. 351 transaction does not have the same continuity of business enterprise and continuity of interest requirements as a Code Sec. 368 reorganization.

Nevertheless, even Code Sec. 351 has its challenges. To qualify as a good tax-free incorporation, the transferors of property to the corporation must have 80-percent control of that corporation immediately after the

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transfer. This "immediately after" requirement may be violated if stock changes hands after the transfer. Perhaps the most famous example is *Intermountain Lumber Co.* [65 TC 1025, Dec. 33,670 (1976).] In that case, the owner of a sawmill sought financing from a new investor after a fire.

In exchange for the financing, the new owner demanded an equal share of stock of the new corporation. They entered into a stock purchase agreement for the old sawmill owner to sell 50 percent of the stock of the new corporation to the new investor. The old sawmill owner contributed the old site to the new corporation and promptly sold 50 percent of the stock to the new investor. The Tax Court ruled that this stock purchase agreement busted the tax-free Code Sec. 351 transaction.

The Tax Court explained that the old sawmill owner was obligated to sell his stock to the new investor at the time of the formation of the new corporation. Therefore, he was not in control of the new corporation "immediately after" its formation as required for a valid Code Sec. 351 transaction. Interestingly, in this context, the traditional roles of the IRS and taxpayer were reversed because the taxpayer was arguing in favor of a taxable transaction.

The taxpayer sought a stepped-up basis in the assets, which would only occur if the transaction busted Code Sec. 351. In spite of this case, Code Sec. 351 remains quite flexible. For example, in an "accommodation transfer," even the transfer of property to an existing corporation can qualify for tax-free treatment. To qualify for Code Sec. 351, existing shareholders can be included in the control group as long as they transfer property worth at least 10 percent of the value of their existing stock. [*See* Revenue Procedure 77-37, 1977-2 CB 568, 570.]

When Code Sec. 351 fails to achieve tax deferral, partnership and joint venture structures can sometimes provide an alternative. However, as a series of cases has demonstrated, the partnership rules can be perilous in their own right.

Disguised Sale Partnership Rules

Normally, a transfer of property by a partner to a partnership in exchange for a partnership interest is a tax-free event. Distributions are tax-free to the extent of the partner's basis in his partnership interest. For structuring a tax-free reorganization, one party contributes the business assets while another provides cash or financing.

Better still, a partner increases his basis in his partnership interest to the extent that partnership liabilities are allocated to a partner under Code Sec. 752. The theory is that each partner in a partnership should bear the economic burden of debt incurred by the partnership. This makes it possible for taxpayers to use partnerships to receive tax-free leveraged distributions, even if the debt is nonrecourse to the partners. This is generally not possible with an S Corporation. The allocation of liabilities under Code Sec. 752 is one of the major advantages of using a partnership as opposed to an S Corporation.

Nonetheless, partnerships have their own perils. A contribution of property to a

The M&A Tax Report
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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

partnership followed by a distribution can trigger a deemed sale of the property. The IRS has won several notable, recent, highly publicized victories in claiming that partnership transactions triggered the disguised sale rules of Code Sec. 707.

Under Code Sec. 707(a)(2)(B), a transfer of property by a partner to a partnership, followed by a distribution by the partnership to the partner, may be integrated and treated as a disguised sale. Worse still, under the regulations, a distribution to a partner made within two years of the contribution of property is presumed to be a sale unless the facts and circumstances clearly establish the transfer was not a sale. [*See* Reg. §1.707-3(c)(1).]

Recent Disguised Sale Cases

In one recent case, the IRS lost in Tax Court but won its argument in the Fourth Circuit that investors in a tax credit partnership actually purchased the tax credits. [*Va. Historic Tax Credit Fund 2001*, CA-4, 2011-1 USTC ¶50,308, 639 F3d 129.] The Fourth Circuit concluded that Virginia historic rehabilitation tax credits had enough of the essential "bundle of rights" to constitute property for tax purposes. Investors were not merely allocated tax credits pursuant to the terms of a partnership agreement. Instead, the investors effectively acquired the right to the state tax credits.

The investors acted more like purchasers than partners. Thus, the Fourth Circuit held that the allocation of state tax credits to investors in exchange for their cash contributions amounted to a sale or exchange of the state tax credits. The Fourth Circuit determined that the investors did not face enough of an entrepreneurial risk for the transaction to be treated as a partnership transaction.

The tax credits were too certain, and the benefit too assured for the transaction to qualify as an assumption of equity-like risk by a partner in a partnership. It seemed to be particularly damaging that the investment fund would not invest in a project unless it had already received state certification that the project would qualify for the state tax credit. It was also damaging that the investors had essentially no material interest in the *income* from the projects.

In another case, the Tax Court held that a leveraged partnership transaction resulted in a disguised sale of business assets contributed by one of the partners. [*Canal Corp.*, 135 TC 199, Dec. 58,298 (2010).] *Canal Corp.* involved the disguised sale rules but ultimately hinged on the debt allocation rules under Code Sec. 752. The court seemed to conclude that the transaction was simply too good to be true. The contributor wound up with cash virtually equal to the value of its property and a limited risk of being liable for the debt encumbering that property.

The contributor (the seller) contributed business assets with substantial built-in gain to a partnership. After the other partner (the buyer) also contributed assets, the partnership borrowed against the property and distributed the cash to the selling partner. The buyer relied on an exception to the disguised sale rules.

When a partner contributes property and the partnership borrows against the property, then a distribution to the contributing partner that was funded by the debt will not necessarily trigger a disguised sale. The key requirement is that the debt incurred by the partnership must be allocated to the contributing partner under the Code Sec. 752 debt allocation rules. Code Sec. 752 allocates recourse partnership debt in accordance with the "economic risk of loss."

The logic behind this exception to the disguised sale rules seems clear. If the debt is incurred in relation to property contributed by the partner, the distribution of the debt should not be taxable because the partner could simply incur the same amount of debt when it held the property directly. However, the exception should only apply to the extent the debt is allocated to the contributing partner. That is, if the contributing partner bears the economic risk of loss for the debt, and the debt can be traced to the contributed property, then the distribution of the loan proceeds should not be treated as a disguised sale.

In *Canal Corp.*, the court refused to accept that the debt should be allocated to the original contributor. The court seemed to be particularly disturbed by what it viewed to be elaborate structuring as well as an exorbitant fee (a fixed fee of $800,000) for a tax opinion. It believed the opinion to be suspect because it was authored by the same tax lawyer who structured the transaction. But the deciding factor seemed to be that the court considered the contributor not to have a real, substantive economic risk of loss on the underlying partnership loan.

In fact, the contributor's exposure was limited to an indemnity provided to the guarantor of the debt. The partnership borrowed approximately $755 million, and the partnership debt was guaranteed by the *other* partner. The contributing partner then agreed to indemnify the other partner for the guarantee.

However, the indemnification was limited to the loan principal and did not include the interest. That principal amount was due in 30 years. Moreover, the contributing partner was a subsidiary with a net worth of approximately $150 million, or 20 percent of the principal amount.

Because the contributor limited its economic exposure to 20 percent of the principal amount, the Tax Court held that the debt should not be allocated to the contributor under the Code Sec. 752 anti-abuse rules. This appears to establish a high bar for the debt allocation rules and creates uncertainty for practitioners. In any case, it was certainly a notable victory for the government in applying the disguised sale rules.

In *G-1 Holdings, Inc.* [DC-NJ, 2010-1 USTC ¶50,332 (2009)], the government achieved yet another significant victory in applying the disguised sale rules. The facts of this case were similar to those of *Canal Corp.* in that two parties contributed business assets to a new partnership. Soon after the formation of the partnership, one contributor (the seller) received cash nearly equal to the value of its property that was funded by a loan.

In contrast to *Canal Corp.,* this partnership did not incur the debt. Instead, the contributor-partner assigned its partnership interest to a trust. The trust then pledged the partnership interest as collateral for a loan and distributed the loan proceeds to the contributor-partner.

The loan was nonrecourse, and the monthly loan payments were funded by a priority return that was paid by the partnership. The general partner of the partnership guaranteed the payment of the priority return regardless of the partnership's profit or loss. One of the more damaging aspects of this case for the taxpayer was that the parties appeared to agree to an asset sale rather than a joint venture as a commercial matter.

This certainly made it easier for the court to find a disguised sale. Of course, the taxpayer did not receive an actual distribution from the partnership. However, the government pointed to the legislative history holding that the disguised sale rules should extend to loans when responsibility for repayment rests directly or indirectly with the partnership.

In this case, the loan was nonrecourse, and the repayment of the loan was funded by the partnership interest. In the end, the distributions from the contributor-seller effectively bore no liability for the loan and walked away with the cash.

The disguised sale rules have also been implicated in tax shelters. In *Buyuk LLC* [106 TCM 502, Dec. 59,683(M), TC Memo. 2013-253], BDO Seidman promoted a distressed debt tax shelter with the assistance of a group of hedge fund entities that specialized in emerging markets debt. The tax shelter partnership acquired receivables with a high basis from a Russian utility following the devaluation of the Russian Ruble. The Seventh Circuit upheld the Tax Court in imposing steep 40-percent gross valuation misstatement penalties in *Superior Trading, LLC.* [CA-7, 2013-2 USTC ¶50,499, 728 F3d 676.] *Superior Trading* involved past-due Brazilian consumer receivables.

Conclusion

Partnerships provide indispensable tools for structuring corporate transactions. They are flexible and may allow the parties to structure a tax-free transaction. Nevertheless, several recent cases demonstrate that courts have limited patience when faced with what they view as financial engineering to achieve tax-free treatment for an ordinary asset sale.

When the contributing partner walks away with cash and little to no liability for debt, the case is ripe for the disguised sale rules. Interestingly, in *Canal Corp.,* a carefully orchestrated transaction failed even though the purported seller remained liable for up to 20 percent of the "sale" price. That seems to set a high bar. In *G-1 Holdings*, the court applied the disguised sale rules even when the partnership did not actually make a distribution.

In all of these cases, courts have shown a willingness to accept government arguments to look beyond the individual steps of the transaction and instead focus on the end result. Although they are applying Code Sec. 707, step-transaction principles appear to play an important role. A key element running through these cases is that the purported sellers do not have a material risk of loss. Nor do they participate in the upside of the partnership. Tax advisers have a high barrier to surmount when faced with a taxpayer who wants to get cashed out of a newly formed partnership.

What *Diebold Foundation* Means For Transferee Liability Cases

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In *Dodging the Boomerang Tax Problems of Intermediary Transactions*, I reported on Midco transactions wending their way through the courts. [21 THE M&A TAX REPORT 2 (2012).] These cases are distressing for taxpayers, since, by definition, a transferee liability case involves the IRS pursuing one person for *someone else's* taxes. The cases are distressing for the government too, since frequently the government loses.

There are several hurdles to collecting money from a third party. Taxpayers like the fact that the courts have often been hard for the IRS to convince in those cases. One particular type of transferee liability case involves so-called Midco transactions. In one sense, they are simple M&A deals.

In another sense, they are tax shelters. These Midco transactions were long ago listed and disfavored. Nevertheless, the large number of deals that were consummated in their heyday left extant tax liabilities. That means transferee liability.

Midco in the Middle

Shareholders owning stock in a C corporation that holds appreciated property have a dilemma if they want or need to sell. In an asset sale, the shareholders cause the company to sell the appreciated property, which triggers a tax on the built-in gain. The company then distributes the remaining proceeds to the shareholders.

In a stock sale, of course, the shareholders sell the stock to a third party. The corporation continues to own the appreciated assets, and a built-in gain tax is not triggered. Buyers generally prefer to purchase assets and receive a new purchase price basis, thus eliminating the built-in gain. Sellers do not want to sell assets because of the built-in tax liability.

Midco transactions involve a seller making a stock sale, and a buyer making an asset purchase. The shareholders sell their appreciated C corporation stock to an intermediary Midco entity. The intermediary sells the assets to the buyer, who gets a purchase price basis in the assets.

The intermediary gives the buyer and seller what they want because it has tax losses or credits it uses to absorb the inherent tax liabilities it acquires. The IRS has long ago successfully attacked such transactions in Notice 2001-16, 2001-1 CB 730. It has pursued the promoters and participants in the deals wherever it can.

Bad Actors?

In many cases, the party that both the government and taxpayers want to attack is the intermediary. In some cases, the intermediary can fairly be called a promoter. One case I covered in my prior article was *D.R. Diebold*. [100 TCM 370, Dec. 58,374(M), TC Memo. 2010-238 (2010), vacated by, remanded by *Diebold Found., Inc.*, CA-2, 736 F3d 172, 2013 US App. LEXIS 22964 (2013).] There, the Tax Court held that the IRS failed to make its transferee liability case.

The government appealed to the Second Circuit, which vacated the Tax Court decision. What's more, the appeals court remanded the case to the Tax Court to decide the remaining transferee liability issues. It goes without saying that the government is happy with this outcome. Taxpayers inside and outside the realm of Midco transactions should pay attention.