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Partnership Tax Planning Without Falling into the Canal (outline)

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PARTNERSHIP TAX PLANNING
WITHOUT FALLING INTO THE CANAL

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I. Introduction

A. In *Canal Corporation v. Commissioner*,[1] the Tax Court analyzed the application of the partnership disguised sale rules under section 707(a)(2)(B) and the regulations thereunder to a "leveraged partnership" transaction.[2] Judge Kroupa held that the transaction at issue failed to qualify for the exception to partnership disguised sale treatment for certain debt-financed distributions, finding that the anti-abuse rule contained in the partnership liability allocation regulations under section 752 applied.

B. In addition, Judge Kroupa found that the taxpayer was subject to an accuracy-related penalty under section 6662(a) despite the fact that the taxpayer had obtained a "should" level tax opinion from a "Big Four" accounting firm that the transaction was not taxable. Judge Kroupa held that the taxpayer could not rely on the tax opinion to avoid the application of the accuracy-related penalty because, in the court's view, the opinion was tainted by an "inherent conflict of interest" for several reasons, including the fact that the accounting firm had advised the taxpayer regarding the structure of the transaction. The court imposed the accuracy-related penalty without discussing whether the taxpayer had substantial authority for its position.

C. This outline summarizes the transaction at issue in *Canal* and analyzes the Tax Court's holdings. As discussed below, we disagree with the court's conclusion on the partnership disguised sale issue. In addition, we believe that the court's analysis regarding the application of the accuracy-related penalty is seriously flawed and that the court's conclusion is incorrect.

D. Unfortunately, on October 28, 2010, the taxpayer issued a press release stating that the company is bankrupt and intends to settle the United States' approximately $106.7 million claim for 50% of the company's $4 million of assets. Although the taxpayer filed an appeal to the Fourth Circuit on October 29,

[1] 135 T.C. No. 9, Dec. 58,298 (2010).
[2] Unless otherwise noted or clear from context, section references contained herein are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

2010 we understand that if the settlement is approved by the Bankruptcy Court, the appeal will not be pursued.

E. This outline also discusses leveraged partnership transaction structuring issues to consider in light of *Canal*.

II. **Summary of the Facts at Issue in *Canal***

A. Canal Corporation (f/k/a Chesapeake Corporation) ("Chesapeake") owned 100% of the stock of Wisconsin Tissue Mills, Inc. ("WISCO"), which (along with other subsidiaries) filed a consolidated Federal income tax return with Chesapeake as the common parent. WISCO was in the business of manufacturing commercial tissue paper products. Due to consolidation in the tissue industry in the late 1990's, WISCO's tissue business was smaller than its competitors.[3] As a result, Chesapeake decided to dispose of its tissue business and concentrate on its specialty packaging business.[4] Chesapeake had a low tax basis in WISCO. Accordingly, an outright sale of Chesapeake's tissue business would have generated a large tax liability.[5]

B. Chesapeake decided to dispose of the business operated by WISCO through a leveraged partnership structure (the "Transaction") with Georgia Pacific ("GP"), which was also in the tissue paper manufacturing business. Chesapeake engaged Salomon Smith Barney and PricewaterhouseCoopers ("PWC") to assist Chesapeake in negotiating and documenting the Transaction. PWC had served as Chesapeake's auditor and tax preparer for many years.[6] PWC and Chesapeake entered into an engagement letter on September 21, 1999, pursuant to which PWC agreed to provide certain specified services to Chesapeake in exchange for an $800,000 fee.[7] These services included (1) issuing a tax opinion in connection with the Transaction (the "Tax Opinion"), (2) overall business and tax consulting regarding issues related to the joint venture with GP, including formation, operations and dissolution, and (3) consultation on an unrelated transaction.[8] The PWC Engagement Letter stated that PWC would bill Chesapeake for these services on the closing of the financing to be entered into in connection with the Transaction. The court construed the terms of the PWC Engagement Letter as providing that the $800,000 fee was contingent on PWC delivering a "should" level tax opinion regarding the tax consequences of the Transaction.[9] However, the PWC Engagement Letter does not, on its face, provide for such a contingency.

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[3] Opening Brief for Petitioner (February 9, 2010) ("Chesapeake's Brief"), at 3-4.
[4] *Id*. at 4.
[5] *Id*.
[6] *Supra* note 1, at 9.
[7] *See* Letter from PWC to Chesapeake, dated September 21, 1999 (the "PWC Engagement Letter"), Docket No. 14090-06, Exhibit 53-J .
[8] *Id*.
[9] *Supra* note 1, at 37.

C. The basic terms of the leveraged partnership structure were set forth in a Letter of Intent dated June 25, 1999.[10] The parties then negotiated the specific terms of the Transaction over an approximately three-month period, and the Transaction closed on October 4, 1999 (the "Closing Date").

D. In the Transaction, WISCO and GP formed Georgia-Pacific Tissue LLC (the "LLC") and contributed assets associated with their respective tissue manufacturing businesses to the LLC. GP contributed assets with an agreed value of $376.4 million in exchange for a 95% interest in the LLC.[11] WISCO contributed assets with an agreed value of $775 million in exchange for a 5% interest in the LLC and a special cash distribution of approximately $755 million.[12] The special cash distribution was funded with the proceeds from a loan from Bank of America (the "BofA Loan").[13] The BofA Loan had a maturity date of the earlier of 180 days from the Closing Date or March 21, 2000. In the LLC operating agreement, WISCO and GP contemplated the refinancing of the BofA Loan with long-term (30-year) debt after closing the Transaction.[14] The LLC did in fact refinance the BofA Loan with two 30-year loans from an affiliate of GP on November 12, 1999 and May 1, 2000 (collectively, the "Refinance Loans").[15] The obligations of the LLC under the BofA Loan and the Refinance Loans were unconditionally guaranteed by GP.[16]

E. WISCO agreed to indemnify GP for any payments of the original principal amount of the BofA Loan or the Refinance Loans that GP was required to make under its guarantee.[17] Interest on the principal amount was not covered by the indemnity. In addition, WISCO's indemnity provided that WISCO would have no obligation to make a payment under its guarantee until GP had exhausted its rights to reimbursement or recovery from the LLC or the LLC's assets.[18] Accordingly, WISCO's indemnity was an indemnity of collection rather than an indemnity of payment. The indemnity also provided that WISCO would be subrogated to GP's rights against the LLC to the extent of any payment it made to GP under the indemnity.[19] WISCO also had the option to obtain an increased interest in the LLC in satisfaction of its subrogation rights against the LLC.[20] However, the indemnity specifically provided that WISCO would have no right to pursue GP or any other member of the LLC for reimbursement for any payments WISCO made under the indemnity.[21] The indemnity provided that it could be

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10 Chesapeake's Brief at 6.
11 *Supra* note 1, at 14.
12 *Id*.
13 *Id*.
14 Brief for Respondent, dated February 9, 2010 ("IRS Brief"), at 40.
15 *Id*.
16 Tax Opinion from PWC to Chesapeake, dated October 4, 1999 (the "Tax Opinion"), Docket No. 14090-06, Exhibit 157-P, at 7.
17 *Id*.
18 *Id*.
19 *Id.* at 7-8.
20 *Id.* at 8.
21 *Id*.

terminated on the third anniversary of the Closing Date or any subsequent anniversary with at least 15 days notice, but only if there was no default on the BofA Loan or the Refinance Loans and neither WISCO nor an affiliate of WISCO owned an interest in the LLC.[22]

F. GP agreed to indemnify WISCO for any tax cost WISCO might incur if GP were to buy out WISCO's interest in the LLC.[23]

G. WISCO used a portion of the proceeds from the special distribution to repay an intercompany loan to another subsidiary of Chesapeake.[24] WISCO used the remaining proceeds of the special distribution to pay a dividend to Chesapeake, repay amounts owed to an affiliate of Chesapeake, and to make a $151.05 million intercompany loan to Chesapeake.[25] Following the closing of the Transaction, WISCO's assets included the $151.05 million intercompany note from Chesapeake and a corporate jet with a value of approximately $6 million. Accordingly, WISCO's net worth represented approximately 21% of its maximum exposure on the indemnity.[26]

H. PWC issued the Tax Opinion to WISCO on the Closing Date, which concluded at a "should" level of comfort[27] that the LLC qualified as a partnership for tax purposes, WISCO was a partner, and the distribution to WISCO qualified for the debt-financed distribution exception to the partnership disguised sale regulations under section 707(a)(2)(B).[28] Further, in connection with the Refinance Loans, PWC issued two additional opinions on November 23, 1999, and on August 3, 2000, with respect to whether the Refinance Loans would have an impact on the conclusions reached in the Tax Opinion. The author of PWC's two additional opinions was not the same as the author of the Tax Opinion.[29] The two additional opinions recited that the Tax Opinion had been issued, that the author of the additional tax opinions had examined the Transaction documents, and concluded that the Refinance Loans should not cause the Transaction to be treated as a disguised sale for Federal income tax purposes.[30]

I. The LLC operated for only approximately one year. In 2001, because of antitrust considerations, GP was required to sell its interest in the LLC in order to

[22] *Id*.
[23] *Id*. at 11.
[24] *Id*. at 15.
[25] *Id*.
[26] *Id*.
[27] A PWC representative testified that a "should" level tax opinion is the highest level of comfort that PWC offers to a client regarding whether the position taken by the client will succeed on the merits. *Id.* At 34.
[28] We note that the Tax Court stated that only a draft of the Tax Opinion was submitted into evidence. However, our review of the record indicates that the final Tax Opinion that was issued on the Closing Date was in fact submitted into evidence. The document that the Tax Court refers to as a draft tax opinion is actually a draft of a supporting memorandum for the Tax Opinion (the "Supporting Memorandum").
[29] Chesapeake's Brief at 28.
[30] Id. at 27-28.

consummate another acquisition transaction.[31] As a result, GP negotiated a transaction for the sale of 100% of the interests in the LLC. In connection with this transaction, WISCO agreed to sell its interest in the LLC for $41 million, which represented a gain of $21.2 million.[32] In connection with the sale of the LLC interests, GP paid WISCO $196 million to compensate WISCO for the loss of tax deferral associated with the Transaction.[33] Chesapeake reported $524 million of capital gain on its consolidated income tax return for 2001. Chesapeake also reported $196 million of ordinary income in 2001 with respect to the indemnity payment it received from GP.[34] Following the sale in 2001, WISCO declared a dividend of $166 million to Chesapeake in cancellation of Chesapeake's intercompany note to WISCO.[35]

J. The Internal Revenue Service (the "IRS") issued Chesapeake a deficiency notice for 1999 in which the IRS determined that the Transaction constituted a disguised sale of assets under section 707(a)(2)(B) that resulted in $524 million of capital gain in 1999. The IRS also argued that the Transaction should be recast as a sale under the substance-over form and economic substance doctrines.[36] In addition, the IRS asserted a $36.7 million accuracy-related penalty under section 6662 for a substantial understatement of income tax in connection with Chesapeake's reporting of the Transaction on its 1999 consolidated Federal income tax return.[37] Chesapeake argued that the Transaction was not a disguised sale because it qualified for the debt-financed distribution exception to disguised sale treatment under Treas. Reg. § 1.707-5(b)(2).

III. <u>**Application of the Partnership Disguised Sales Rules**</u>.

A. As noted above, the IRS argued that the Transaction should be recast as a sale both under the technical requirements of section 707(a)(2)(B) and under general substance over form or economic substance grounds. The Tax Court, however, limited its analysis to the application of the technical requirements of section 707(a)(2)(B) and the regulations thereunder to the Transaction, as discussed below. Given the explicit provisions of the regulations that address the fact pattern raised by the Transaction, we believe that the Tax Court's rejection of the IRS's economic substance and substance over form arguments was appropriate.

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[31] *Supra* note 1, at 17.
[32] *Id*. at 18.
[33] *Id*.
[34] *Id*.
[35] *Id*.
[36] IRS Brief at 99-104.
[37] *Id*. The amount of the accuracy-related penalty plus approximately $28 million of interest on the penalty exceeded the asserted deficiency of $42 million. As noted above, because Chesapeake reported its deferred gain associated with the Transaction in 2001, the deficiency related only to the interest accrued on this amount from 1999 through 2001.

B. Partnership Disguised Sales – In General

1. Section 707(a)(2)(B) provides that, if

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

> such transfers shall be treated either as a transaction occurring between the partnership and one who is not a partner or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

2. Similarly, the regulations under section 707(a)(2)(B) provide that

> A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances –
>
> (i) The transfer of money or other consideration would not have been made but for the transfer of property; and
>
> (ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[38]

3. Regarding the requirement in section 707(a)(2)(B)(iii) that "the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property," the Conference Report relating to the disguised sale legislation in 1984 states:

> 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

[38] Treas. Reg. § 1.707-3(b).

> 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. However, to the extent the other partners directly or indirectly bear the risk of loss with respect to the borrowed amounts, this may constitute a payment to the contributing partner.[39]

4. The regulations under section 707(a)(2)(B) implement this “borrowing through the partnership” exception to disguised sale treatment. Specifically, Treas. Reg. § 1.707-5(b)(2) provides:

> For purposes of §1.707-3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability.

5. In the case of a recourse partnership liability, a partner’s “allocable share” of the partnership liability is equal to the partner’s share of the liability determined under the section 752 regulations, multiplied by a fraction, the numerator of which is the portion of the proceeds that are distributed to the partner and the denominator of which is the total amount of the liability.[40]

C. <u>Allocation of Recourse Liabilities Under Section 752</u>

1. Under the section 752 regulations, a recourse partnership liability is allocated to a partner to the extent that such partner bears the “economic risk of loss” for the liability. A partner is treated as bearing the economic risk of loss for a partnership liability to the extent that, if the partnership’s assets were worthless and the partnership liquidated, the partner or a related person would be obligated to make a payment because the liability becomes due and payable. For this purpose, obligations of the partner or a

[39] H.R. Rep. H.R. Rep. No. 98-861, at 862 (1984).
[40] Treas. Reg. § 1.707-5(b)(2).

related person with respect to the liability, including obligations to the lender, the partnership or other partners, are taken into account.[41]

2. In order to determine who bears the economic risk of loss for a recourse liability, the regulations employ a mechanical "constructive liquidation" test. Treas. Reg. § 1.752-2(b)(1) provides that upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

- All of the partnership's liabilities become payable in full;

- With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;

- The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);

- All items of income, gain, loss, or deduction are allocated among the partners; and

- The partnership liquidates.

3. A partner bears the economic risk of loss for a liability to the extent that if the partnership constructively liquidated, the partner (or a related person) would be obligated to pay a creditor or make a contribution to the partnership because the liability would be due and the partner (or related person) would not be entitled to reimbursement.[42] Treas. Reg. § 1.752-2(b)(3) provides that all statutory and contractual obligations relating to the partnership liability are taken into account for purposes of determining which partner bears the economic risk of loss, including contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership; obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.[43] Special rules apply

[41] Treas. Reg. § 1.752-2(b).
[42] *Id*.
[43] For a general discussion of these rules, *see* Blake D. Rubin, Andrea M. Whiteway and Jon G. Finkelstein, *Working With the Partnership Liability Allocation Rules: Guarantees, DROs and More*, 68 N.Y.U. Federal Tax Institute Ch. 8 (2010).

when the obligation is imposed on an entity that is disregarded as separate from its owner, such as a single-member limited liability company.[44] In addition, a partner is considered to bear the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner.[45]

4. The section 752 regulations contain a presumption that a partner or related person will in fact satisfy an obligation to make a payment to a creditor or the partnership in connection with the constructive liquidation of the partnership.

5. Specifically, Treas. Reg. § 1.752-2(b)(6) provides that, 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, <u>irrespective of their actual net worth</u>, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. [Emphasis added].

6. However, the section 752 regulations also contain an anti-abuse rule, pursuant to which a partner's or a related person'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.[46]

7. Treas. Reg. § 1.752-(j)(4) contains the following example of an arrangement that would be subject to the section 752 anti-abuse rule:

8. A and B form a general partnership. A, a corporation, contributes $20,000 and B contributes $80,000 to the partnership. A is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to A and 80% to B until B's capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a $150,000 recourse loan from a bank. B guarantees payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. <u>A is a subsidiary, formed</u>

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[44] Treas. Reg. § 1.752-2(k). For a discussion of these rules, *see* Blake D. Rubin, Andrea M. Whiteway and Jon G. Finkelstein, *Final Regulations on the Treatment of Disregarded Entities Under Code Sec. 752: Questions and Complexities Continue*, 10 Journal of Passthrough Entities No. 2 (2007). These rules were not applicable to the tax year at issue in *Canal*.

[45] Treas. Reg. § 1.752-2(c).

[46] Treas. Reg. § 1.752-2(j).

by a parent of a consolidated group, with capital limited to $20,000 to allow the consolidated group to enjoy the tax losses generated by the property while at the same time limiting its monetary exposure for such losses. These facts, when considered together with B's guarantee, indicate a plan to circumvent or avoid A's obligation to contribute to the partnership. The rules of section 752 must be applied as if A's obligation to contribute did not exist. Accordingly, the $150,000 liability is a recourse liability that is allocated entirely to B. [Emphasis added.]

9. The IRS has previously asserted the application of the section 752 anti-abuse rule in ILM 200246014. In that case, a subsidiary of the taxpayer that was a partner in a partnership guaranteed a partnership liability, the proceeds of which were distributed to the partner. In concluding that the subsidiary's guarantee should be disregarded under the section 752 anti-abuse rule, the IRS noted that the subsidiary partner was "severely undercapitalized with respect to the loan guarantee."[47]

IV. **Court's Analysis Regarding Application of Debt-Financed Distribution Exception**

A. In its analysis of the application of the debt-financed distribution exception to disguised sale treatment to the Transaction, Judge Kroupa focused on the fact that WISCO, rather than Chesapeake, served as the indemnitor with respect to the BofA Loan and the Refinance Loans. Specifically, the court noted that "WISCO was chosen as the indemnitor, rather than Chesapeake, after PWC advised Chesapeake's executives that WISCO's indemnity would not only allow Chesapeake to defer tax on the transaction, but would also cause the economic risk of loss to be borne only by WISCO's assets, not Chesapeake's."[48] The court also noted that the indemnity agreement did not obligate WISCO to maintain a specified net worth.[49] Accordingly, the court analyzed the transaction under the section 752 anti-abuse rule. The court determined that the anti-abuse rule contained in Treas. Reg. § 1.752-2(j) was applicable to the transaction because WISCO's indemnity created the appearance that it bore the economic risk of loss when, in substance, it did not. Judge Kroupa stated:

> WISCO's principal asset after the transfer was the intercompany note. The indemnity agreement did not require WISCO to retain this note or any other asset. Further, Chesapeake and its management had full and absolute control of WISCO. Nothing restricted Chesapeake from cancelling the note at its discretion at any time to reduce the asset level of WISCO to zero.[50]

[47] *See* Blake D. Rubin and Andrea Macintosh Whiteway, *Here Comes the Kitchen Sink: IRS Throws 'Everything But' at Two Partnership Tax Deferral Structures*, 6 Journal of Passthrough Entities No. 2 (2003).
[48] *Supra* note 1, at 24.
[49] *Id.*
[50] *Id*. at 26.

B. The court found that the structure at issue was not distinguishable from the example in the section 752 anti-abuse regulation.

> [T]his appears to be a concerted plan to drain WISCO of assets and leave WISCO incapable, as a practical matter, of covering more than a small fraction of its obligation to indemnify GP. We find this analogous to the illustration [in the section 752 anti-abuse regulation] because in both cases the true economic burden of the partnership debt is borne by the other partner as guarantor. Accordingly, we do not find that the anti-abuse rule illustration extricates Chesapeake, but rather it demonstrates what Chesapeake strove to accomplish.[51]

C. The 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."[52] As a result, the court held that the distribution of cash to WISCO did not qualify for the debt-financed distribution exception to the disguised sale rules and that the transaction should be recast as a sale of WISCO's business assets to GP in 1999.[53]

D. While we acknowledge that the structure of the Transaction, with an indemnity from a subsidiary of limited net worth rather than the parent of a consolidated group, raises an issue under the section 752 anti-abuse rule, we do not agree that WISCO's indemnity should be disregarded. WISCO's net worth supporting its indemnity obligation bears no resemblance to the net worth of partner A in the example set forth in Treas. Reg. § 1.752-2(j)(4). In the example, A's net worth is limited to the value of its interest in the partnership. As noted above, for purposes of the constructive liquidation test set forth in Treas. Reg. § 1.752-2(b)(1), it is assumed that all assets of the partnership are worthless, including cash. As a result, an analysis of the allocation of the partnership's recourse debt in the example requires one to assume that the value of A's interest in the partnership is $0 and, therefore, A's net worth is $0. In contrast, WISCO's net worth on the Closing Date, not taking into account its interest in the LLC, was approximately $156 million.

E. In addition, we note that, although WISCO did not enter into an agreement with GP to maintain its net worth in connection with its indemnity, it did represent to PWC in connection with the issuance of the Tax Opinion that it would hold assets with a net fair market value greater than or equal to $151 million at all times during which the WISCO's indemnity remained in effect.[54] The Tax Opinion could only be relied upon by Chesapeake to the extent that WISCO's representations were true. As noted repeatedly by the Tax Court, WISCO likely

[51] *Id*. at 27-28.
[52] *Id.* at 27.
[53] *Id.* at 30.
[54] *See* Certificate of WISCO, dated October 4, 1999, attached to the Tax Opinion (the "WISCO Certificate").

would not have participated in the Transaction if it had been structured as a taxable transaction.[55] Accordingly, WISCO had a significant incentive to maintain its net worth in accordance with its representation to PWC at a level far in excess of the net value of the partner in the section 752 anti-abuse regulation example. In fact, WISCO did maintain its net worth until its interest was sold to GP in 2001. Further, unlike the example in the section 752 anti-abuse regulation, WISCO was not a newly formed entity created to shelter Chesapeake from liability. WISCO was the historic owner of the assets contributed to the LLC.

F. Given the purely mechanical nature of the partnership recourse liability allocation rules in the section 752 regulations, which do not take into account the actual net worth of partners for purposes of allocating partnership recourse liabilities, and the fact that WISCO's indemnity is distinguishable from the extreme example set forth in the section 752 anti-abuse rule involving a newly created entity partner with $0 of net worth, we do not agree that WISCO's indemnity should be disregarded.

G. The court also found that the terms of the indemnity reduced the likelihood of GP invoking the indemnity against WISCO, thereby further creating the appearance that WISCO bore the economic risk of loss when it in fact did not. The terms of the indemnity that troubled Judge Kroupa include the fact that the indemnity only covered principal and not interest; that GP had to first proceed against the joint venture's assets before demanding indemnification from WISCO; and that, to the extent WISCO paid on the indemnity, it would receive an increased interest in the LLC.[56] The court's analysis regarding whether it was likely that WISCO would have to satisfy its indemnity is wholly inconsistent with the constructive liquidation test mandated by the section 752 regulations. The constructive liquidation test is by its nature hypothetical and requires assumptions that are unlikely if not impossible to occur (e.g., that cash become worthless). The point of the test is to assess who bears the ultimate risk of loss, regardless of how remote such risk may be.

H. Regarding WISCO's guarantee of principal, the section 752 regulations clearly provide that such a guarantee is effective to treat the guarantor as bearing the economic risk of loss for the guaranteed principal. Treas. Reg. § 1.752-2(f), *Example 5* states as follows:

I. A partnership borrows $10,000, secured by a mortgage on real property. The mortgage note contains an exoneration clause which provides that in the event of default, the holder's only remedy is to foreclose on the property. The holder may not look to any other partnership asset or to any partner to pay the liability. However, to induce the lender to make the loan, a partner guarantees payment of $200 of the loan principal. The exoneration does not apply to the partner's guarantee. If the partner paid pursuant to the guarantee, the partner would be

[55] *See supra* note 1, at 7, 8-9, 37.
[56] *Id*. at 24.

subrogated to the rights of the lender with respect to $200 of the mortgage debt, but the partner is not otherwise entitled to reimbursement from the partnership or any partner. For purposes of section 752, $200 of the $10,000 mortgage liability is treated as a recourse liability of the partnership and $9,800 is treated as a nonrecourse liability of the partnership. The partner's share of the recourse liability of the partnership is $200.

J. Thus, the example confirms that a guarantee of principal (without a guarantee of interest) shifts the economic risk of loss to the guarantor. The court does not analyze or even cite this example in its analysis.

K. Further, the fact that WISCO's indemnity was an indemnity of collection should have no bearing on whether WISCO bore the economic risk of loss for the BofA Loan or the Refinance Loans. The section 752 regulations simply do not take into account the likelihood that an obligation will need to be satisfied in determining whether a partner bears the economic risk of loss for a liability. As discussed above, the deemed liquidation analysis set forth in Treas. Reg. § 1.752-2(b)(1) mandates that all assets of the partnership are deemed to be worthless in determining whether a partner bears the economic risk of loss with respect to a partnership liability. Treasury determined not to require an analysis of the credit risk associated with a loan in connection with the evaluation of whether a partner has an obligation to make a payment with respect to a partnership liability and opted instead to utilize the deemed liquidation analysis. Accordingly, pursuant to these rules, tax practitioners are comfortable that a partner's "bottom" guaranty of a well-secured partnership liability should be taken into account as an obligation despite the fact that there is a very low likelihood that the partner would actually ever have to make a payment with respect to such a guaranty.[57] We also note that the section 704(b) regulations specifically address the consequences of a "bottom" guarantee on the computation of "minimum gain" under the section 704(b) regulations, but do not in any way suggest that the "bottom" guarantee is illusory or should be disregarded.[58] Similarly, Treas. Reg. § 1.737-4(b), *Example 2* involves a fact pattern in which a partner guarantees a partnership nonrecourse debt with a principal purpose of increasing the partner's basis under section 752(a) and avoiding gain under section 737.[59] Notwithstanding this malicious principal purpose, the example concludes that the basis increase under section 752(a) must be given effect and that the section 737 gain is therefore avoided.

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[57] A "bottom guarantee" is a guarantee of the last dollars of the liability, which is the least risky portion of the liability. *See* Terrence Floyd Cuff, *Investing in an UPREIT – How the Ordinary Partnership Provisions Get Even More Complicated*, 102 Journal of Taxation 43 (January 2005); John P. Napoli and John F. Smith, *Emerging Issues in UPREIT Transactions*, 26 Journal of Real Estate Taxation No. 3 (Spring 1999); Blake D. Rubin, Andrea Macintosh Whiteway and Jon G. Finkelstein, *Handling UPREIT and DownREIT Transactions: Latest Techniques and Issues*, 65 N.Y.U. Federal Tax Institute Ch. 7 (2007). To be clear, WISCO's indemnity was not a bottom indemnity.

[58] Treas. Reg. § 1.704-2(m), *Example 1(vii)*.

[59] Section 737 generally requires gain recognition in the case of certain distributions of property to a partner to the extent the fair market value of the property exceeds the partner's basis in the partnership interest.

Accordingly, the fact that a guaranty may be tax motivated should not impact the section 752 analysis with respect to the allocation of debt.

L. Likewise, because the section 752 regulations mandate the assumption that all of the LLC's assets are worthless, the fact that GP must pursue all of the assets of the LLC prior to making a claim on the indemnity should have no impact on the analysis of whether WISCO has an obligation to make a payment for purposes of Treas. Reg. § 1.752-2(b). The pursuit of the LLC's assets under the assumptions required by the regulations would not prevent WISCO from having to satisfy its indemnity.

M. Similarly, the fact that WISCO had the option to receive an additional interest in the LLC in satisfaction of its subrogation rights with respect to payments made under the indemnity should have no impact on the analysis of whether WISCO's indemnity should be taken into account for purposes of section 752. The section 752 regulations clearly allow a capital contribution obligation to be taken into account as an obligation for purposes of allocating partnership recourse liabilities despite the fact that such a contribution will generally result in the contributing partner receiving both an additional capital and profits interest in the partnership.[60] Under the deemed liquidation analysis, such an additional interest in the partnership is worthless and therefore is not taken into account as a reimbursement right. Similarly, under the section 752 regulations' deemed liquidation test, WISCO's option to receive an additional interest in the LLC was worthless and should have no impact on the analysis as to whether WISCO had a payment obligation.

N. Finally, we note that the Tax Court's partnership disguised sale analysis did not take into account the capital expenditures that WISCO had incurred with respect to the assets contributed to the LLC. The WISCO Certificate states that WISCO made in excess of $47 million of capital expenditures with respect to the assets contributed to the LLC during the two years immediately preceding the Closing Date. Further, the WISCO Certificate states that the fair market value of the property resulting from the capital expenditures made by WISCO with respect to the contributed assets during the two years immediately preceding the Closing Date was at least $40 million as of the Closing Date. Treas. Reg. § 1.707-4(d) provides:

> (d) *Exception for reimbursements of preformation expenditures.* – A transfer of money or other consideration by the partnership to a partner is not treated as a part of a sale of property by the partner to the partnership under § 1.707-3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that –

[60] *See* Treas. Reg. § 1.752-2(b)(3).

(1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(2) Are incurred by the partner with respect to –

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

O. Under this exception to disguised sale treatment, even if WISCO's indemnity obligation is disregarded, at least $46 million of the distribution should have been analyzed as a nontaxable reimbursement of WISCO's preformation expenditures. The court did not analyze or even cite the pre-formation expenditures exception to partnership disguised sale treatment.

P. Fundamentally, the court seemed to be uncomfortable treating the Transaction as a nontaxable partnership distribution because it felt the Transaction resembled a sale. While a leveraged partnership, like a sale, results in the taxpayer receiving cash proceeds, so does a borrowing. As noted above, Congress specifically directed that such a transaction should not result in taxable gain because it viewed it as essentially equivalent to a borrowing through the partnership. Treasury issued Treas. Reg. § 1.707-5(b)(2) at Congress's direction. The disguised sale regulations, including the section 752 liability allocation rules incorporated therein, are extremely detailed and mechanical and taxpayers should be entitled to rely on them in planning their transactions. Although a debt-financed distribution, a direct borrowing and a sale all may result in the receipt of cash proceeds, the tax consequences are different and taxpayers are not obligated to structure transactions in a manner that maximizes their taxable income.[61]

V. <u>Application of Accuracy-Related Penalty</u>

A. Having concluded that the transaction at issue constituted a disguised sale, the court then analyzed whether the accuracy-related penalty for a substantial understatement of income tax under section 6662(a) should apply to Chesapeake.[62] A substantial understatement of income tax exists for a corporation if the amount of the understatement exceeds the greater of 10% of the

[61] *See e.g., Salyersville National Bank v. U.S.*, 613 F.2d 650, 653 (6th Cir. 1980).
[62] *Supra* note 1, at 30.

tax required to be shown on the return, or $10,000.[63] The accuracy-related penalty does not apply, however, to any portion of an understatement to the extent that a taxpayer shows there was reasonable cause for, and that the taxpayer acted in good faith with respect to, the understatement.[64] Further, section 6662(d)(2)(B) provides that the amount of any understatement is reduced by that portion of the understatement that is attributable to (i) the tax treatment of any item by the taxpayer if there is or was substantial authority for the treatment, or (ii) any item if – (I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and (II) there is a reasonable basis for the tax treatment of such item by the taxpayer.[65]

B. Chesapeake argued that its reliance on a "should" level tax opinion from PWC constitutes "reasonable cause" and "good faith."[66] Judge Kroupa found that it was not reasonable for Chesapeake to rely on PWC's Tax Opinion.[67] Among the factors cited by the court were that Chesapeake paid PWC an $800,000 flat fee for the Tax Opinion and the court's determination that the Tax Opinion was "riddled with questionable conclusions and unreasonable assumptions."[68] The court further stated that:

> [PWC] assumed that the indemnity would be effective and that WISCO would hold assets sufficient to avoid the anti-abuse rule. <u>PWC assumed away the very crux of whether the transaction would qualify as a nontaxable contribution of assets to a partnership</u>. [Emphasis added.][69]

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[63] Section 6662(d).
[64] Section 6664(c)(1).
[65] In 1999, section 6662(d)(2)(B) did not apply to any item of a corporation attributable to a tax shelter. In the case of any item of a taxpayer other than a corporation which was attributable to a tax shelter, section 6662(d)(2)(B)(ii) did not apply, and section 6662(d)(2)(B)(i) did not apply unless the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment. Currently, section 6662(d)(2)(C) provides that, with respect to any taxpayer, section 6662(d)(2)(B) does not apply to any item attributable to a tax shelter. A "tax shelter" is defined as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Section 6662(d)(2)(C)(ii). Prior to the passage of the Taxpayer Relief Act of 1997, P.L. 105-34, such a partnership, entity, plan or arrangement was only characterized as a "tax shelter" if the principal purpose of such entity, plan or arrangement was the avoidance or evasion of Federal income tax. The regulations with respect to the pre-1997 definition of "tax shelter," which have not been modified or withdrawn, explain that "the principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose." Treas. Reg. § 1.6662-4(g)(2)(ii). We do not believe that a leveraged partnership transaction should be characterized as a "tax shelter" for purposes of section 6662(d)(2)(B) because such a transaction is entirely consistent with the legislative history of, and the regulations under, section 707(a)(2)(B), which clearly contemplate that such a transaction should not give rise to taxable income.
[66] *Supra* note 1, at 32.
[67] *Id*. at 35-36.
[68] *Id*. at 33-34.
[69] *Id*. at 35.

C. The court also stated that PWC's advice was tainted by an inherent conflict of interest because:

> [PWC] not only researched and drafted the tax opinion, but [PWC] also "audited" WISCO's and the LLC's assets to make the assumptions in the tax opinion. [PWC] made legal assumptions separate from the tax assumptions in the opinion. [PWC] reviewed State law to make sure the assumptions were valid regarding whether a partnership was formed. In addition, [PWC] was intricately involved in drafting the joint venture agreement, the operating agreement and the indemnity agreement. In essence, [PWC] issued an opinion on a transaction [PWC] helped plan without the normal give-and-take in negotiating terms with an outside party.[70]

D. The court found that Chesapeake's reliance on PWC's opinion did not constitute "good faith reliance" and held Chesapeake liable for the accuracy-related penalty.[71] Judge Kroupa did not even mention the existence of the two additional tax opinions issued by PWC, which address the Federal income tax consequences of the Refinance Loans on the Transaction, arguably confirm the conclusions in the Tax Opinion and were issued to Chesapeake prior to the filing of Chesapeake's 1999 Federal tax return.

E. We believe that the court's analysis with respect to the application of the accuracy-related penalty is seriously flawed. First, while WISCO represented that the indemnity was a valid and legally enforceable obligation of WISCO under applicable state law and that WISCO would hold assets with a fair market value greater than or equal to $151 million during all times that the indemnity remained in effect, we see no basis in the record for Judge Kroupa's assertion that PWC "assumed that the indemnity would be effective and that WISCO would hold assets sufficient to avoid the anti-abuse rule." Rather, PWC analyzed the application of the section 752 anti-abuse rule based on the facts at issue at length in the Supporting Memorandum and concluded that it should not apply. Thus, based on our review of the record, we find no justification for Judge Kroupa's statement that "PWC assumed away the very crux of whether the transaction would qualify as a nontaxable contribution of assets to a partnership."

F. Second, the court's assertion that a taxpayer cannot in good faith rely upon a tax opinion if the author was involved in structuring the subject transaction is extremely troubling and potentially disastrous for taxpayers. The court faults PWC for "auditing" WISCO's assets and researching state law issues associated with the formation of the LLC. The court concludes that these activities created an impermissible conflict of interest for PWC. The court equates the Tax Opinion to tax advice given by promoters of non-economic loss producing marketed tax

[70] *Id*. at 36-37.
[71] *Id*. at 38.

shelters.[72] The Transaction is clearly distinguishable from these marketed tax shelters. Unlike the transactions at issue in the tax shelter cases cited by the Tax Court, the Transaction had significant non-tax economic consequences. Pursuant to the Transaction, Chesapeake disposed of a significant interest in its tissue manufacturing business and received a significant distribution of borrowed funds and an interest in a partnership. In addition, the Transaction was not a marketed tax shelter, but was specifically structured in light of the business goals and the economic and tax characteristics of Chesapeake and GP. Moreover, the Transaction was structured in accordance with clear, detailed and mechanical rules set forth in regulations as directed by Congress. The court's holding with respect to whether the Transaction was taxable rested on the application of a vague anti-abuse rule with a single example of a clearly abusive transaction. As noted above, the Transaction can be readily distinguished from the example in the section 752 anti-abuse regulations. Accordingly, it is inappropriate to equate the Transaction with the tax shelters in the cases cited by the court.

G. Further, tax practitioners are often actively involved in negotiating transaction terms and drafting transaction documents where the parties' tax liabilities are of concern. Nothing prohibits such involvement. In addition, not only is it prudent for a tax practitioner to engage in due diligence and research in connection with issuing a tax opinion, it is required by Treasury Circular 230.[73] The court's conclusion in this respect is wrong and unworkable.

H. Third, as noted above, the $800,000 fee paid to PWC was not only for services related to issuing the Tax Opinion, but was also for consultation with respect to tax issues associated with the formation, operation and dissolution of the joint venture with GP, as well as for tax advice with respect to an unrelated transaction. We understand that the two additional tax opinions issued by PWC in connection with the Refinance Loans were also covered by the $800,000 fee. The court did not analyze the hours worked by PWC personnel on the Transaction and the other services noted in the engagement letter or whether the fee was objectively unreasonable.[74] The court simply concluded that the existence of a large flat fee was evidence of bad faith. We note that flat fee engagements are increasingly replacing the bill-by-the-hour approach in the legal industry. Clients are demanding a more creative approach to billing that incentivizes all parties to be efficient and productive. Chesapeake was clearly a sophisticated consumer of professional services and presumably negotiated a flat fee that it thought was

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[72] *Id*. at 32 (citing *Mortensen v. Commissioner*, 440 F.3d 375 (6th Cir. 2006) (holding that taxpayer could not in good faith rely on tax advice from promoter of loss-producing cattle breeding tax shelter); *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993) (holding that investors in marketed loss-producing master recording lease program tax shelter could not in good faith rely on tax advice from promoters); *Neonatology Associates, P.A. v. Commissioner*, 115 T.C. 43 (2000), *aff'd*. 299 F.2d 221 (3d Cir. 2002) (holding that investors in a marketed loss-producing tax shelter involving contributions to life insurance plans could not in good faith rely on advice from promoters who were not tax professionals).

[73] *See* Section 10.33 and Section 10.35 of Circular 230, 31 CFR § 10.33 and § 10.35.

[74] A PWC representative testified that PWC spent "hundreds of hours" analyzing the structure of the Transaction, helping to document the transaction and working on the Tax Opinion. Chesapeake's Brief at 23.

reasonable for the services that were being provided. Without further analysis or explanation, the court's suggestion that a flat fee is per se evidence of bad faith for purposes of applying the accuracy-related penalty is unrealistic and unjustified.

I. Fourth, even if the Tax Opinion could not be relied upon due to a conflict of interest or otherwise, the court never determined whether there was "substantial authority" within the meaning of section 6662(d)(2)(B) for the taxpayer's position. As noted above, the general section 752 recourse partnership liability allocation regulations are mechanical and, under those general rules, WISCO clearly should be allocated 100% of the BofA Debt and the Refinance Loans. In addition, WISCO's indemnity is distinguishable from the single example in the section 752 anti-abuse regulations of an obligation that should be disregarded. Further, the legislative history of section 707(a)(2)(B) clearly evidences Congress's intention that a borrowing through a partnership in the form of a debt-financed distribution does not constitute a taxable event. Accordingly, we believe that Chesapeake clearly had at least substantial authority for its position and, as a result, the accuracy-related penalty should not apply to the Transaction.

VI. **Conclusion Regarding *Canal***

A. As discussed above, we believe that the Transaction complied with the clear requirements set forth in the partnership disguised sale regulations. Further, we believe the court's application of the section 752 anti-abuse rule to the Transaction was incorrect. In addition, we believe that the court's analysis with respect to the application of the accuracy-related penalty is seriously flawed. The court's conclusion that a taxpayer may not in good faith rely on a tax opinion issued by its tax advisors if those advisors participate in the structuring and negotiation of the subject transaction is extremely troubling. Taxpayers routinely rely on their tax advisors to structure transactions in compliance with complex tax rules so that the advisor can issue a tax opinion. The court's suggestion that these tax advisors are unable to render a tax opinion on which the client may rely is simply unworkable.

B. As noted above, Chesapeake issued a press release stating that the company is bankrupt and intends to settle the United States' claim for 50% of the company's $4 million of assets available for priority claims or unsecured claims after approval of a Chapter 11 bankruptcy plan. Accordingly, although Chesapeake filed an appeal to the Fourth Circuit on October 29, 2010, we understand that if the settlement is approved by the Bankruptcy Court, the appeal will not be pursued.

VII. **Leveraged Partnerships – Current Planning and Transactional Considerations**

A. In light of *Canal*, outlined below are issues that should be considered in connection with structuring a leveraged partnership transaction.

B. Facts and Circumstances

1. In analyzing the structuring of a leveraged partnership it is most important to note that there is no "One Size Fits All" structure.

2. 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.

C. General Considerations

1. It is important that the transaction structuring process and the parties involved in the transaction take into account the intended characterization of the transaction for tax purposes. Be mindful of the characterization of the transaction in:

   a. presentations to client management, officers, and board of directors, credit agencies, and other stakeholders;

   b. negotiations with third party bank and partner(s);

   c. working with professionals – investment bankers, attorneys, accountants;

2. Be mindful of language used in agreements and communications – contribution rather than purchase and sale, partner/member rather than buyer/seller.

3. Consider the accounting treatment of the transactions and related disclosures.

   a. GAAP treatment as sale – relevance when other clearly delineated nonrecognition transactions are also treated as sales for GAAP purposes.

   b. Is the transaction structured to avoid any disclosure obligation to the Service? Does a three or six year statute of limitations apply?

4. Consider what the investor to the partnership:

   a. Business/Real Estate/Operating Assets that are synergistic with assets of historic owner;

   b. Business/Real Estate/Operating Assets that are not synergistic with assets of historic owner;

   c. Financial Assets; or

   d. Cash

D. Specific Issues and Considerations

1. Capitalization

   a. What level of capitalization is required?

   b. Is capitalization determinative?

   c. Are interests determined based on remaining capital in deal?

   d. What residual percentage interest is necessary?

   e. What management rights are necessary?

2. Debt Structure

   a. Third party debt.

   b. Related party debt.

   c. Use of indemnities

3. Does the following impact the analysis:

   a. Does asset value support the debt?

   b. Will asset revenues support debt service?

   c. Do projections support debt repayment?

   d. Term of debt?

   e. Will or must the debt be refinanced and under what parameters? Can the debt amount be increased? Can the interest rate be changed?

4. What section 704(c) method will be used for the contributed assets?

   a. Remedial allocation method;

   b. Curative method; or

   c. Traditional method.

5. Does the fact that the acquiror is put in the same or better position than if the acquiror purchased property by virtue of the use of the remedial or curative allocation method impact the treatment of the transaction?

6. Does the fact that the taxpayer will receive ordinary income allocations through the use of the remedial or curative allocation methods impact the analysis?

7. What are the contractual terms of the guarantee or indemnity?

    a. 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;

    b. Unconditional payment obligation in the event of default;

    c. Principal only or principal and interest?

    d. Guarantee/Indemnity of collection or of payment? Will the obligation be subject to the satisfaction of any additional conditions (e.g., proceeding against the partnership's assets before demanding payment)?

    e. Does the term of the payment obligation coincide with term of the indebtedness?

    f. Are there any early termination provisions (e.g., termination upon sale of or redemption from the partnership)?

    g. Does the guarantee or indemnity obligation reduce by its terms over time?

    h. Is the guarantee or indemnity for the entire debt, or only a portion of the debt?

    i. What is the enforceability of the guarantee or indemnity under state law?

    j. Is there a right to guarantee or indemnify with respect to refinanced debt?

    k. Are there multiple obligors? If so, is the obligation of each obligor clearly quantified?

    l. Are there competing guarantees that could result in the obligation of guarantor being reduced?

    m. Consider the net worth of the guarantor/indemnitor.

    n. Consider the quality of assets owned by the guarantor/indemnitor.

    o. Consider the identity of the guarantor/indemnitor in the corporate structure.

p. What is the guarantor's/indemnitor's actual net worth upon entering into the guaranty/indemnity obligation?

q. Consider the relevance of a subsequent change in net worth. If net worth increases, can assets be removed? If net worth declines - then what?

r. Is there a capital contribution obligation by the parent of the guarantor/indemnitor?

s. Does the guarantor's/indemnitor's net worth consist of liquid assets or an operating business? Is a valuation of the business required?

t. Is there a net worth covenant? Who should the net worth covenant run in favor of? Is there a continuing obligation to establish net worth?

8. In a leveraged partnership transaction involving nonrecourse borrowing and a preferred return:

a. Do the assets owned by the partnership support the debt?

b. Are there special allocations that suggest one partner is bearing the interest expense of the debt?

c. Is the debt from a third party or related to a partner?

d. What is the projected income allocation associated with the preferred return?

e. What residual common percentage interest is required?

f. What preferred return income allocation constitutes a "significant item of partnership income or gain" for purposes of Treas. Reg. § 1.752-3(a)(3)?

9. Consider lockout terms to protect the contributing partner from recognizing built-in gain.

a. Prohibition on sale of assets.

b. Prohibition on debt repayment/amortization.

c. Time frame for lockout protection.

d. Amount of lockout protection:

(i) Indemnify for tax acceleration (time value of money);

(ii) Indemnify for tax payable; or

(iii) Indemnify for tax payable, including gross-up to pay for tax due on indemnity.

10. Consider obtaining positive covenants from the guarantor/indemnitor.

a. Specific assurances that the obligor will undertake certain actions in connection with its ability to satisfy its potential payment obligations.

b. Example: A legal provision requiring the maintenance of a minimum level of capital or assets.

11. Consider obtaining negative or restrictive covenants from the guarantor/indemnitor.

a. Specific assurances that the obligor will NOT undertake certain actions that would undermine its ability to satisfy its potential payment obligations.

b. Examples:

(i) Legal provision limiting the disposition of assets;

(ii) Legal provision limiting the further encumbrance of assets (e.g., negative pledge clause);

(iii) Legal provision limiting the incurrence of additional indebtedness; and

(iv) Legal provision limiting the making of distributions or payments of dividends.

12. Representations

a. Level of due diligence required?

b. Can tax advisors rely on representations from both taxpayers and non-legal advisors (i.e., economists)?

c. Are covenants preferable to representations?

d. Who should representations run to? Advisors, third party lenders, other partners?

e. Are net worth covenants/representations enough?

13. Consider how the following partnership agreement provisions impact the leveraged partnership structure:

    a. Capital Contributions

        (i) Additional capital contributions v. loans.

        (ii) Dilution.

    b. Management Rights

        (i) Partners' roles in management.

        (ii) Major decisions/voting rights.

    c. Distribution Provisions/Profit and Loss Allocations

    d. Transfer Provisions

        (i) Puts and calls.

        (ii) Right of first refusal or first offer.

    e. Dissolution/Liquidation

E. <u>Other Considerations</u>

1. Potential attacks on the leveraged partnership transaction

    a. Substance over form doctrine;

    b. Economic substance doctrine (Section 7701(o));

    c. Sham doctrine;

    d. Moline Properties and Culbertson-Tower test - business purpose; and

    e. Partnership anti-abuse rule (Treas. Reg. § 1.701-2).

2. Tax and legal advisor's fee structure – flat fee/hourly/premium.

3. Role of advisor – longstanding advisor/new advisor/promoter.

4. Opinions

    a. Reliance opinions and penalty protection.

    b. Can the advisor who works on structuring transaction issue the opinion?

c. Opinion(s) - contingent?

d. Is a separate planning practice/opinion practice needed?

e. Role of second opinion.

f. Assumptions used in opinion.

F. Summary

1. Fundamental questions to ask regarding the leveraged partnership structure:

a. Does the guarantee/indemnity obligation substantively give rise to an economic risk of loss to the obligor?

b. Were the contractual terms of the payment obligation negotiated based on arm's length terms and conditions?

c. Do the terms of the obligation generally provide sufficient legal protections regarding the obligor's wherewithal to make a payment?

d. Is the property contributing partner retaining a significant interest in the partnership?

e. What is the quality and value of assets that support the guarantee or indemnity obligation? How remote is the guarantee or indemnity obligation? Is the guarantee or indemnity of collection or payment?

VIII. Conclusion

A. While it is evident from recent rulings and the successful challenge of the transaction in *Canal* that the Service will scrutinize a leveraged partnership transaction, the ongoing viability of such structures is not in question.

B. Where Congress and the Treasury provide clear statutory and regulatory provisions intended to permit these transactions, a carefully structured leveraged partnership transaction should withstand judicial scrutiny.