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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JOHN M. ALTMAN
SENIOR TRIAL ATTORNEY CC:NER:PODCIN

FROM: Curtis G. Wilson
Assistant Chief Counsel (Administrative Provisions and Judicial Practice) CC:PA:APJP

SUBJECT: Disguised Sale

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LEGEND

Date 1 =
Date 2 =
A =
B =
C =
D =
E =
F =

ISSUES

Whether "partnership items" include the determination that a series of contributions and distributions entered into by related partnerships and their partners constitute a disguised sale.

CONCLUSIONS

Contributions to and distributions from a partnership constitute partnership items and are properly determined in a notice of final partnership administrative adjustment.

FACTS[1]

On Date 1, A loaned $X to B and also purchased an option to later purchase an interest in B. At the time of the loan, B's primary partners were the C group. B distributed the loan proceeds to C, and C executed term loans in favor of B in the aggregate of $X. B pledged the term loans as security for the A loan.

During Date 2, B divided into two continuing entities, B and D. C contributed to D an interest in B in exchange for an interest in D. Some of the C group made new guarantees of the A loan, and A released the term loans as security. B, in turn, transferred the term loans to D. D then transferred its interest in B to B.

E contributed property to B in exchange for an interest therein. In exchange for an interest in E, A transferred to E an interest in the A loan and an interest in the

[1]This is an abbreviated version of only those facts that are necessary to resolve the question presented. The complete details of the transaction are not set forth herein.

option to purchase B. Similarly, F, which owned an interest in the A loan and option, transferred its entire interest in those items to E in exchange for an interest therein. Through this series of transactions, E obtained on interest in the A loan and all of the option.

E contributed its interest in the A loan and option to B in exchange for an interest therein. A contributed its remaining interest in the A loan to B in exchange for an interest in B. The loan was retired.

After this series of transactions, D held the term loans as a partnership asset. C, who owned nearly all of D, pays the interest on the loans through a circular escrow arrangement, whereby the interest is: deposited into an escrow account; paid to D from the escrow account; and returned to the same escrow account as a cash distribution.

The IRS has determined that the series of transactions occurring during Date 2 constituted a disguised sale of a portion of C's interest in B to A and E. It has further been determined that D's ownership of the term loans lacks economic substance (as demonstrated by the circular escrow arrangement), and that the loans should be treated as having been distributed directly from B to C.

LAW AND ANALYSIS

In 1982, Congress enacted the TEFRA unified audit and litigation procedures to simplify and streamline the partnership audit, litigation, and assessment process. The underlying principle of TEFRA is that "the tax treatment of items of partnership income, loss, deductions, and credits will be determined at the partnership level in a unified partnership proceeding rather than separate proceedings with the partners." Conf. Rep. No. 97-760, at 62 (1982), 1982-2 C.B. 600, 662. "[A] 'partnership item' means any item required to be taken into account for the partnership's taxable year to the extent prescribed by [the Commissioner's] regulations as an item that 'is more appropriately determined at the partnership level'." Maxwell v. Commissioner, 87 T.C. 783 (1986) (quoting I.R.C. § 6231(a)(3)).

The ultimate issue in the present case is whether the adjustments at issue in the examination of B are partnership items.[2] Despite the complexity of the overall series of transactions, each transaction, standing alone, is either a contribution or distribution to a partnership. Thus, the issue is whether contributions to and distributions from a partnership constitute partnership items.

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[2]The incoming request does not question the applicability of the TEFRA provisions to B; therefore, the issue will not be addressed, herein.

Generally, partnership items are items of income, gain, loss, deduction and credit. See Treas. Reg. § 301.6231(a)(3)-1(a). The regulations promulgated under section 6231(a)(3), however, sets forth the full list of what constitutes partnership items. Among the items expressly listed are items related to contributions, distributions, and certain transactions in which a partner is not acting as a partner. See Treas. Reg. § 301.6231(a)(3)-1(a)(4). The determination of whether these items are, in fact, partnership items turns, in part, on the extent to which the partnership is required to determine the character and amount of a partner's interest in the partnership for purposes of partnership books and records. Id. The regulation clarifies by providing specific illustrations. See generally, Treas. Reg. § 301.6231(a)(3)-1(c).

For purposes of its illustration regarding contributions, the regulation states that the partnership needs to determine, among other things, the character of an amount received from a partner "for example, whether it is a contribution, a loan, or a repayment of a loan." Treas. Reg. § 301.6231(a)(3)-1(c)(2)(i). It is the character of the amount received from the partners that are among the items at issue here, and the character of the amounts received clearly fall within the definition of partnership items.

For purposes of its illustration regarding distributions, the regulation states that the partnership needs to determine, among other things, the character of an amount transferred to a partner "for example, whether it is a distribution, a loan, or a repayment of a loan." Treas. Reg. § 301.6231(a)(3)-1(c)(3)(i). It is the character of amounts transferred to partners that are among the items at issue here, and the character of amounts transferred clearly fall within the definition of partnership items.

It must be noted, however, that the list set forth in the regulations is broad and inclusive. Partnership items not only include those items expressly listed, such as the information underlying contributions and distributions, but also "the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc." Treas. Reg. § 301.6231(a)(3)-1(b). For example, in Doe v. Commissioner, 97-1 USTC § 50,460 (10th Cir. 1997), the Service made certain basis determinations in a partner level deficiency proceeding that were inconsistent with the partnership's characterization of certain loans. On appeal, the Tenth Circuit held that, absent a TEFRA proceeding, the Service was bound by the treatment of the loans on the partnership's books and records. The corollary to this is that the proper method to challenge the characterization of a loan is at the entity level.[3]

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[3]We also note that the recent case of Rhone-Poulenc Surfactants & Specialties, L.P. v. Commissioner, 114 T.C. No. 34 (June 29, 2000), similarly involved the

Having determined that the transactions at issue are partnership items, a question remains as to which entity they belong. Among the adjustments to be made, the Service seeks to recharacterize the transfer of the term loans from B to D as a distribution from B to C. It follows that a corresponding adjustment must be made to D's characterization of the same transaction, as well as its treatment of the term loans as valid indebtedness. Therefore, notices of final partnership administrative adjustment should be issued to both B and D.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call if you have any further questions.

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recharacterization of contributions and distributions. In its opinion, the Tax Court noted without further inquiry that the parties agreed that the recharacterization issue was a partnership item. This is significant, because the court's jurisdiction in the proceeding was limited to partnership items. See I.R.C. § 6226(f). Thus, if the court concluded that the disguised sale issue was not a partnership item, it would have been incumbent on the court to dismiss the action sua sponte. Liberty Mutual Ins. Co. v. Wetzel, 424 U.S. 737 (1976) ("Though neither party has questioned the jurisdiction of the Court of Appeals to entertain the appeal, we are obligated to do so on our own motion if a question thereto exists.").