Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

(Large & Mid-Size Business)

from: Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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subject: Application of Partnership Anti-Abuse Regulations

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

LEGEND

Taxpayer:

Spouse:

Son:

Daughter:

LLC 1:

LLC 2:

Trust 1:

Trust 2:

X:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Date 6:

Date 7:

a:

b:

c:

d:

e:

f:

g:

h:

i:

j:

k:

l:

m:

n:

o:

p:

ISSUE

Whether it is appropriate to invoke the partnership anti-abuse rule contained in § 1.701-2 of the Income Tax Regulations?

CONCLUSION

The Service should invoke § 1.701-2 in order to recast a portion of the series of transactions. As discussed below, both the Taxpayer and Spouse should be treated as having contributed the X stock directly to the CRUTS (Trust 1 and Trust 2) in an amount equivalent to the cash actually distributed to the CRUTs from the LLCs (LLC 1 and LLC 2). Both the Taxpayer and Spouse should be treated as having been allocated the gains from the sale of the rest of the X stock that was previously allocated to the CRUTs. For example, Taxpayer's CRUT would be treated as having received $o of X stock from Taxpayer, because that is the amount of cash that Taxpayer's CRUT received in redemption of its LLC interest. Taxpayer would be allocated additional gains from the portion of the X stock sold by the LLC that was previously allocated to his CRUT but not distributed to the CRUT. Similarly, Spouse's CRUT would be treated as having received $p of X stock from Spouse, because that is the amount of cash that Spouse's CRUT received in redemption of its LLC interest. Spouse would be allocated additional gains from the portion of the X stock sold by the LLC that was previously allocated to her CRUT but not distributed to the CRUT.

FACTS

(1) On Date 1, Taxpayer and Son formed LLC 1 by contributing a shares of high value low basis publicly traded X stock (b voting shares and c nonvoting shares) and $d in cash. On that same day, Spouse and Daughter formed LLC 2 by contributing e shares of X stock (f voting and g nonvoting shares) and $h in cash. Both LLCs were taxed as partnerships.

(2) Nine days later, on Date 2, Taxpayer and Spouse each established a separate Charitable Remainder Unitrust (CRUTs). Taxpayer and Spouse funded the CRUTs with cash and 90% nonvoting interests in the respective LLCs using a 45% discount to value the contributed interests. The fair market value of the LLC interest Taxpayer contributed to his CRUT (reflecting 90% of the market price of the X stock in LLC 1) was $i. After the 45% discount (based on the lack of marketability of the LLC interest and the lack of control of the LLC), the LLC interest was valued at $j. Similarly, the fair market value of the LLC interest Spouse contributed to her CRUT was $k. After the 45% discount (based on the lack of marketability of the LLC interest and the lack of control of the LLC), the LLC interest was valued at $l. At the same time, Taxpayer and

Spouse also sold LLC interests to family trusts for the benefit of their grandchildren that are not the subject of this advice. (No opinion is expressed or implied in this memo regarding any issues related to any transactions related to the trusts).

(3) Section 1.1 of the LLC operating agreements provides under the definition of "Capital Account" that the provisions of the agreements relating to the maintenance of Capital Accounts are intended to comply with § 1.704-1(b) and shall be interpreted and applied in a manner consistent with such regulation. Section 4.1(a) provides that Voting Units shall have the exclusive right to vote on, consent to or withhold consent with respect to all matters relating to the Company or its operation. Section 4.3(a) provides that the cash or other assets of the Company may be distributed by the Company to the members, at such times and in such amounts as shall be determined by a majority in interest of the voting members, in proportion to the positive balances, if any, standing in the members' respective capital accounts, taking into account the reasonable capital needs of the company. Prior to a distribution in kind of property of the Company, in liquidation or otherwise, the difference between the value of the property to be distributed and its book value shall be credited or charged, as appropriate, to the members' capital accounts in proportion to their respective positive capital account balances, if any, as of such time (but said adjustment to capital accounts is not intended to duplicate any adjustment to capital accounts by reason of a revaluation of Company assets pursuant to the definition of "Capital Accounts" in § 1.1 above).

(3) Six days later, beginning on Date 3, the LLCs sold all of the X stock at full fair market value and realized gains of $m and $n respectively.

(4) Three months later, on Date 5, the LLCs elected to be classified as corporations with a fiscal year ending three months later, Date 6. Within those three months, the LLCs redeemed the CRUTs' interests in the respective LLCs. However, the redemptions were based on the discounted values ascribed to the LLC interests held by the CRUTs, not the 90% LLC interests owned by the CRUTs. Thus, rather than receive 90% of the assets held by the respective LLCs, the CRUTs received approximately 60% of the assets held by the respective LLCs. As a consequence although 90% of the gains from the sale of the X stock was allocated to the CRUTs (which are tax exempt), the CRUTs only received 60% of the proceeds, leaving approximately 40% of the proceeds in the LLCs for the Taxpayer, Spouse, Son, Daughter and family trusts.

(5) Less than 3 months after the redemptions, both LLCs made S elections beginning Date 7, and have remained S corporations in the following years.

LAW AND ANALYSIS

Section 1.701-2(a) of the Income Tax Regulations 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.

Section 1.701-2(a)(1) provides that 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.

Section 1.701-2(a)(3) provides, in part, that the tax consequences under subchapter K to each partner of partnership operations and transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

Section 1.701-2(b) provides, in part, that 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.

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.

Section 1.701-2(c) lists a number of factors that the Commissioner may apply in making a determination to recast a transaction. The factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of § 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

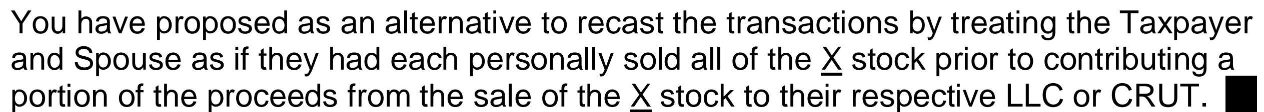
As stated in the conclusion above, under § 1.701-2 the series of transactions should be recast for the following reasons: (1) Had the partners owned the partnership assets directly, the taxable partners would have had to include in income 40% of the gains from the sale of the X stock rather than the 10% percent the taxable partners actually included; (2) Taxpayer and Spouse established their LLCs with related parties (Taxpayer/Son, Spouse/Daughter) with the son and daughter acting as accommodation parties having only minor interests in the LLCs, for the purpose of contributing partnership interests to the CRUTs, the value of which could be discounted 45%; (3) The LLCs were partnerships for three and a half months (from Date 1 through Date 4), just long enough to create the CRUTs' transitory interests in the LLCs, sell all of the X stock in the LLCs and allocate 90% of the gain to the respective CRUTs; (4) The redemptions were based on the discounted values ascribed to the LLC interests held by the CRUTs, not the 90% LLC interests owned by the CRUTs, contrary to § 1.1 of the LLC operating agreements providing that members' capital accounts will be maintained in accordance with § 1.704-1(b) of the income tax regulations, and § 4.3(a) of the operating agreements providing that distributions to members are made in accordance with the members' respective capital accounts. Thus, rather than receive 90% of the assets held by the respective LLCs, the CRUTs received approximately 60% of the assets held by the respective LLCs. As a consequence, although 90% of the gains from the sale of the stock was allocated to the CRUTs (which are tax exempt), the CRUTs only received 60% of the proceeds, leaving approximately 40% of the proceeds from the sale of the X stock in the LLCs for the Taxpayer, Spouse, Son, Daughter and the family trusts.

While this advice only focuses on whether it is appropriate to apply the partnership anti-abuse regulations under § 1.701-2 to the facts in this case, we do not object to your

proposal that the Service also argue judicial doctrines, such as economic substance to support the same result.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

You have proposed as an alternative to recast the transactions by treating the Taxpayer and Spouse as if they had each personally sold all of the X stock prior to contributing a portion of the proceeds from the sale of the X stock to their respective LLC or CRUT.



In Palmer, the taxpayer had voting control of both a corporation and a tax-exempt private foundation. Pursuant to a single plan, the taxpayer donated shares of the corporation's stock to the foundation and then the corporation redeemed the stock from the foundation. It was the position of the Service that the substance of the transaction was a redemption of the stock from the taxpayer, taxable under § 301, followed by a gift of the redemption proceeds by the taxpayer to the foundation. The tax court rejected this argument and treated the transaction according to its form because the foundation was not a sham, the transfer of stock to the foundation was a valid gift, and the foundation was not bound to go through with the redemption at the time it received title to the shares.

In Rev. Rul. 78-197, the Service stated that it would treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

The Palmer doctrine and Rev. Rul. 78-197 were addressed in Rauenhorst v. Commissioner, 119 T.C. 157 (2002). In Rauenhorst, the taxpayers contributed warrants to purchase stock in a corporation to four § 170(c)(2) organizations just prior to the warrants being purchased by a third party. The timely contribution of the warrants allowed the taxpayers to obtain a charitable deduction for the full value of the warrants and avoid paying any gain on the sale of the warrants. The Service issued a notice of deficiency that taxed the gain on the redemption to the taxpayers under the anticipatory assignment of income doctrine. The tax court rejected the Service’s argument that the right to the proceeds of the stock transaction had ripened to a practical certainty and, relying on Palmer and Rev. Rul. 78-197, stated that “nothing in the record . . . raise[s] a genuine issue of material fact regarding whether the donees were legally bound, or could be compelled, to sell the stock warrants at the time of the assignments by [taxpayers].” Rauenhorst at 181.

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Please call (202) 622-3060 if you have any further questions.

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