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# Partnership Tax Planning Without Falling into the Canal (Slides)

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# Partnership Tax Planning Without Falling into the Canal

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# Leveraged Partnerships – General Background

# Section 707(a)(2)(B) Disguised Sale Rules – General Overview

- Section 707(a)(2)(B) and final regulations thereunder treat certain contributions of property to the partnership and distributions of money (or other property) to the partner as disguised sales to the partnership
- However, the legislative history of Section 707(a)(2)(B) indicated that an exception should apply for certain debt-financed distributions

# Section 707(a)(2)(B) Legislative History

- “[W]hen a partner of a partnership contributes property to a 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.”
  - H. Rep. No. 98-861, 98th Cong., 2d Sess., at 862 (1984).

# Leveraged Distribution Rules

- Debt-financed distributions to a partner are “taken into account only to the extent that the amount of money or the fair market value of other consideration transferred [to the partner] exceeds that partner’s allocable share of the liability”
  - Reg. § 1.707-5(b).

# Recourse Debt

- If the transferee partner bears the “economic risk of loss” under Reg. § 1.752-1(a)(1) with respect to the liability that is the source of the distribution, the distribution will not exceed the partner’s “allocable share” of the liability and therefore is not “taken into account” for purposes of Reg. § 1.707-3
  - A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of Section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under Reg. § 1.752-1(a)(1) or would be treated as a recourse liability under that Section if it were treated as a partnership liability for purposes of that Section.

# Nonrecourse Debt

- A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under Reg. § 1.752-3(a)(3)
  - Reg. § 1.752-3(a)(3) – A partner's share of excess nonrecourse liabilities is determined in accordance with the partner's share of partnership profits, and the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the Section 704(b) regulations) of some other significant item of partnership income or gain



# Presumption of Performance

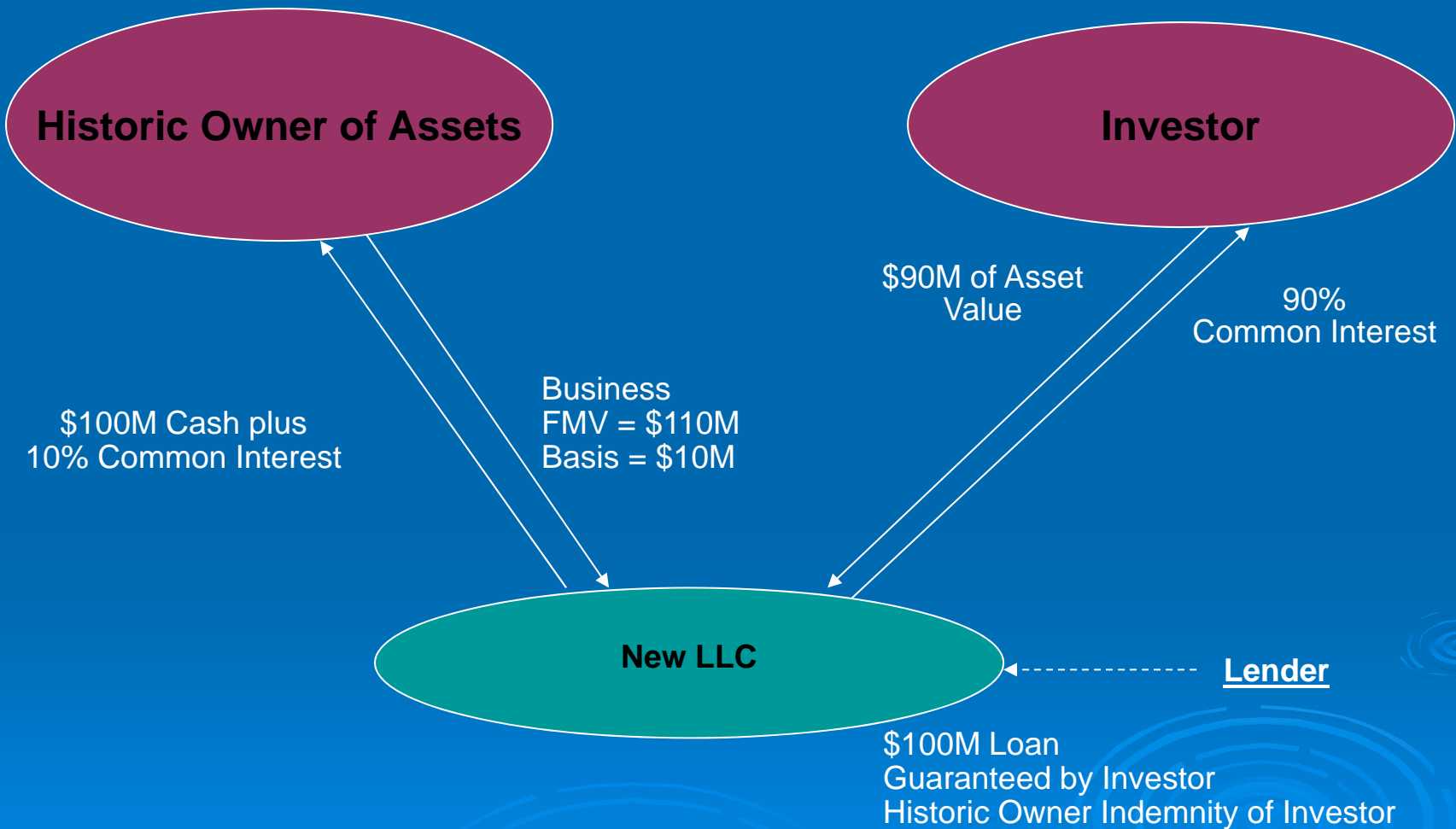
- For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation
  - Reg. § 1.752-2(b)(6).

# Anti-Abuse Rule

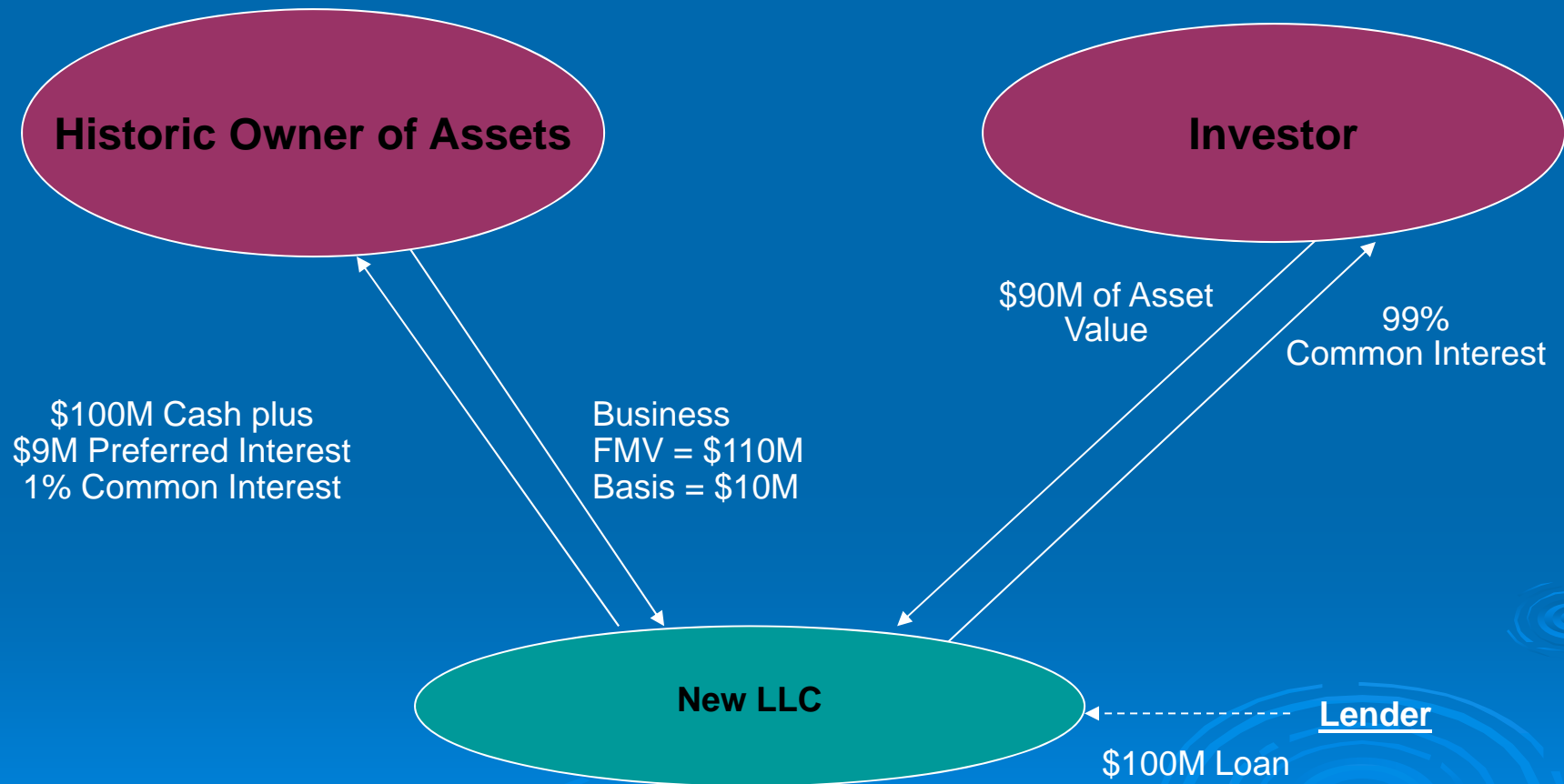
- An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.
  - Reg. § 1.752-2(j)(1).
- An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.
  - Reg. § 1.752-2(j)(3).

# Leveraged Partnerships – General Transactional Form

# Leveraged Partnership – Recourse Debt



# Leveraged Partnership – Nonrecourse Debt



# Leveraged Partnerships – Recent Case Law and Other Guidance

# *United States v. G-I Holdings Inc* – Borrowing Outside Partnership

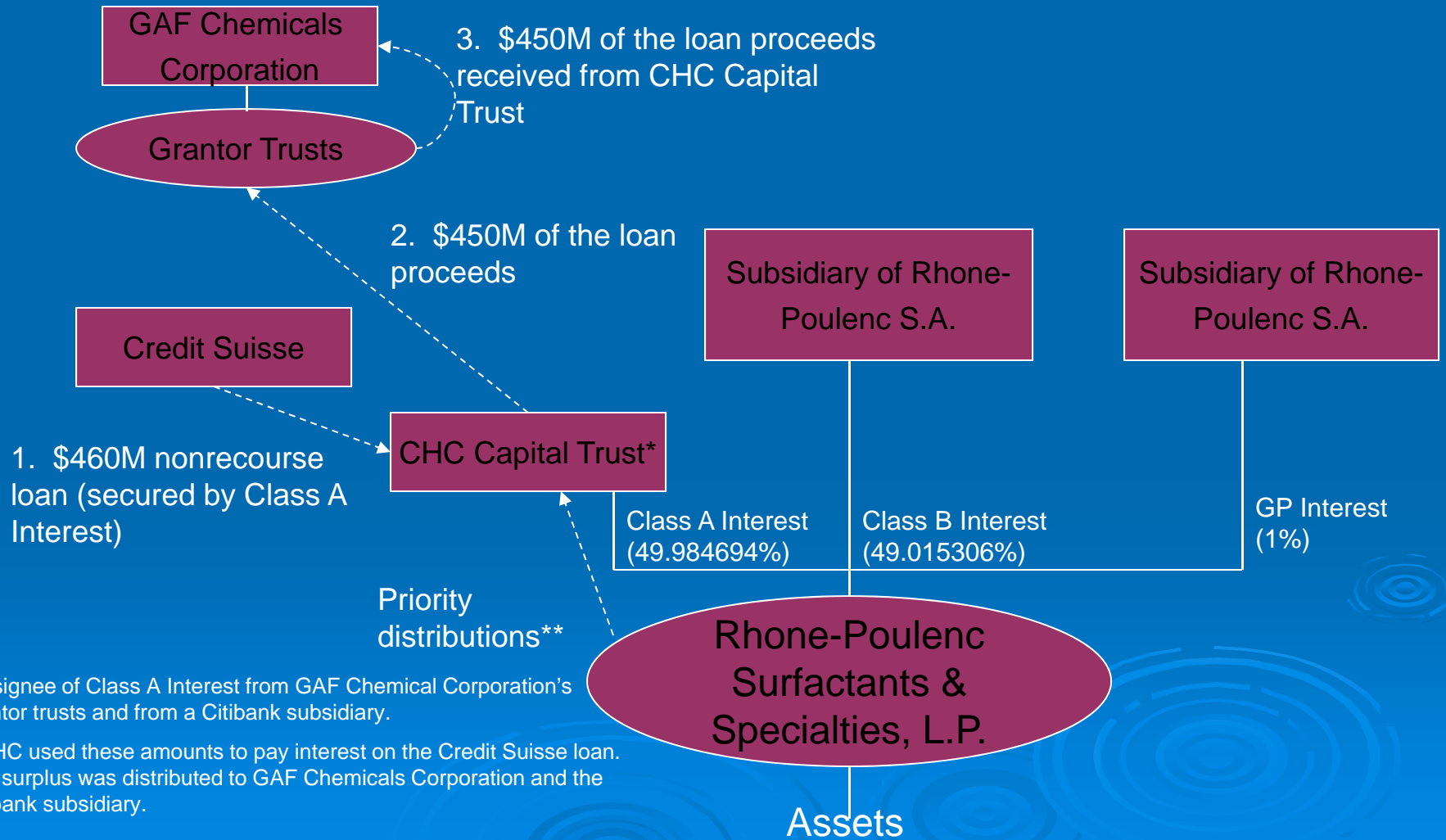
- GAF through two grantor trusts (the “GAF Trusts”) and a subsidiary of Citibank formed a limited partnership with Rhone Poulenc (“RP”):
  - GAF Trusts contributed chemicals business with value of \$480 million in exchange for 49% limited partner interest
  - Citibank contributed \$10 million in cash in exchange for a 1% limited partner interest
  - RP contributed certain chemicals business assets and cash with a value of approximately \$490 million in exchange for a 49% limited partner interest and a 1% general partner interest.

# *United States v. G-I Holdings Inc* – Borrowing Outside Partnership

- GAF Trusts and Citibank assigned limited partner interests to CHC, a grantor trust
  - GAF Trusts owned a 98% interest in CHC and Citibank owned a 2% interest in CHC.
  - CHC borrowed \$460 million on a nonrecourse basis secured by 50% limited partner interest
  - CHC distributed \$450 million of loan proceeds to GAF Trusts that was immediately distributed to GAF and \$10 million of loan proceeds to Citibank
  
- CHC was entitled to a 9.125% per annum cumulative preferred return on its \$490 million of capital, that was used to pay interest due on the loan



# United States v. G-I Holdings Inc – Borrowing Outside Partnership



\*Assignee of Class A Interest from GAF Chemical Corporation's grantor trusts and from a Citibank subsidiary.

\*\*CHC used these amounts to pay interest on the Credit Suisse loan. Any surplus was distributed to GAF Chemicals Corporation and the Citibank subsidiary.

# *United States v. G-I Holdings Inc* – Borrowing Outside Partnership

## ➤ The Decision

- Loan to partner recharacterized as in substance a loan to partnership
  - transactions carefully structured to create appearance that partner repaid the loan, but all repayment came from partnership
- Disguised sale under Section 707(a)(2)(B)
  - No risk of loss – nonrecourse loan where pledged collateral was interest in partnership
  - No profit potential as transaction costs exceeded anticipated profit
- Government's claim dismissed as time barred - three year rather than six year statute of limitations applied as no understatement of 25% under Section 6501(d)

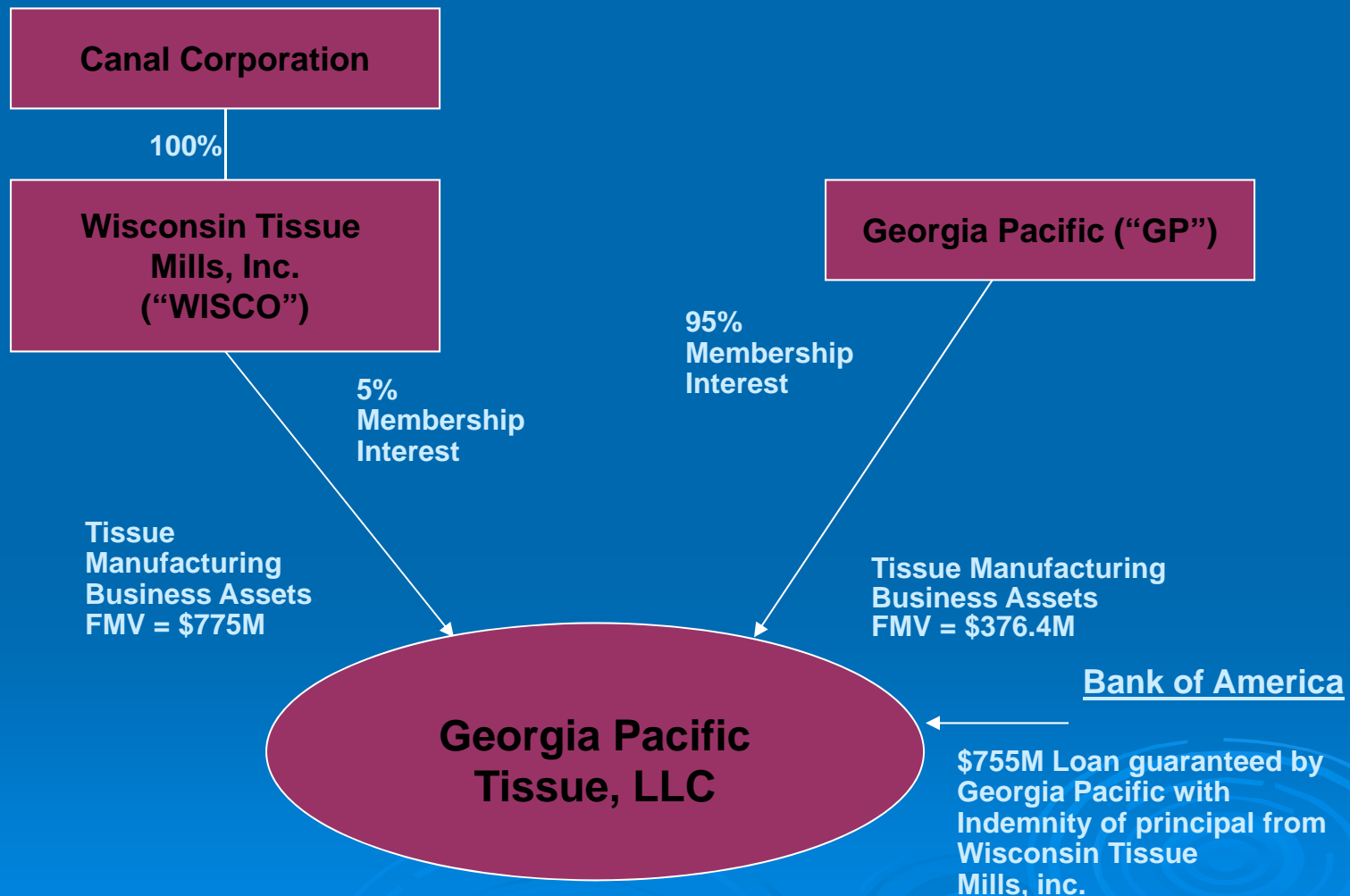
# *Canal Corp. v. Comm'r* – Leveraged Partnership

- WISCO and GP formed Georgia-Pacific Tissue LLC:
  - GP contributed tissue business with agreed value of \$376.4 million in exchange for a 95% interest
  - WISCO contributed tissue business with agreed value of \$775 million in exchange for a 5% interest in the LLC and a special cash distribution of approximately \$755 million
- LLC borrowed \$755.2 million from Bank of America, used to fund special cash distribution
  - Principal amount of Loan (and not interest) was guaranteed by GP pursuant to a guarantee of collection
  - WISCO agreed to indemnify GP for any principal payments GP was required to make
    - Indemnity provided that WISCO would receive a proportionately increased LLC interest if WISCO had to pay under indemnity

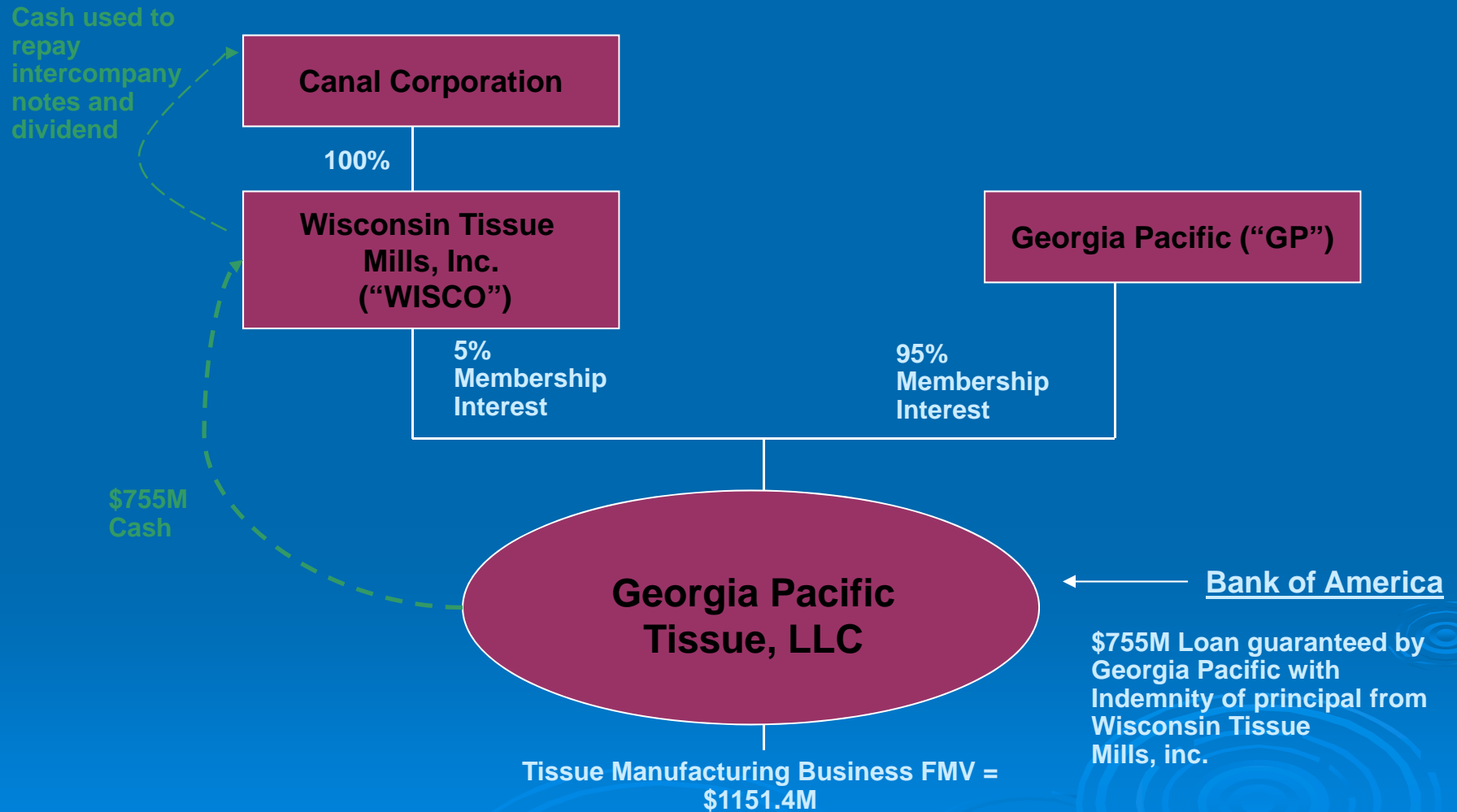
# *Canal Corp. v. Comm'r* – Leveraged Partnership

- WISCO used a portion of the proceeds from the special distribution to repay an intercompany loan, to pay a dividend to Chesapeake, and to lend \$151.05 million to Chesapeake in exchange for an intercompany note
  - Following the transaction, WISCO had a net worth of \$157 million, representing approximately 21% of its maximum exposure on the indemnity
- GP agreed to tax make-whole payment for early triggering of gain to WISCO
- PWC issued a “should” level tax opinion to WISCO

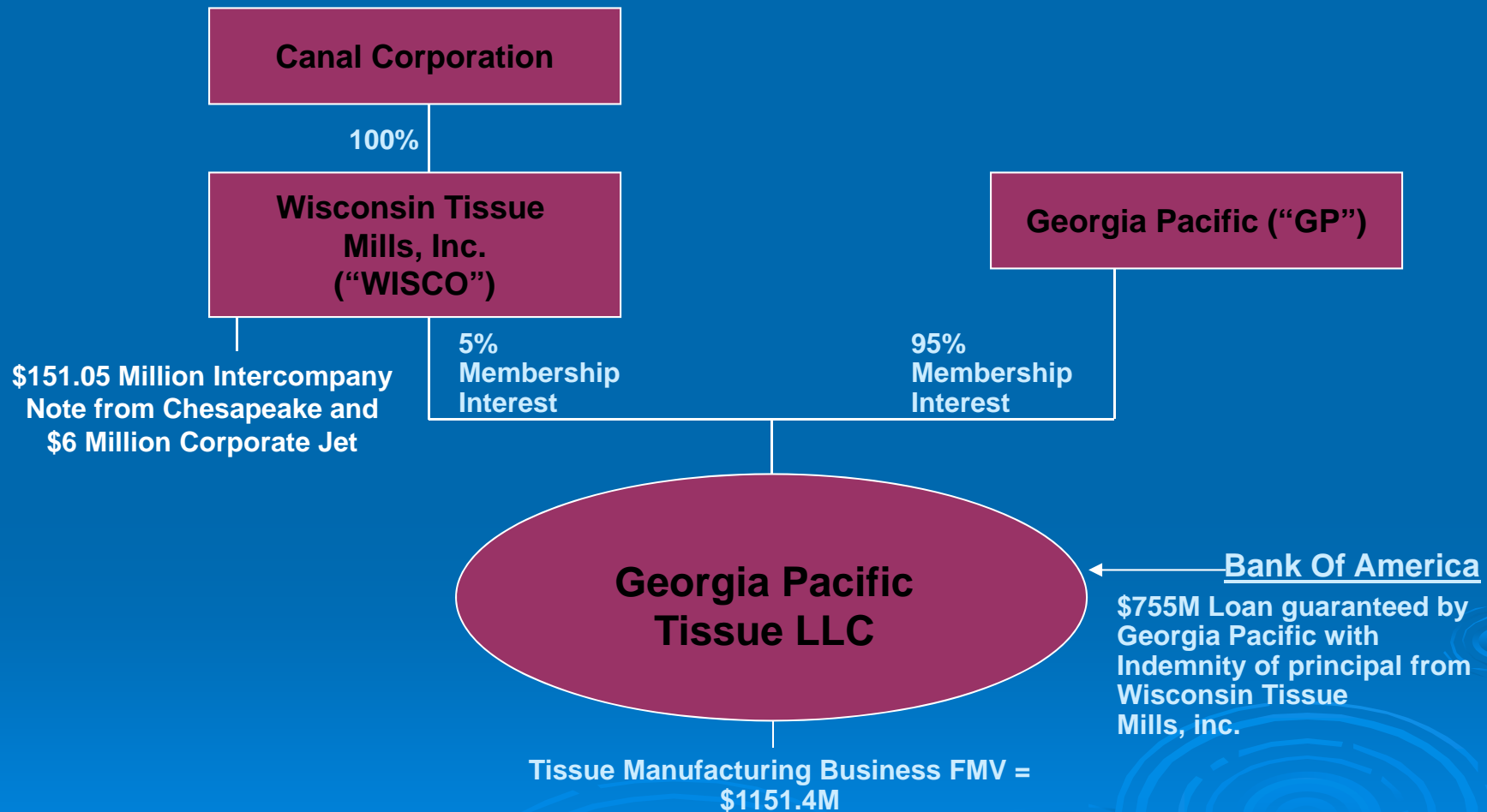
# Canal Corp. v. Comm'r – Leveraged Partnership



# Canal Corp. v. Comm'r – Leveraged Partnership



# Canal Corp. v. Comm'r – Leveraged Partnership



# *Canal Corp. v. Comm'r* – Leveraged Partnership

## ➤ The Decision

- Disguised sale rules except certain debt financed distributions to a partner in determining whether a partner received money or other consideration
- A distribution financed from the proceeds of a partnership liability may be taken into account for disguised sale purposes to the extent the distribution exceeds the distributee partner's allocable share of the partnership liability
- Partner's share of a recourse partnership liability generally equals the portion of that liability, if any, for which the partner bears the economic risk of loss, which it does to the extent that the partner would be obligated to make an unreimbursable payment to any person (or contribute to the partnership) if the partnership were constructively liquidated and the liability became due and payable
- Indemnity agreement generally is recognized as an obligation under the regulations, but IRS asserted that WISCO's agreement should be disregarded under the Reg. § 1.752-2(j) anti-abuse rule



# Canal Corp. v. Comm'r – Leveraged Partnership

- Anti-abuse rule provides that a partner's obligation to make a payment may be disregarded
  - if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's or related person's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise
- Tax Court:
  - Chesapeake crafted indemnity from WISCO, rather than Chesapeake to limit actual risk while creating appearance that Chesapeake bore the economic risk of loss when, in substance, it did not
  - Indemnity structured to reduce likelihood of GP invoking the indemnity
    - Indemnity only covered principal, which was due in 30 years, and not interest
    - Required GP to first proceed against the joint venture's assets before demanding indemnification from WISCO
    - To the extent WISCO paid on the indemnity, it would receive an increased interest in the LLC
  - The Tax Court stated that “[a] thinly capitalized subsidiary with no business operations and no real assets cannot be used to shield a parent corporation with significant assets from being taxed on a deemed sale.”

# Other Guidance

- CCA 200246014
  - Leveraged partnership where taxpayer took a cash distribution from a partnership
- CCA 200250013
  - Partnership borrowed against historic assets, bought new assets and distributed historic assets subject to debt to a partner in complete redemption
- TAM 200436011
  - Partners may not disproportionately allocate nonrecourse liabilities to a partner under Reg. § 1.752-3(a)(3) based upon partner's preferred return interest in the partnership
- ILM 200513022
  - Preferred interest in capital proceeds did not justify allocation of 100% of liabilities under Reg. § 1.752-3(a)(3) and transfer was a disguised sale under Section 707(a) that subjects the transferor to the Section 6662 accuracy-related penalty for a substantial understatement of tax

# Leveraged Partnerships – Current Planning and Transactional Considerations

# Facts and Circumstances

- In analyzing the structuring of a leveraged partnership it is most important to note that there is no “One Size Fits All” structure
- Analysis of each structure on its own merits, the economics of the transaction, the facts and the legal analysis based on existing law are critical
- Nothing contained herein can be relied upon as guidance on how to structure a leveraged partnership that will withstand judicial and administrative scrutiny as each transaction will need to be analyzed based on its own merits

# General Considerations

## ➤ **Transaction Structuring Process**

- Presentations to client management, officers, and board of directors, credit agencies, and other stakeholders
- Negotiations with third party bank and partner(s)
- Professionals – investment bankers, attorneys, accountants
- Be mindful of language – contribution rather than purchase and sale, partner/member rather than buyer

## ➤ **Accounting treatment and disclosures**

- GAAP treatment as sale – relevance when other clearly delineated nonrecognition transactions are also treated as sales for GAAP purposes
- Is transaction structured to avoid any disclosure obligation to the IRS? Does 3 or 6 year statute of limitations apply?

# General Considerations

## ➤ Investor Contribution

- Business/Real Estate/Operating Assets that are synergistic with assets of historic owner
- Business/Real Estate/Operating Assets that are not synergistic with assets of historic owner
- Financial Assets
- Cash

# Specific Issues / Considerations

## ➤ Capitalization

- What Level of Capitalization Is Required?
- Is Capitalization Determinative?
- Are interests determined based on remaining capital in deal?
- What residual percentage interest is necessary?
- What management rights are necessary?

# Specific Issues / Considerations

## ➤ Debt Structure

- Third Party Debt
- Related Party Debt
- Use of Indemnities

## ➤ Does the following impact analysis:

- Does asset value support debt?
- Will asset revenues support debt service?
- Do projections support debt repayment?
- Term of Debt?
- Refinancing of Debt – parameters, when? Can debt amount be increased? Can interest rate be changed?



# Specific Issues / Considerations

## ➤ **Section 704(c) Method**

- Remedial Allocation Method
- Curative Method
- Traditional Method

➤ **Does fact that Acquiror is put in same or better position than if purchased property by virtue of remedial/curative allocation impact analysis?**

➤ **Does fact that Taxpayer will receive ordinary income through remedial/curative allocation impact analysis?**

# Specific Issues / Considerations

## ➤ **Guarantee v. Indemnity -- Contractual Terms of Obligation**

- Waiver of rights of subrogation, reimbursement, exoneration or indemnity and any benefit of, and any other right to participate in, any security for the indebtedness
- Unconditional payment obligation in the event of default
- Principal only or Principal and interest?
- Collection v. Payment – obligation subject to the satisfaction of any additional conditions (e.g., proceeding against the partnership's assets before demanding payment)?
- Does the term of the payment obligation coincide with term of the indebtedness?
- Are there any early termination provisions (e.g., termination upon sale of or redemption from the partnership)?

# Specific Issues / Considerations

## ➤ **Guarantee v. Indemnity -- Contractual Terms of Obligation**

- Does guarantee or indemnity reduce by its terms over time?
- Is guarantee or indemnity for the entire debt, or only a portion?
- What is the enforceability of the guarantee or indemnity under State law?
- Rights to guarantee or indemnity on refinanced debt?
- Are there multiple obligors – clearly quantifying obligation of each?
- Are there competing guarantees that could result in obligation of guarantor being reduced?

# Specific Issues / Considerations

- **Guarantee v. Indemnity -- Contractual Terms of Obligation**
  - Net Worth of Guarantor/Indemnitor
  - Quality of assets of Guarantor/Indemnitor
  - Identity of Guarantor/Indemnitor in corporate structure
  - Actual Net Worth at time of entering into Guaranty/Indemnity
  - Subsequent change in Net Worth – relevance? If increase, can assets be removed? If decline - then what?
  - Capital Contribution obligation by parent of Guarantor/Indemnitor
  - Is Net Worth liquid assets or operating business? Valuation of business required?
  - Net Worth Covenant? Who should it run in favor of?  
Continuing obligation to establish Net Worth?

# Specific Issues / Considerations

- **Nonrecourse borrowing with Preferred Return**
  - Do assets inside partnership support the debt?
  - Are there special allocations that suggest one partner is bearing interest expense of the debt?
  - Is debt third party or related?
- **Preferred Return**
  - What is projected income allocation associated with Preferred Return?
  - What residual common percentage interest is required?
  - What preferred return income allocation constitutes a “significant item of partnership income or gain” for Reg. § 1.752-3(a)(3) purposes?

# Specific Issues / Considerations

## ➤ Lockout Protection

- Sale of assets
- Prohibition on debt repayment/amortization
- Time frame
- Amount
  - Indemnify for tax acceleration (time value of money)
  - Indemnify for tax payable
  - Indemnify for tax payable, including gross-up to pay for tax due on indemnity

# Specific Issues / Considerations

## ➤ Positive Covenants

- Specific assurances that the obligor will undertake certain actions in connection with its ability to satisfy its potential payment obligations
- Examples:
  - Legal provision requiring the maintenance of a minimum level of capital or assets (“Net Worth Covenant”)

## ➤ Negative or Restrictive Covenants

- Specific assurances that the obligor will NOT undertake certain actions that would undermine its ability to satisfy its potential payment obligations
- Examples:
  - Legal provision limiting the disposition of assets
  - Legal provision limiting the further encumbrance of assets (e.g., negative pledge clause)
  - Legal provision limiting the incurrence of additional indebtedness
  - Legal provision limiting the making of distributions or payments of dividends

# Specific Issues / Considerations

## ➤ Representations

- Level of due diligence required?
- Can tax advisors rely on representations from both taxpayers and non-legal advisors (i.e., economists)?
- Are covenants preferable to representations?
- Who should representations run to? Advisors, third party lenders, other partners?
- Are Net Worth Covenants/Representations enough?



# Specific Issues / Considerations

## ➤ Partnership Agreement Provisions

- Capital Contributions
  - Additional Capital Contributions v. Loans
  - Dilution
- Management Rights
  - Role in Management
  - Major Decisions/Voting rights
- Distribution Provisions/Profit and Loss Allocations
- Transfer Provisions
  - Puts/Calls
  - Right of First Refusal/First Offer
- Dissolution/Liquidation

# Other Considerations

- **Substance of the leveraged partnership transaction**
  - Substance Over Form Doctrine
  - Economic Substance Doctrine (Section 7701(o))
    - Sham Doctrine
      - Moline Properties and Culbertson-Tower Test
        - Business Purpose
    - Partnership Anti-Abuse Rule (Reg. § 1.701-2)
- **Fee Structure – flat fee/hourly/premium**
- **Role of advisor – longstanding advisor/new advisor/promoter**

# Other Considerations

## ➤ Opinions

- Reliance Opinions and Penalty Protection
- Can advisor who works on structuring transaction issue opinion?
- Opinion(s) - contingent?
- Separate planning practice/opinion practice needed?
- Role of second opinion
- Assumptions used in opinion

# Summary

## ➤ Questions to ask

- Does obligation substantively give rise to an economic risk of loss to the obligor?
- Contractual terms of payment obligation negotiated based on arm's length terms and conditions?
  - Generally provide sufficient legal protections regarding the obligor's wherewithal to make a payment
- Retention of significant interest in partnership?
- Guarantee or Indemnity – quality and value of assets that support guarantee or indemnity/remoteness of guarantee/is guarantee of collection or payment?