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Passthrough and Joint Venture Tax Planning

By Jonathan Van Loo • Wood LLP • San Francisco

It seems nearly a generation ago that M&A practitioners worried only about corporations, usually C corporations at that. The tax law seemed to make sense then, with terminology and techniques that, if not easy, at least were practiced. There were the corporate reorganization rules, with their alphabet soup of offerings.

There were also taxable stock and assets deals, and in 1982, Congress enacted Internal Revenue Code Section ("Code Sec.") 338. That shiny new provision would make it a snap to elect asset purchase treatment even if you bought stock. What a simple and streamlined thing that would be, obviating the old "buy and liquidate within two years" rule of Code Sec. 334(b)(2). Of course, we all know how simple Code Sec. 338 turned out to be, but still, it was a grand design.

The sea change of *General Utilities* repeal in 1986 meant that tax and corporate lawyers had to retool if not downright redefine themselves. Passthrough entities became fashionable beyond the realm of real estate. Meanwhile, S corporations too were more attractive, but also became more complicated. And not too many years later, the advent of LLCs would reshape the choice of entity debate and the whole check-the-box concept would be born.

These days, merely knowing something about corporate acquisitions and reorganizations may not qualify you for a seat at the table. You'll need at least passing familiarity with the passthrough rules in nearly every kind of deal. And learning about them and keeping up with developments can be daunting. This is all the more true in light of the astonishing variety of passthrough tax entities, each with *its* own set of rules: S corporations, REITs, RICs, REMICs, publicly traded partnerships and disregarded entities (which are *almost* always disregarded).

The annual Practicing Law Institute (PLI) conference on tax planning for partnerships and joint ventures provides an excellent way to get up to speed on partnership developments. PLI sponsored

the 2012 Conference for Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances in San Francisco. It was co-chaired by Louis Freeman and Clifford Warren. It is held every year in San Francisco, New York and Chicago and is broadcast nationwide. It should soon be available as a CD-ROM.

Structuring Investment Funds for Sponsors and Outside Investors

Some of the familiar topics covered in previous conferences were reprised. Partnership formation, noncompensatory partnership options and the disguised sale rules were addressed. Plus, this conference included several new panels.

One was a panel on "top-side planning" by private equity and hedge funds, presented by Eric Sloan of Deloitte Tax LLP and Lew Steinberg of Credit Suisse Securities (U.S.A.) LLC. The focus was on changes in private equity fund and hedge fund structures based on the tax attributes and tax preferences of major fund investors.

Fund investors consist of five major categories: tax-exempt U.S. investors, taxable U.S. investors, "super" tax-exempt U.S. investors, sovereign investors and taxable non-U.S. investors. The most important outside sources of capital are the "super" tax-exempt U.S. investors and sovereign investors. There is a who's-who that controls what each investor wants.

The "super" tax-exempt investors are public pension funds claiming an exemption from U.S. federal income tax under Code Sec. 115. The super tax-exempts are not subject to "unrelated business taxable income" (UBTI) under Code Sec. 511 because their tax-exempt status does not derive from Code Sec. 501(c).

However, query whether income that would otherwise be treated as UBTI would qualify for the exemption under Code Sec. 115 as income derived from an "essential government function." In any case, the super tax-exempts are also generally exempt from the annual reporting requirements that apply to exempt organizations. [*See* Reg. §1.6033-2(g)(v).] Then there are sovereign investors.

Under Code Sec. 892, sovereign investors also enjoy a broad exemption from U.S. tax. That includes most notably dividend withholding tax and gain from the sale of a domestic corporation that is a "United States real property holding corporation" under Code Sec. 897. [*See* Example 1 of Temporary Reg. §1.892-3T; Notice 2007-55, 2007-2 CB 13.] However, Code Sec. 892 investors can lose their special tax-exempt status if they earn even a single peppercorn of income from "commercial activities."

It doesn't matter if the "commercial activities" income is earned from foreign sources. The investor loses its tax-exempt status even if it earns its income from non-U.S. sources. Under proposed regulations, the IRS has created safe harbors from the "all-or-nothing" commercial activities rules for sovereign investors.

In certain circumstances, investors may conduct commercial activities inadvertently or through a limited partnership interest while *still* retaining their status as good Code Sec. 892 investors. These new safe harbors

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provide a significantly more forgiving framework. Code Sec. 892 investors were previously subject to potential penalties for inadvertent compliance failures.

Sponsors Count

The most important group of taxable U.S. investors consists of the fund sponsors (the individual fund managers who have a carried interest in the fund). Rounding out the group of investors are taxable non-U.S. investors such as investment funds and foreign corporations as well as tax-exempt institutional investors such as private foundations and university endowments. Another important consideration when dealing with U.S. pension fund and retirement account investors is to avoid subjecting the investment fund to the "plan asset" rules under ERISA, which would impose fiduciary duties on the investment fund managers.

Juggling the demands of this disparate group of investors in an investment fund can lead to complex structures with "feeder funds." Separate feeder funds may be set up to accommodate each group's different tax issues. For example, tax-exempt U.S. investors normally do not like to make a direct investment if there is any leverage, because debt-financed investment income is subject to tax as UBTI.

However, debt-financed income from real estate is exempt from UBTI, provided the investment fund complies with the notoriously complex "fractions rule." To avoid the complexities of the "fractions rule," another option is to take advantage of an entirely different passthrough tax regime and structure the real estate investment through a REIT. The use of a passthrough also raises the specter of the "plan asset" rules, which may require an ERISA expert to provide an opinion that the investment fund qualifies as a VCOC or an REOC.

In contrast to tax-exempt investors, taxable non-U.S. investors like debt. After all, U.S.-source interest is generally exempt from U.S. withholding tax as "portfolio interest." In contrast, dividends are subject to 30-percent withholding unless reduced by treaty.

Direct and Blocker Vehicles

The choice of making a direct investment through a partnership or using a corporate blocker is not always available. Suppose the portfolio investment is a large public U.S. corporation or a business that is a C corporation with a lot of built-in gain. There typically is no realistic possibility of structuring the investment as direct ownership because an asset sale would trigger a huge tax liability.

If the target investment takes the form of a separate business division or an S corporation, then the investment fund will have more flexibility. The sponsors of the investment fund typically want to take advantage of lower rates for long-term capital gain and (less frequently) qualified dividend income. Gain from the sale of stock is only subject to tax at a rate of 15 percent.

However, this generally comes at the expense of the target being subject to two layers of tax. One faces the corporate-level tax, and then a second tax at the shareholder level. If a taxable U.S. investor owns the business and assets directly, it is likely to be allocated ordinary operating income.

This often gives rise to phantom income that is ordinary and not taxed at the preferential capital gains rate. Of course, direct ownership has the advantage of allowing the buyer of the business to get a step-up in basis in the business assets without any additional tax cost. For all the advantages of passthrough treatment for the sponsors, there are costs for many other classes of investors.

Tax-exempt U.S. investors may be subject to tax on allocations of operating income as UBTI, and gain on exit may be subject to tax as debt-financed income. Non-U.S. taxable investors would be subject to tax on allocations of operating income as "effectively connected income" (and foreign corporations would be subject to "branch profits" tax). Sovereign investors want to avoid "commercial activities."

Even if a sovereign investor can maintain its Code Sec. 892 status relying on the safe harbor for limited partnership investments, it would still have to pay U.S. tax on any income earned through "commercial activities."

Despite these disadvantages, there is a trend for investment funds to structure U.S. portfolio investments as direct investments to take advantage of the potential tax efficiencies. Direct investment allows the buyer to get a basis step-up in the business assets at the

exit, which means the buyer will be willing to pay more. However, this type of structure requires setting up several different alternative investment vehicles or feeder funds to accommodate investor demands.

Some invest through a blocker that is heavily leveraged, such as foreign corporations. Sovereigns will sometimes want to use a blocker to avoid commercial activities. Even so, Sovereigns may be indifferent between the various forms of investment income (interest, dividends, or gain).

Carried Interest Conundrum

One of the complications raised in this type of structure is how to calculate the carried interest. When a fund holds stock of a big (formerly public) company, the carried interest will be determined as a percentage of the gain from the sale of stock. However, some investors may hold their fund investment through a U.S. corporate blocker while others will hold it directly through a partnership.

Should the carried interest be calculated based on the gain from the sale of the assets or from the sale of stock? This determination is likely to depend, in turn, on whether the exit is expected to take the form of a sale of the assets or a sale of the stock in the blocker corporations. An asset sale would likely give rise to a U.S. tax liability for the U.S. corporate blockers.

In contrast, a sale of the stock of the blocker corporations by the tax-exempts and non-U.S. investors may be entirely tax free. After all, tax-exempts are not subject to tax on their investment income. The non-U.S. investors are generally not subject to U.S. tax on gain from the sale of stock, provided the gain is not subject to FIRPTA.

Mixing-Bowl Transactions

In another panel, Louis Freeman provided an overview of tax planning strategies and opportunities for partnerships and joint ventures. One of the topics was an introduction to "mixing bowl" transactions and the disguised sale rules. A mixing-bowl transaction provides the opportunity for partners to effectively exchange assets in a tax-free transaction.

Partner A contributes appreciated asset X while Partner B contributes appreciated asset Y. After at least seven years, if all goes according to plan, Partner A will receive asset Y in a tax-free distribution or liquidation. Partner B, in turn, will receive asset X in what would also be a tax-free distribution or liquidation.

In a mixing-bowl transaction, taxpayers must navigate both the disguised sale two-year presumption rule in Reg. §1.707-3(c)(1) and the seven-year rule in Code Sec. 704(c)(1)(B). Under the disguised sale regulations, a taxable sale of property is presumed to occur when a partner transfers property to a partnership and, within two years, the partnership transfers money to the partner. Code Sec. 704(c)(1)(B) was enacted in 1989 to limit the use of a partnership to engineer a tax-free exchange of property.

Under Code Sec. 704(c)(1)(B), if a partner contributed appreciated property to a partnership, and the partnership distributes it to a different partner within seven years, the contributing partner must recognize the built-in gain.

Sound easy? Actually, mixing bowls are challenging. First, the partners must have considerable patience. Even after waiting the requisite seven years, they may encounter obstacles when they wish to exit and liquidate the partnership. The partners will either have to contend with valuation issues if the property to be distributed is not marketable, or they will have to confront Code Sec. 731(c).

Under Code Sec. 731(c), the distribution of "marketable securities" to a partner will trigger gain. One well-known example of a mixing-bowl transaction was the Times Mirror Chandler Trust transaction. The Chandlers as controlling shareholders of Times Mirror wanted to increase their yield on their low-yielding Times Mirror stock. To accomplish this goal, the shareholders contributed stock of Times Mirror to a partnership.

Times Mirror contributed cash and real estate to the same partnership. The Chandlers got the yield from the high-yielding securities that were bought with the cash and also received the rent from the real estate. As a result, Times Mirror was effectively able to deduct a dividend, because it treated the rent it paid to the partnership as a deductible expense.

Canal Corporation and Penalties

Another new panel this year discussed the implications of the Tax Court decision in *Canal Corporation*. It was presented by Robert

Crnkovich of Ernst & Young, Richard Lipton of Baker & McKenzie and Clifford Warren, Special Counsel to the Associate Chief Counsel, Passthroughs & Special Industries, IRS. This panel produced a lively discussion of penalties and taxpayer reliance on opinions in light of *Canal Corp.*, 135 TC 199, Dec. 58,298 (2010).

In *Canal Corp.*, Wisconsin Tissue Mills, Inc. (WISCO) entered into a leveraged partnership transaction with Georgia Pacific (GP). WISCO (a subsidiary of the predecessor corporation to Canal) desired to sell its tissue business and found a buyer in GP. However, WISCO wanted to defer the tax liability from the gain on the sale, and one of its advisors recommended a leveraged partnership transaction.

In this leveraged partnership transaction, WISCO contributed its tissue business assets to a newly-formed partnership. GP contributed its own related business assets to the partnership. WISCO's assets had an agreed value of $775 million. The new partnership, with total gross assets of $1.151 billion, borrowed $755.2 million from an external lender.

GP guaranteed the debt and WISCO provided an indemnity to GP in the event GP would ever have to pay under the guarantee. The new partnership distributed the proceeds of $755.2 million to WISCO. At the end of the leveraged partnership transaction, WISCO had $755.2 million in cash and a five-percent interest in the new partnership. It used the cash to pay off liabilities and make a distribution to its parent. It used the remaining funds to lend $151 million to its parent in exchange for a Note.

To avoid recognizing gain under the disguised sale rules, WISCO relied on an exception under Reg. §1.707-5(b). Under this exception, a distribution of cash does not result in the recognition of gain under the disguised sale rules to the extent that (1) the distribution of cash is funded by debt that was borrowed against the partner's contributed property, and (2) the debt is properly allocable to the partner under the partnership debt allocation rules in Code Sec. 752. The theory of this exception is that debt borrowed against property directly held by a partner would not result in income.

Therefore debt borrowed against property held by a partnership should also not result in income. Yet the debt must be properly allocable to the partner receiving the distribution of the proceeds of the debt. WISCO took the position that the debt was properly allocable to itself under the indemnity agreement with GP.

In determining how the debt should be allocated, the Tax Court focused on the anti-abuse rule in Reg. §1.752-2(j). According to the anti-abuse rule, in applying the debt allocation rules in a partnership, an obligation of a partner to make a payment may be disregarded in some cases. One is if the "facts and circumstances" indicate that a "principal purpose" of the arrangement is either to eliminate the partner's actual economic risk of loss on the obligation.

Another is if it is to create the appearance that the partner bears the economic risk of loss when the substance is otherwise. The Tax Court held that the anti-abuse rule applied to disregard WISCO's indemnity agreement. After all, following the formation of the partnership, WISCO's only material asset was the Note.

Yet the indemnity agreement did not require WISCO to retain the Note or any other asset. There was nothing preventing WISCO's parent from causing WISCO to distribute the Note. That would leave WISCO without any material assets. In light of these facts, the Tax Court determined that the Note "served to create the appearance, rather than the reality, of economic risk for a portion of the [new partnership] debt." [*Canal Corp.*, 135 TC, at 214.]

Significantly, *Canal* was the first decision applying the anti-abuse rule. Moreover, WISCO received a "should" opinion from PWC that the transaction would not trigger the disguised sale rules. Nevertheless, the Tax Court held that accuracy-related penalties applied.

The decision cited the fact that WISCO paid a flat fee to its advisor rather than an hourly rate. In addition, the Tax Court criticized the opinion's unreasonable assumptions that the indemnity would be effective and that WISCO would hold sufficient assets (at least 20 percent of the partnership debt). All advisors, we are reminded, must question each assumption and even each factual representation.

In the end, the IRS never collected the tax liability. Instead, after Canal Corporation entered bankruptcy, the IRS settled for $2 million out of a total tax liability of over $106 million.

Canal Queries

With the twists and turns of a Dickens novel, the *Canal* decision provoked a lively discussion. Was the court correct to apply penalties? Would the decision have come out in favor of the taxpayer if WISCO was required to retain the Note under the indemnity?

Did it make a difference that there was evidence that WISCO had previously considered selling the tissue business *before* entering into the leveraged partnership transaction? What are the implications for "cherry-picking" strategies? With questions aplenty and a paucity of answers, the panelists offered their own critiques.

However you come out on the application of the anti-abuse rule, in Dick Lipton's view there was no basis to impose penalties. The case represented the first application of the anti-abuse rules. The taxpayer should have been able to rely on its opinion.

The decision creates uncertainty over the extent to which taxpayers may rely on opinions to avoid penalties. Perhaps the biggest question from the case was whether the anti-abuse rules would not have been applied had WISCO been required to retain the Note. However, the panel generally agreed that the fact that WISCO had previously considered selling its business was probably a red herring.

True, it was an unfavorable fact. Yet it probably did not make a difference to the outcome. Instead, what generally should matter is the actual transaction that a taxpayer pursues, not any previously contemplated transactions.

In a "cherry-picking" strategy, a partner contributes low-basis property to a partnership. Perhaps it sells high-basis property to the same partnership as part of the same transaction. In this way, the cash is allocated entirely to the high-basis property. This technique is not explicitly proscribed under the existing disguised sale rules.

Even so, it is interesting to compare this approach to Rev. Rul. 68-55, 1968-1 CB 140. That ruling involved a tax-free contribution of capital under Code Sec. 351. There, any boot or cash the contributor receives from the corporation in consideration for a capital contribution must be allocated pro rata to the property contributed. [For discussion of that ruling, *see* Jonathan Van Loo, *Debt Pushdowns in Overlapping Transactions: Part II,* M&A Tax Rep., July 2012, at 7.]

Conclusion

Partnership tax topics can be far more dizzying than corporate ones. The panelists at this conference covered a wide array of partnership issues ranging from the basics of partnership formation and dissolution to more topical issues. If practitioners could not attend, the CD-ROM will soon be available. Details are available at *www.pli.edu*.