Proposed Guidance Under Internal Revenue Code Section 707 Relating to Disguised Sales of Property[1]

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EXECUTIVE SUMMARY

The Internal Revenue Code (the "Code") provides generally that partners are entitled to contribute property to a partnership tax free and are entitled to receive a tax-free return of previously taxed profits through distributions. This result does not apply, however, where the transaction is characterized as a disguised sale of property. Disguised sales treatment may occur when a partner contributes property to a partnership and soon thereafter receives a distribution of money or other consideration from the partnership. The Treasury Regulations (the "Regulations") provide an exception to the disguised sales rules for certain debt-financed distributions. Under these circumstances, the partner is not deemed to have received "money or other consideration" for disguised sale purposes.

The Treasury Regulations specify that a partner's share of a recourse liability equals the portion of that liability for which the partner bears the economic risk of loss. For purposes of determining the extent to which a partner has a payment obligation (or economic risk of loss), all partners who have obligations to make payments are presumed to actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Therefore, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation, all payment obligations allocated to the partners will increase the partner's basis in the partnership (and therefore reduce taxes on future distributions).

In *Canal Corp. v. Commissioner of Internal Revenue*, 135 T.C. 199 (2010), the court dealt with the allocation of recourse liabilities in a disguised sales context. Wisconsin Tissue Mills, Inc. ("WISCO"), a wholly owned subsidiary of Chesapeake Corporation ("Chesapeake"), entered into a joint venture with Georgia Pacific ("GP"). WISCO transferred its assets to the joint venture in consideration for a minority interest. The joint venture borrowed funds and simultaneously made a distribution to Chesapeake. GP guaranteed the debt and WISCO executed an indemnity agreement, indemnifying GP in the event GP had to make a payment under the guarantee. Chesapeake claimed the distribution qualified as a debt-financed distribution, and should therefore fall within the exception to the disguised sales rules. The court disagreed and characterized the transaction as a disguised sale. It reasoned, in large part, that WISCO was too thinly capitalized and the guarantee did not have substance under the anti-abuse regulations.

Canal Corp. casts doubt on the applicability of the presumption of payment rule and the need for sufficient capitalization. On the one hand, the Regulations presume partners will satisfy obligations regardless of their net worth, and, on the other hand, *Canal Corp.* presumably requires partners to have some minimal net worth – how much is unknown. This paper urges the Treasury and Internal Revenue Service to eliminate taxpayer uncertainty by setting forth guidelines that detail when the presumption of payment rule will apply in light of *Canal Corp.* and how the taxpayer's capitalization affects the presumption.

I. BACKGROUND

The leveraged partnership transaction[3] has been an effective and tax-accepted method of transferring ownership interests in an ongoing business concern in exchange for cash (or some other consideration) while avoiding sale treatment and enjoying the benefits of tax deferral. In simple terms, the leveraged partner transfers its assets to a joint venture, structured as a partnership for federal tax purposes, in exchange for a minority interest (e.g., 10%) and a cash distribution. The partnership finances the distribution and allocates the liability to the distributee partner, thereby increasing the distributee partner's basis in the partnership to offset any gain realized from the cash distribution. The leveraged partnership transaction simply allows the partner to contribute property and immediately borrow against it. So long as the transaction has economic substance, the leveraged partner should avoid, or at least defer, taxation on the distribution.[4]

The court's opinion in *Canal Corp. v. Commissioner of Internal Revenue*,[5] created significant doubt as to the feasibility of the leveraged partnership transaction; it struck down the taxpayer's transaction under the anti-abuse rule (see below) found in the Treasury Regulations.[6] The court found the taxpayer's subsidiaries indemnity, which gave rise to the recourse liability allocation, was not authentic and the corresponding allocation was disallowed.

The taxpayer, Chesapeake Corporation ("Chesapeake," who is now known as Canal Corporation), was a Virginia paper corporation. WISCO was Chesapeake's wholly owned subsidiary. Chesapeake purchased WISCO from Philip Morris in 1985. WISCO manufactures commercial tissue products. WISCO was responsible for almost half of Chesapeake's sales, and, as Chesapeake's largest subsidiary, WISCO and Chesapeake shared the majority of the same principal officers and board members.

Chesapeake began exploring options to sell WISCO to free up cash so that it could invest in the packaging industry. After receiving preliminary interest from GP, also a player in the paper business, Chesapeake determined a current sale was not warranted due to its low tax basis in WISCO.[7]

Chesapeake retained Salomon Smith Barney ("Barney") and PricewaterhouseCoopers ("PWC") to determine how to best liquidate its investment in WISCO at the lowest possible tax cost. Ultimately, Barney and PWC recommended a leveraged partnership transaction (a joint venture) with GP. The joint venture took the form of an LLC taxed as a partnership for federal tax purposes. Under the agreement, WISCO would transfer all of its assets to the LLC. In return, WISCO received a minority interest and GP received a majority interest in the LLC. The LLC would secure a loan for approximately $755,000,000 from a third party and immediately distribute the proceeds to Chesapeake in a special distribution. GP guaranteed the LLC's repayment of the loan.

To approve the transaction, Chesapeake's executives insisted the proceeds of the special distribution not be taxable, at least not currently. In consideration for the tax-deferral benefit, Chesapeake agreed to a lower valuation of WISCO - $775,000,000. PWC advised that, in order to qualify for tax deferral, an indemnity must be executed in favor of GP. Chesapeake's board did not want to expose Chesapeake's assets to the indemnity. WISCO therefore executed the indemnity agreement in favor of GP.

WISCO's liability under the indemnity agreement was somewhat limited. In particular, GP was required to utilize the LLC's assets to satisfy the third-party obligation before calling upon WISCO for indemnification. WISCO would receive a proportionate increase in its interest in the LLC in the event it performed under the indemnity. The indemnity did not require WISCO to maintain a minimum net worth and WISCO was not limited in its ability to incur additional liabilities.

After the terms of the transaction were agreed upon, both GP and WISCO contributed their assets to the LLC. The LLC immediately borrowed approximately $755,000,000 and made a special distribution to Chesapeake. Chesapeake did not treat the transaction as a sale; rather, it treated the transaction as falling within the debt-financed transfer exception to the disguised sales rules. WISCO and Chesapeake characterized the special distribution as follows: (1) WISCO's payment of its various debts owed to Chesapeake; (2) WISCO's repayment of an intercompany loan of almost $400,000,000 to Cary St., another wholly owned Chesapeake subsidiary; (3) WISCO's payment of a dividend to Chesapeake; and (4) a loan by WISCO to Chesapeake in the approximate amount of $150,000,000. In consideration for the loan, Chesapeake executed a note in favor of WISCO. WISCO's primary assets after the transaction, excluding its interest in the LLC, were the Chesapeake note and a corporate jet worth approximately $6,000,000.

Soon after the initial borrowing, the LLC obtained additional financing and paid off the original $755,000,000 loan used to finance the special distribution to Chesapeake. GP then purchased WISCO's interest in the LLC for approximately $40,000,000 plus a payment of approximately $200,000,000 to compensate Chesapeake for loss of tax deferral. WISCO used the proceeds to issue a dividend to Chesapeake. In lieu of distributing cash to Chesapeake, WISCO cancelled the Chesapeake note.

The IRS disagreed with Chesapeake's assertion that the debt-financed transfer exception to the disguised sales rules applied. It reasoned that tax avoidance was the parties' primary consideration. Accordingly, the IRS disallowed the debt allocation and imposed a substantial understatement of income tax penalty on Chesapeake in the approximate amount of $36,000,000. Chesapeake appealed the penalty.

The court in *Canal Corp.* agreed with the IRS; the court concluded the parties' transaction, as a whole, showed intent to circumvent or avoid the obligation (WISCO's indemnity) and WISCO should therefore not have received an increased basis in the LLC. The LLC's distribution to WISCO should have been taxable as a result of WISCO's insufficient basis.

The court's decision focused on a few critical facts. First, the court noted that WISCO's only asset was the Chesapeake note that could be cancelled at will by Chesapeake. Secondly, by exposing WISCO's assets to the indemnity agreement, as opposed to Chesapeake's assets,[8] the court reasoned the parties purposefully limited their

exposure to only WISCO's assets in an attempt to avoid the debt. The court also reasoned that it would be highly unlikely that WISCO would be called upon to satisfy the obligation and, therefore, their assets were never truly at risk. In coming to these conclusions, the court disallowed the entire allocation of liability to WISCO based on the anti-abuse rules found in Code §1.752(j).

The court's ruling created significant uncertainty in applying the disguised sales rules and, in particular, the presumption of payment rule. First, the Regulations do not direct that allocating recourse liabilities requires an all-or-nothing approach. The allocations should reflect the economic realities of the transaction. That is, an allocation should be respected to the extent that the partner in question has assets with true value. Whether the Chesapeake note had substance (and, therefore, whether WISCO was adequately capitalized) was a primary consideration in the court's denial of the allocation. The court did not take into account the value of the corporate jet, which undoubtedly was a real, tangible asset with value. To the extent of the jet's value, the allocation should have been respected.[9]

Secondly, the court stated WISCO's assets would not likely be called upon to satisfy the obligation in question. This is not the correct test; the court should have determined whether WISCO's assets were potentially subject to forfeiture under the constructive liquidation test. As detailed below, under the constructive liquidation test, all of the assets of the partnership become worthless and the obligation becomes due. This test presumes that the assets would be called upon to satisfy the obligation (quite opposite the court's approach).

Finally, if taken literally, the court's opinion leads to the conclusion that wholly-owned subsidiaries will not have sufficient capitalization to support a recourse liability allocation due to the fact that its parent entity can, at any time, remove its assets before they are called upon to satisfy the obligation in question. Further, the court did not believe the possibility of a fraudulent conveyance claim (in bankruptcy court) should change its analysis.

II. GENERAL NON-RECOGNITION TREATMENT FOR PARTNERSHIP CONTRIBUTIONS AND DISTRIBUTIONS

In general, no gain or loss will be recognized to a partnership or any of its partners when a partner contributes property to the partnership in exchange for an interest in the partnership.[10] Similarly, in the case of a distribution by a partnership to a partner, the partner shall not recognize gain, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.[11] Generally, the partner's loss upon a distribution of property is equal to the excess of the partner's adjusted basis in the partnership over the sum of (a) money received in the distribution, and (b) the basis of unrealized receivables and inventory received.[12]

The general rule of non-recognition under Code §§ 721 and 731 is premised on the assumption that the partner is acting in his or her capacity as a partner and the transaction is not treated as a disguised sale for purposes of Code §707. If the transfer of property by the partner results in the partner's receipt of money or other consideration, the transaction may be treated as a disguised sale under Code §707.[13]

III. PARTNER'S BASIS IN THE PARTNERSHIP

The partner's basis in the partnership must be determined before determining the extent of gain or loss on a transaction under Code §§721 and 731. Under Code §722, the contributing partner's basis in the partnership equals the amount of cash contributed plus the adjusted basis of any such property contributed to the partnership.[14] If, as part of the acquisition of the partnership interest, the partner had taxable income, such income shall be added to the partner's basis in the partnership interest.[15] Any amount of partnership liabilities assumed by the partner shall be considered a contribution of money by the partner to the partnership and shall also increase the partner's basis in the partnership.[16]

Effectively, the partner has a carry-over basis in the partnership equal to the partner's basis in the contributed assets.[17] This ensures that the inherent gain or loss in the partner's contributed property will not be lost; instead, it will be recognized when distributed or disposed of or upon liquidation or sale of the partner's partnership interest.

IV. DISGUISED SALE OF PARTNERSHIP PROPERTY

A. In General

A transfer of property by a partner to a partnership followed closely by a distribution by the partnership to the partner may result in disguised sale treatment. The transaction may result in a sale if, based on all the facts and circumstances (1) the transfer of money or consideration would not have been made but for the transfer of property by the partner, and (2) the subsequent transfer is not dependent on the entrepreneurial risks of the partnership.[18] Under these circumstances, the partner is acting in a capacity other than as a member of the partnership and the non-recognition provisions of Code §§721 and 731 are inapplicable.[19]

The Regulations set forth a laundry list of facts and circumstances to consider when determining whether a disguised sale took place.[20] Subsequent transfers by the partnership to the partner made within two years are presumed to be a sale of property to the partnership unless the facts and circumstances clearly establish the transfers do not constitute a sale.[21] Conversely, transfers made more than two years apart are presumed not to be a sale of property to the partnership.[22]

In *Canal Corp.*, the contribution of property to the LLC and the special distribution to Chesapeake occurred simultaneously. Consequently, unless the facts and circumstances state otherwise, or unless the debt-financed transfer exception applies, a disguised sale is presumed to have occurred under Regulation §1.707-3(c)(1).

The disguised sales Regulations state that a partner's share of a recourse liability of the partnership equals the partner's share of the liability under Code §752 and the accompanying Regulations.[23] Below is a summary of the debt-financed transfer exception and the §752 Regulations.

B. Debt-Financed Transfers of Considerations by Partnerships

Congress recognized that the disguised sales rules may be applied too liberally. In the legislative history to Code §707, they stated as follows:

> The conferees wish to note that when a partner of a partnership contributes property to the 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 provision 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.[24]

Regulation §1.707-5(b) was enacted as a direct response to this legislative direction and is an exception to the general rule of disguised sales. In short, if the partnership borrows funds and immediately thereafter makes a distribution to a partner, the disguised sales rules are inapplicable to the extent that the partnership liability is allocable to the contributing partner.[25] Chesapeake argued that the LLC's entire liability was allocable to WISCO under the debt-financed exception due to WISCO's ultimate risk of loss under the indemnity.[26] The court disagreed, of course, stating that WISCO's assets were insufficient to justify the large allocation.

Whether the debt-financed transfer of consideration exception applies is not necessarily the first factor to consider. Applying the debt-financed transfer of consideration exception to any particular case requires the assumption that there exists a valid debt. Regulation §1.707-5(b) (the debt-finance transfer exception) explicitly refers to Regulation §1.707-5(a)(2) (relating to the partner's share of recourse liabilities).[27] Therefore, WISCO's share of recourse liabilities must be determined before deciding whether the debt-financed transfer exception applies.

C. Partnership Recourse Liabilities

1. *In General*

A partner's share of a recourse partnership liability equals the portion of the liability for which the partner or related person bears the economic risk of loss.[28] In general, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or contribution to the partnership) because that liability becomes due and payable.[29] In determining the extent of an obligation to make a payment, Regulations §752 should take account current commercial practices and arrangements, such as assumptions, guarantees, indemnities, etc., and should be based on the manner in which the partners share the economic risk of loss with respect to partnership debt.[30]

Chesapeake argued WISCO had the ultimate economic risk of loss with respect to the financed distribution; therefore, Chesapeake asserts the nature of WISCO's indemnity was a recourse liability. Although it did not explicitly state this, it can be inferred that the court, despite the test provided for in the Regulations, requires an analysis of the party's net worth when deciding whether a party has the economic risk of loss (i.e., whether a party can be allocated a recourse liability).[31] Ultimately, the court believed WISCO was inadequately capitalized and therefore had no economic risk of loss.

2. *Characteristics of Debtor-Creditor Relationship*

It is helpful to analyze the characteristics of the creditor-debtor relationship to help determine whether a valid recourse debt is present. In *Hambuechen v. C. I. R.*, 43 T.C. 90, 99-100 (1964), the court discussed the characteristics of such a relationship:

> Numerous factors and criteria have been mentioned by this Court as well as other

> courts which are pertinent to the question whether a debtor-creditor relationship has been established for tax purposes. Such factors as adequacy of the capitalization of the debtor, issuance of any notes, provision for and payment of interest, presence or absence of a maturity date, intention to repay, whether the alleged debt is subordinated to claims of outside creditors, whether outside creditors would have made similar advances under the circumstances, presence or absence of security for the alleged loan, reasonableness of expectation of payment, use to which the funds were put, and whether payment can only be paid out of future profits, are a few of those most frequently mentioned. . . . It has been aptly stated that the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event. . . . Although no one factor by itself is determinative of the question, a significant factor is whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture, or were placed at the risk of the business.[32]

The court did not believe the WISCO indemnity resulted in a valid creditor-debtor relationship. Primarily, the court indicated that GP did not request that the indemnity be provided and did not place any restrictions on WISCO's continued ability to assume additional debt. Additionally, the lack of WISCO's capitalization indicated, in the court's opinion, that the indemnity was a sham and never intended to be utilized. These factors point to the lack of commerciality of the transaction. However, a strong argument can be made that the transaction, while unique, did not lack sufficient consideration and commerciality to uphold the indemnity.

The indemnity was critical in WISCO (and therefore Chesapeake) avoiding current taxes on the transaction. In fact, the whole deal was contingent upon receiving tax deferral. Inherent in the indemnity being upheld was the legitimacy of Chesapeake's note. The parties were advised specifically that the note was necessary. It would be unreasonable to think that, in the face of its advisor's explicit instructions, Chesapeake would have cancelled the note to avoid the indemnity (in the event that GP called upon WISCO to satisfy its obligations) and, in the meantime, subjected itself to both a significant substantial understatement penalty (resulting from the transaction failing under the disguised sales rules) and a fraudulent conveyance claim by GP. Further, while WISCO was not prohibited from further encumbering its assets, doing so would have affected its net worth ratios; therefore, assuming additional debt would have blown the entire transaction.

In *Canal Corp.*, WISCO satisfied many of the listed factors above, with respect to both GP (regarding the indemnity) and Chesapeake (regarding the note). The note carried interest, a maturity date, Chesapeake had more than sufficient capitalization to satisfy the note, payment was not expectant on Chesapeake's future profits, and it could be reasonably determined that WISCO expected to be paid back (as it eventually did as a result of the dividend). Due to the steep consequences of failing to follow Chesapeake's tax advisors, coupled with the general rule that courts are not to substitute their judgment with that of bargaining parties in determining the adequacy of consideration, it is unreasonable to think that the indemnity didn't have adequate consideration and should not have merit.

3. *Presumption of Payment & Anti-Abuse Rule*

For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons 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.[33]

Throughout the entire term of the LLC's debt, WISCO's net worth was approximately $150,000,000. The Regulations expressly state it is not necessary for a partner's net worth to equal the value of the allocated debt. In fact, it is quite common for partners to have a net worth far less than the partnership liabilities allocated to them.

The *Canal Corp.* decision disregarded the presumption of payment rule due to the belief that WISCO did not bear any economic risk of loss (primarily because the Chesapeake note did not have substance and the indemnity was a sham). Under the anti-abuse rules, 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 or to create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance is otherwise, the partner's obligation may be disregarded.[34]

What facts and circumstances can a partner refer to in order to determine whether such partner has the economic risk of loss? How much of an allocation should be disallowed if a partner is attempting to eliminate its economic risk of loss? The Regulations do little to answer these questions, and the court's opinion in *Canal Corp.* further clouds the issues. The court took an all or nothing approach and denied the entire allocation to WISCO. The Regulations do not warrant such a rigid interpretation. In

fact, the overriding tax policy on any transaction is that the substance of the transaction should take precedence over its form and that, by the same token, to the extent that a transaction has economic substance (or the partners have true economic risk of loss), the transaction should be respected.

While the *Canal Corp.* court may have disallowed the transaction based upon the anti-abuse rules and the substance over form doctrine, it should not have done so with such a broad stroke. At the bare minimum, assuming the Chesapeake note had no substance (as a result of Chesapeake's ability to cancel the note at any time), WISCO still owned the corporate jet, worth approximately $6,000,000. The court did not consider this presumably for the same reason it decided the note did not have substance – because Chesapeake could have transferred title to the corporate jet to avoid WISCO's economic risk of loss. Is it possible then, in light of *Canal Corp.*, for a wholly-owned subsidiary involved in a partnership to be allocated partnership liabilities? Will the allocations fail because of the subsidiary's insufficient capitalization due to the fact that its parent can remove its assets? Where do we draw the line and how do we determine whether a subsidiary will ever be sufficiently capitalized.

The policy underlying the *Canal Corp.* analysis is completely at odds with the policy underlying the presumption of payment rule. On the one hand, *Canal Corp.* presumes that majority partners will purposefully engage in what amounts to fraudulent conveyances and deceitful conduct to avoid their subsidiary's obligations. On the other hand, the Regulations assume that partners will honor their obligations regardless of their net worth. While this author does not believe that the Regulations' approach is perfect, it undoubtedly fosters a more business-friendly environment: one in which business opportunities are not foreclosed upon strictly by reason of the individual partner's ownership structure.

The court did not give much thought to Chesapeake's fraudulent conveyance argument, stating that the potential fraudulent conveyance claim is too remote to create an "obligation" within the meaning of the recourse liability Regulations. While this is technically true, it is clear that the Regulations do not require a technical approach be taken under all circumstances. To the extent that facts and circumstances give a transaction economic substance, those facts and circumstances should be considered. A potential fraudulent conveyance claim should carry some weight, even if insignificant, and should be a fact and circumstance the court should consider in determining if the overall transaction has economic substance.

Finally, Chesapeake's advisors specified that WISCO must keep a net worth of at least 20% of the allocated debt. The record reflects that Chesapeake's board of directors would not have signed off on the transaction unless PWC issued a "should" opinion (reflecting their highest level of confidence) that the special distribution would not result in current taxes. Chesapeake cancelling the note would fly in the face of PWC's opinion, which makes it highly unlikely that Chesapeake would have cancelled the note in the first place. While being successful in a fraudulent conveyance claim in bankruptcy court may have been unlikely: equally as unlikely was Chesapeake cancelling the note and compromising the tax deferral status it so intently wanted to preserve.

V. PROPOSAL

It is clear that the *Canal Corp.* decision creates significant uncertainty in allocating recourse liabilities, especially in the wholly-owned and majority-owned subsidiary context.[35] The reality that partners in a partnership, whether they are wholly-owned or not, rely on allocating partnership debt to help offset gain that would otherwise be imposed on future distributions.

This article recommends that guidance be issued setting forth factors to assist in the application of the presumption of payment rule. Specifically, this article asks that the Regulations explicitly permit wholly-owned and majority-owned subsidiaries to rely on the presumption and it should further specify that an entity's ownership structure should not work against them in applying the presumption; instead, it can be simply a factor to be considered when analyzing the transaction. Wholly-owned subsidiaries, like any other partners in partnerships, should be afforded the opportunity to engage in business transactions, for both tax and non-tax purposes, and their basis (or investment) in the partnership should reflect the economic realities of guaranteeing partnership debt.

Before determining that a partner is inadequately capitalized, the following factors should be considered: (1) the capitalization of the debtor partner compared to the value of the debt (any ratio in excess of 50% automatically qualifies for the presumption), (2) the liquidity of the debtor partner's assets, (3) risks associated with the debtor partner's assets (market demand, industry considerations, etc.), (3) the debtor partner's cash flow from operations, (4) the debtor partner's net income for the past three years, (5) the partner's future earning capacities, and (6) the debtor partner's agreements with other parties to be reimbursed for any losses sustained.

Finally, the all-or-nothing approach taken by the *Canal Corp.* court should be emphatically abolished. So long as the

subsidiary partner has some true asset value (i.e., a corporate jet), that portion of the attempted debt allocation should be permitted.

VI. CONCLUSION

Canal Corp. has shaken the leveraged partnership world and clouded whether and to what extent à wholly-owned partnership engaging in a joint venture can rely on recourse liability allocations. While abuses should never be tolerated, fostering and promoting business should be of paramount importance. Partnership debt allocations (and corresponding increases in partnership basis) are engrained in transacting business, clarity is essential. Not only will further clarity provide taxpayer confidence, but it will also result in uniform enforcement by the Internal Revenue Service and our courts.[36]

ENDNOTES

1. The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California or the Los Angeles County Bar Association. Although the participants on this project may have clients affected by the rules applicable to the subject matter of this paper and may have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this paper.

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3. A leveraged partnership transaction is only successful in tax deferral to the extent the debt-financed transfer exception to the disguised sales rules apply.

4. For purposes of this article, "partnership(s)" shall also include limited liability companies electing to be treated as a partnership for federal tax purposes.

5. *Canal Corp. v. Commissioner of Internal Revenue,* 135 T.C. 199 (2010).

6. For purposes of illustration and convenience, the Internal Revenue Code will be referred to as the "Code" and the Treasury Regulations will be referred to as the "Regulations."

7. Chesapeake would have been exposed to over $500,000,000 in taxable income if a current sale of WISCO took place. Chesapeake's Board of Directors therefore wanted to explore alternative strategies for tax deferral.

8. Chesapeake had sufficient assets to cover the indemnity.

9. As discussed below, it is not necessary that a partner's assets equal the amount of any particular debt allocation; therefore, the allocation should have been respected even beyond the value of the corporate jet.

10. 26 U.S.C. § 721.

11. 26 U.S.C. § 731(a)(1).

12. 26 U.S.C. § 731(a)(2). A discussion of the partner's basis in unrealized receivables and inventory is beyond the scope of this article.

13. 26 C.F.R. 1.752-1(a). See below for a more complete discussion of the disguised sales rules.

14. 26 U.S.C. § 722.

15. 26 C.F.R. § 1.721-1(b).

16. 26 U.S.C. § 752(a). Likewise, the partner's basis will decrease by the amount of liabilities associated with the contributed property assumed by the partnership or other partners. (See 26 U.S.C. § 752(b).)

17. Items of profit, loss, deductions, credits, among other ites, will adjust the partner's basis in the partnership from time to time as such items are allocated to the partner.

18. 26 C.F.R. § 1.707-3(b)(1).

19. 26 C.F.R. § 1.707-3(a)(2).

20. The Regulations under §1.707-3(b)(2) set forth factors to consider in the disguised sale context. Among the factors to consider are whether (1) the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer; (2) the transferor has a legally enforceable right to the subsequent transfer; (3) the partner's right to receive the transfer of money or other consideration is secured in any manner; (4) any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration; (5) any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer (taking into account whether the obligation is subject to contingencies); (6) the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt; (7) the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer; (8) partnership distributions, allocation or control of partnership operations are designed to effect an exchange of the burdens and benefits of ownership of property; (9) the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and (10) the partner has no obligation to return or repay the money or other consideration to the partnership.

21. 26 C.F.R. § 1.707-3(c)(1); In fact, under Regulation 1.707-3(c)(2), partners must report any transfers within the two-year window to the IRS if the partner does not treat the transfer as a sale for tax purposes.

22. 26 C.F.R. § 1.707-3(d).

23. 26 C.F.R. §1.707-5(a)(2)(i).

24. Petitioner's opening brief, citing H.R. Rep. No. 98-861, 862 (1984).

25. 26 C.F.R. § 1.707-5(b).

26. Under such circumstance, WISCO would have been allocated the entire $755,000,000 liability, which would have increased its basis in the partnership to $755,000,000. The distribution of $755,000,000 does not therefore exceed WISCO's basis and is not taxable.

27. For our purposes, I will only discuss Regulation §1.707-5(a)(2)(i) dealing with recourse liabilities.

28. 26 C.F.R. § 1.752-2(a).

29. 26 C.F.R. § 1.752-2(b); in a constructive liquidation, all of the following events are deemed to occur simultaneously: (a) all of the partnership's liabilities become payable in full; (2) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero; (3) the partnership disposes of all of its property in a fully taxable transaction for no consideration (except for relief of liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership; (4) all items of income, gain, loss, or deduction are allocated among the partners; and (5) the partnership liquidates.

30. H. Rep. No. 861, 98th Cong., 2d Sess. 869 (1984).

31. Although a plain reading of Regulation §1.752-2(b)(6) leads to a much different rule. Again, the Regulations presume that partners will satisfy their payment obligations, irrespective of their net worth. The *Canal Corp.* case clearly requires an investigation of net worth. Principal in the court's reasoning in determining that a disguised sale occurred was the fact that WISCO's only significant asset was the Chesapeake note, which could be cancelled at any time. Furthermore, the court noted that GP did not require WISCO to sign the indemnity agreement or maintain a minimum net worth. Neither of these requirements exist in the Code or the Regulations. Notwithstanding a compelling argument that Chesapeake would be subject to a fraudulent conveyance claim if the note was cancelled immediately prior to WISCO being called to indemnify GP, the court accepted the IRS' assertion that a fraudulent conveyance action is not an obligation, rather, it's an action. The IRS claims that the Code and Regulations do not allow a recourse liability allocation as a result of a potential action against a partner. The court agreed.

32. *Hambuechen v. C. I. R.*, 43 T.C. 90, 99-100 (1964) (citations omitted).

33. 26 C.F.R. § 1.752-2(b)(6).

34. 26 C.F.R. § 1.752-2(j)(1).

35. This uncertainty does not extend itself to just wholly/majority-owned subsidiaries and their parents, but to controlling partners in their individual capacity as well. Presumably, a 60% individual partner in a partnership that is engaged in a joint venture could remove assets from the partnership before they are subject to forfeiture just as easily as Chesapeake could have cancelled the note owed to WISCO.