Department of the Treasury | **Internal Revenue Service** | **Office of Chief Counsel**

Notice

CC-2003-030

September 10, 2003

Subject: Son of Boss Loan Premium Tax Shelters

Cancel Date: **Upon incorporation into the CCDM**

Purpose

The purpose of this Notice is to assist Chief Counsel attorneys in advising field personnel in the development of cases involving the type of transaction described in the first fact pattern of Notice 2000-44, 2000-2 C.B. 255, and substantially similar transactions (referred to herein as Son of Boss loan premium transactions).

Summary

The transaction involves the taxpayer borrowing at a premium and a partnership's subsequent assumption of that indebtedness. The terms of the loan agreement provide for an inflated stated rate of interest and a stated principal amount that is less than the issue price of the note (the issue price of the note is the amount of cash received by the taxpayer). In some cases, to mitigate interest rate risk, the partnership enters into an interest rate swap with the lender. The taxpayer claims that the basis in the taxpayer's partnership interest is reduced under Internal Revenue Code § 752 only for the stated principal amount of the indebtedness. Subsequently, taxpayer claims a loss on the disposition of the partnership interest even though taxpayer has incurred no corresponding economic loss[1]. It is the position of Counsel that:

(1) Under § 752, the total amount of cash that the taxpayer receives from the lender constitutes a § 752 liability to the extent that incurring the liability creates or increases the basis to the Partnership of any of the Partnership's assets (including cash

[1] Notice 2000-44 described one variation of the Son of Boss loan premium transaction. In other variations, the inflated partnership basis is transferred to partnership assets through a distribution in liquidation of the partnership. In variations involving the transfer of the inflated basis to partnership assets, the tax shelter may either result in the generation of a loss on the subsequent sale of the distributed assets or the elimination of built in gain in the distributed assets.

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attributable to borrowings). Further, the issue price of the Note determines the amount of the liability the Partnership assumes for purposes of § 752.

Alternatively, if the issue price of the Note is not determined to be the amount of the liability and if the Note is a contingent payment debt instrument (within the meaning of § 1.1275-4 of the Income Tax Regulations), under § 1.1275-6, the Commissioner may integrate the Note and the interest rate swap. The resulting synthetic debt instrument would have a principal amount equal to the sum of the stated principal amount of the Note and the premium. The principal amount of the synthetic debt instrument would constitute the amount of the § 752 liability assumed by the Partnership to the extent that incurring the liability created or increased the basis to the Partnership of any of the Partnership's assets (including cash attributable to borrowings).

(2) In the event a Partnership assumed a liability from a taxpayer after October 18, 1999 but before June 24, 2003, and the total amount of money the taxpayer received in exchange for the Note is not treated as a liability under § 752(a) and (b), the Service will apply § 1.752-6T, after application of § 752(a) and (b), to reduce the outside basis in the Partnership of the taxpayer from whom the liability was assumed.

(3) The Service may apply § 1.701-2 to a Partnership formed or availed of in connection with a Son of Boss loan premium transaction because the principal purpose of the transaction is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. The Service can determine, based on the facts and circumstances, that to achieve results that are consistent with the intent of subchapter K the purported Partnership should be disregarded in whole or in part, one or more of the purported partners of the Partnership should not be treated as a partner, the methods of accounting used by the Partnership or a partner should be adjusted to reflect clearly the Partnership's or the partner's income, the Partnership's items of income, gain, loss, deduction, or credit should be reallocated, or the claimed tax treatment should otherwise be adjusted or modified. In the case of a Partnership formed in connection with a Son of Boss loan premium transaction, disregarding the Partnership is also consistent with existing case law. ASA Investerings P'ship v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000).

(4) For an individual partner, the loss that a partner claims (directly or through an intermediary such as an S corporation, a partnership, or a limited liability company) resulting from the artificial inflation of the partner's outside basis in a Partnership used in a Son of Boss loan premium transaction may be disallowed under § 165(c)(2) because the partner lacked the requisite economic profit objective.

(5) Under § 465(b)(2) and (4), taxpayers are not considered at risk for the amount received from the lender under the nonrecourse financing and the Son of Boss loan premium structure as such amounts are protected from loss.

Background

Notice 2000-44, 2000-2 C.B. 255, describes two partnership transaction structures that create an artificial loss for the partners and provides that the purported losses resulting from the transactions do not reflect bona fide losses reflecting actual economic consequences under § 165. In addition, the Notice provides that purported tax benefits from the transactions may be subject to challenge under other provisions of the Code and regulations, such as § 752, § 1.701-2 or other anti-abuse rules, and in the case of individuals, § 165(c)(2). The first fact pattern in the Notice describes a Son of Boss loan premium transaction, which involves a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that indebtedness. The following is a description of a variation of that first fact pattern in the Notice.

In a Son of Boss loan premium transaction, a Taxpayer forms a single member limited liability company (LLC) and contributes $1,000,000 to the LLC.[2] Taxpayer, through LLC, borrows money from Bank, on a non-recourse basis. The amount of money received from Bank pursuant to the borrowing transaction is $40,000,000. The loan is evidenced by a Note with a stated principal amount of $25,000,000. The stated interest rate for the Note is 17.5 percent per annum, well in excess of the market rate at the time. The terms of the Note require quarterly interest payments and a balloon principal repayment of $25,000,000 on the seventh anniversary of the Note.

Under the terms of the borrowing, the debtor has a right to repay the Note at any time with five days' notice to Bank. However, should the debtor exercise the prepayment right, the debtor is required to repay the aggregate outstanding stated principal amount of the Note, all accrued interest on the outstanding stated principal amount, a "prepayment amount" and a "breakage fee". The prepayment amount is determined on the date of the prepayment; however, this amount is approximately equal to the unamortized premium at the time of the prepayment.

Under the terms of the Note, the debtor is required to leave the $40,000,000 in a collateral account with Bank and is limited in the types of investments that may be purchased with the funds. The terms of the Note also provide that Bank may only collect against those assets identified in the Note, which assets are limited to the assets in the collateral account (initially, the $40,000,000).

LLC invests its $41,000,000 in assets in a Partnership in exchange for a Class A interest in Partnership. The proceeds LLC invests in Partnership are subject to the Note from Bank. Partnership assumes the Taxpayer's obligation to Bank under the terms of the Note and is substituted as the debtor. To mitigate its interest rate risk, Partnership enters into a fixed for floating interest rate swap with Bank for the duration of the Note's seven year term. Partnership treats the stated principal amount of the Note, $25,000,000, as a § 752 liability, and allocates the entire liability to Taxpayer.

Partnership has two other members, Growth LLC (Growth), with a Managing Member interest and Resources LLC (Resources), with a Class B interest. Growth and Resources contribute a total of $100,000.

[2] Under § 301.7701-3(b)(1)(ii), LLC is disregarded for federal tax purposes.

Partnership's profits and losses are allocated among the members according to the Partnership agreement, with 90 percent allocated to the Class A member, 9 percent allocated to the Class B member, and 1 percent allocated to the Managing Member. Partnership pays a substantial management fee to the Managing Member. The management fee deduction is allocated only to the Class A and Class B members. The Class B member is entitled to a preferred return of 12 percent of its capital account balance per year (or portion thereof) prior to the allocation of profit to the Class A and Managing Member.

According to the investment plan given to Taxpayer before the transactions were entered into, Partnership planned to invest its assets in foreign currency options. According to the plan, the initial 60 day investment phase was designed to be low risk. Partnership's low risk investment plan was to invest the funds in options to purchase and sell Euros. For the second investment phase consisting of 120 days, the investment focus would be on medium risk currencies. For the third investment phase, consisting of six and one half years, the investment would focus on high risk currencies.

The plan provides that Taxpayer is permitted to leave the Partnership on any 60 day anniversary of the formation of Partnership, if Taxpayer notifies Growth of Taxpayer's desire to leave by the date ten days before the anniversary date. By the 50 day anniversary, Taxpayer notifies Growth of Taxpayer's desire to leave the Partnership, and on the 60 day anniversary, Taxpayer's interest in Partnership is redeemed. Taxpayer receives 90 percent of Partnership's assets, cash in the amount of $300,000 and 30,000 Euros. The outstanding obligation to Bank, including the prepayment amount and the breakage fee, is satisfied by Partnership after Taxpayer is redeemed out of Partnership.

Taxpayer treats the distribution of cash and assets as a liquidating distribution under § 732(b). In connection with the termination of Taxpayer's interest in Partnership, Taxpayer takes the position that it received a deemed distribution of $25,000,000, the amount of Taxpayer's share of Partnership liabilities. As a result, Taxpayer claims an outside basis in Partnership of $16,000,000 ($41,000,000 - $25,000,000). Under § 732(b), Taxpayer's purported basis in the distributed Euros was $15,700,000 ($16,000,000 - $300,000). Taxpayer sells the Euros to a third party for their fair market value of approximately $30,000 and reports a foreign currency loss of $15,670,000.

<u>Discussion</u>

1. <u>Under § 752, the total amount of money the taxpayer receives in exchange for the Note is a Partnership liability.</u>

Revenue Ruling 88-77, 1988-2 C.B. 128, provides that for purposes of § 752, the terms "liabilities of a partnership" and "partnership liabilities" include obligations only if and to the extent that incurring the liabilities creates or increases the basis to the partnership of any of the partnership's assets (including cash attributable to borrowings), gives rise to an immediate deduction to the partnership, or, under § 705(a)(2)(B), currently decreases a partner's basis in the partner's partnership interest. In the case of a Son of Boss loan premium transaction, the parties enter into an obligation evidenced by a Note and other loan documents that require repayment of that obligation. The amount of the § 752 liability, as determined under Rev. Rul. 88-77, is the obligation to the extent that incurring the liability created or increased the basis to the Partnership of any of the Partnership's assets (including cash attributable to borrowings). The Partnership's assumption of the liability on the Note would have increased the basis in the assets of the Partnership, for purposes of § 752, by $40,000,000, the cash attributable to the borrowing. Consequently, the § 752 liability created by the Partnership's assumption of the Note is $40,000,000, rather than the $25,000,000 reported by the Taxpayer.

In addition, the amount of the § 752 liability created by the assumption of the Note is equal to the issue price of the Note.[3] The issue price of a debt instrument (which does not necessarily equal the stated principal amount of the debt instrument) generally measures the "principal component" of the instrument for federal tax purposes. For example, the amount of the debtor's interest deduction generally is measured by reference to a debt instrument's issue price rather than its stated principal amount. See §§ 1.163-7 and 1.163-13.[4]

The issue price of a debt instrument is determined under either § 1273 or § 1274 and the regulations thereunder. In general, the issue price of a single debt instrument issued for money is the amount of money loaned to the borrower. See §1.1273-2(a). As a result, the issue price of the Note in this Son of Boss loan premium transaction is $40,000,000, the total amount of money transferred to the Taxpayer. The $40,000,000 in this Son of Boss loan premium transaction includes the amount designated as a premium.[5]

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[3] If the Note is assumed after its issue date, the adjusted issue price, rather than its issue price, is the appropriate measure of the amount of the § 752 liability. See § 1.1275-1(b) to determine a debt instrument's adjusted issue price.

[4] Determining the amount of the liability for purposes of § 752 based on the issue price of the Note also is consistent with the rules for determining the seller's amount realized under § 1.1001-1(g) and the buyer's adjusted basis under § 1.1012-1(g) when a debt instrument is issued in exchange for property. Further, the use of issue price is consistent with the rules for determining the debtor's income from the discharge of indebtedness. See § 108(e)(10) and § 1.61-12(c)(2)(ii). In addition, the use of issue price is consistent with the rules for assumptions of debt instruments with original issue discount under § 1.1274-5(d).

[5] The use of issue price to determine the amount of the liability under § 752 also is consistent with treating the premium as an additional principal amount on the Note based on the "economic reality" of the transaction. See <u>Glick v. U.S.</u>, 96 F. Supp.2d 850 (S.D. Ind. 2000). The debt instrument in <u>Glick</u> was a REMIC regular interest that provided for a nominal principal amount and 1006 percent stated interest (an "IOette"). However, the IOette had an anticipated yield to maturity of 7.92 percent, based on the purchase price of the instrument and the anticipated cash flows the purchaser would receive on the instrument. The court in <u>Glick</u> recharacterized the IOette as a debt instrument issued at a discount based on the 7.92 percent anticipated yield to maturity, rather than an instrument issued at a premium. Based on <u>Glick</u>, the Note might be recharacterized for federal tax purposes as a debt instrument with a stated principal amount of $40,000,000 and a market rate of interest.

If the § 752 liability is not determined to be the total amount of cash the taxpayer receives from the lender (that is, the issue price of the Note), and if the Note is a contingent payment debt instrument (within the meaning of § 1.1275-4), under § 1.1275-6, the Commissioner may integrate the Note and the interest rate swap. The resulting synthetic debt instrument would have a principal amount equal to the sum of the stated principal amount of the Note and the premium.

In general, a debt instrument is a contingent payment debt instrument if the timing or amount of at least one payment is not fixed when the instrument is issued. See § 1.1275-4. If the Note provides the obligor with a call option (that is, the right to prepay the Note) and the prepayment amount is not known as of the issue date, the Note is a contingent payment debt instrument under §1.1275-4.[6]

Section 1.1275-6 generally provides for the integration of a "qualifying debt instrument" with a "§1.1275-6 hedge" if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed rate debt instrument or a variable rate debt instrument that pays interest at a qualified floating rate. When §1.1275-6 applies, the combined cash flows of the qualifying debt instrument and the §1.1275-6 hedge generally are treated as a synthetic debt instrument for all federal tax purposes.

The Commissioner may require integration of the Note (qualifying debt instrument) and the interest rate swap because the Note is a contingent payment debt instrument and the combined cash flows are substantially equivalent to the cash flows on a variable rate debt instrument that pays interest at a qualified floating rate. The resulting synthetic debt instrument would have a principal amount for federal tax purposes equal to the sum of the stated principal amount of the Note and the premium; and the § 752 liability would equal the principal amount of the synthetic debt instrument to the extent that incurring the liability created or increased the basis to the Partnership of any of the Partnership's assets (including cash attributable to borrowings).

[6] In general, under § 1.1275-4, a debt instrument provides for a contingent payment if the timing or amount of the payment is not fixed when the instrument is issued. Even though a debt instrument may provide for a contingent payment, § 1.1275-4 does not apply to the instrument in certain situations. For example, § 1.1275-4 does not apply to a debt instrument subject to § 1.1272-1(c), which applies to a debt instrument that provides for alternative payment schedules (for example, if the instrument provides for a put or call option). However, § 1.1272-1(c) only applies if the timing and amounts of the payments comprising each payment schedule are known as of the issue date. (For purposes of this Notice, we have assumed that the only possible contingent payments are those attributable to the prepayment (call) option.)

2. For Son of Boss loan premium transactions involving the assumption of the liability on the Note after October 18, 1999, but before June 24, 2003[7], if the total amount of money the taxpayer received in exchange for the Note is not treated as a liability under § 752(a) and (b), the Service will apply § 1.752-6T to reduce the outside basis in the Partnership of the taxpayer from whom the liability on the Note was assumed.

Section 1.752-6T(a) provides that if, in a transaction described in § 721(a), a partnership assumes a liability (defined in § 358(h)(3)) of a partner (other than a liability to which § 752(a) and (b) applies), then, after application of § 752(a) and (b), the partner's basis in the partnership is reduced (but not below the adjusted value of such interest) by the amount (determined as of the date of the exchange) of the liability. For purposes of § 1.752-6T, the adjusted value of a partner's interest in a partnership is the fair market value of that interest increased by the partner's share of partnership liabilities under § 1.752-1 through § 1.752-5. Section 358(h)(3) defines liability to include any fixed or contingent obligation to make a payment, without regard to whether the obligation is otherwise taken into account for federal tax purposes. Under § 1.752-6T, the reduction in a partner's basis is not required after an assumption of a liability to which § 752(a) and (b) do not apply, if the trade or business with which the liability is associated is transferred to the partnership assuming the liability as part of the transaction. However, the Son of Boss loan premium transaction described above does not involve the transfer of a trade or business and therefore, does not meet the exception.

In addition, § 1.752-6T(b)(1) includes another exception contained in § 358(h)(2)(B), which provides that the reduction in basis is not required after an assumption of a liability (described in § 358(h)(3)) if substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange. This exception does not apply to Son of Boss loan premium transactions. § 1.752-6T(b)(2).

In the event a Partnership assumed a liability from a taxpayer after October 18, 1999 but before June 24, 2003, and the total amount of money the taxpayer received in exchange for the Note is not treated as a liability under § 752(a) and (b), the Service will apply § 1.752-6T, after application of § 752(a) and (b), to reduce the outside basis in the Partnership of the taxpayer from whom the liability was assumed.

[7] The Temporary regulations are effective for this period. § 1.752-6T(d). Proposed regulations have been issued that apply to assumptions of liabilities by partnerships on or after June 24, 2003.

3. <u>The Service may recast a Son of Boss loan premium transaction involving a Partnership formed or availed of in connection with such transaction to achieve results that are consistent with the intent of subchapter K.</u>

Section 1.701-2(a), the partnership anti-abuse rule, provides in pertinent part that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements:

> (1) the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;
>
> (2) the form of each partnership transaction must be respected under substance over form principles; and
>
> (3) except as otherwise provided, the tax consequences under subchapter K to each partner of the partnership operations and of transactions between the partnership and the partner must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

Section 1.701-2(b) provides that the provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in § 1.701-2(a). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Service can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Service can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K: (1) the purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.

Section 1.701-2(c) provides that whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Section 1.701-2(c) lists factors that may be considered in making the determination but those factors do not create a presumption that a partnership was or was not used in a manner inconsistent with subchapter K.

One of the factors on the list indicative of a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's activities directly. The loss generated in a Son of Boss loan premium transaction is achieved through the inflated outside basis in the Partnership. This inflated basis is not supported by the underlying economics of the transaction. Thus, if the investors in a Son of Boss loan premium transaction engaged in the borrowing activity and invested the proceeds of the borrowing individually, the tax loss would not have been generated. This is true whether the Partnership was formed for the purpose of engaging in a Son of Boss loan premium transaction or an existing Partnership was used to engage in the Son of Boss loan premium transaction.

A Partnership formed or availed of in connection with a Son of Boss loan premium transaction does not operate in a manner consistent with the intent of subchapter K. First, the requirement that each partnership transaction or series of related transactions be entered into with a substantial business purpose is not met. A Partnership formed or availed of in connection with a Son of Boss loan premium transaction engages in minor investment activities. The Partnership engages in the investment transactions to generate the appearance of a business purpose in the event the transaction is challenged. The real purpose of the Partnership is the generation of the loss through the Son of Boss loan premium transaction. Although establishment of substantial business purpose is a fact specific inquiry, the reasonably expected pre-tax profit from the investment transactions is minimal when compared to the purported reduction in tax liability achieved through the Son of Boss loan premium transaction.

Second, the requirement that the tax consequences to each partner of the partnership operations and of transactions between the partnership and the partner must accurately reflect the partner's income is not met. In a Son of Boss loan premium transaction, a large tax loss is generated through an inflated basis in the Partnership interests received by the contribution of money and a liability that does not reflect the cash attributable to the borrowing. Property is later distributed to the partner in redemption of the partner's interest in the Partnership, the partner's basis is reduced by the partner's share of the understated Partnership liability, and the property that is distributed acquires the artificially high outside basis and is later sold for a loss. For the tax consequences of a Son of Boss loan premium transaction to clearly reflect the partners' income, the partners or the Partnership would need to have experienced a net economic loss at least equal to the claimed tax loss or the tax loss would need to be clearly contemplated by a provision in the Code or regulations. The tax loss generated in the transaction does not accurately reflect an underlying economic loss experienced by either the partners or the Partnership. Further, no provision in subchapter K contemplates the creation of the large non-economic losses generated in the Son of Boss loan premium transaction.

Section 1.701-2(b) gives the Service broad authority to recast a transaction or series of transactions in the event that a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. In light of this, the partnership anti-abuse rule should be applied either to disregard the Partnership or some of the partners, to disregard the assumption of the obligation by the Partnership, or to reduce the partner's basis in the Partnership to reflect the actual § 752 liability, depending on the particular facts of the transaction.

If a Partnership is formed in connection with a Son of Boss loan premium transaction, the Service may disregard the Partnership and recast the transaction in a manner that is consistent with the partners engaging in the activities directly. This approach will eliminate the discrepancy between outside basis and inside basis, and eliminate the purported loss.

Other authorities support the Service's disregarding of the purported Partnership. Under § 761 a partnership includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. See also, § 7701(a)(2). The Supreme Court in Commissioner v. Culbertson, 337 U.S. 733, 742 (1949), stated that a partnership is created for federal income tax purposes if:

> [C]onsidering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

The Tax Court in Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964) set forth the following nonexclusive list of factors relevant to the consideration of whether a partnership is created:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party had made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the

> parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over the assumed mutual responsibilities for the enterprise.

In ASA Investerings P'ship v. Commissioner, the Court of Appeals for the D.C. Circuit found that a partnership formed for a tax purpose and which engages in de minimis business activity in furtherance of that tax purpose is not a valid partnership. ASA at 512; See also Boca Investerings P'ship v. United States, 2003 U.S. App. LEXIS 429. Moreover, the ASA Court stated that whether "the 'sham' be in the entity or the transaction . . . the absence of a nontax business purpose is fatal." Id.

Applying this analysis to the facts before it, the court of appeals in ASA found that even though the "investment in LIBOR Notes might have had a business purpose, the prior three-week investment in and subsequent sale of the private placement Notes (PPNs) was . . . a business activity merely conducted for tax purposes." Id. at 513. The court of appeals realized that the taxpayer may have had an interest in potential gain from its investments, but those interests were "dwarfed by its interest in the tax benefit." Id. at 513. In concluding that ASA Investerings was not a legitimate partnership, the court further clarified that "[a]lthough a taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation." Id. (quoting, Zamuda v. Commissioner, 731 F.2d 1417, 1421 (9th Cir. 1984)). Hence, the standard in the D.C. Circuit is that a de minimis business purpose will not validate a partnership whose true purpose is the pursuit of tax benefits. Rather, the relevant legal inquiry, as found by the Court of Appeals for the D.C. Circuit, is a comparison of the purported business purpose to the expected tax benefit. Id. at 513. The weight placed upon this legal factor led the D.C. Circuit to disregard the partnership entity. Id. at 516.

On the issue of risk, the D.C. Circuit Court of Appeals in ASA allowed for the existence of de minimis risk in the transaction noting that "no investment is entirely without risk." Id. at 514. The court further concluded that a carve out of de minimis risk is consistent with the Supreme Court's view that "a transaction will be disregarded if it did 'not appreciably affect [taxpayer's] beneficial interest except to reduce his tax.'" Id. (quoting Knetsch v. United States, 364 U.S. 361, 366 (1960)).

As with the transactions in ASA and Boca, de minimis risk exists in the Son of Boss loan premium transactions. The Son of Boss loan premium transactions are structured specifically to generate a tax benefit while limiting each partner's risk of loss by restricting investment to stable currencies and providing for (possibly even contemplating) a short investment period (60 days). The minor investment activities engaged in by the Partnerships are de minimis compared to the amount of the claimed tax savings. Further, the modicum of business purpose asserted by the promoters for the formation of the Partnership in a Son of Boss loan premium transaction does not alter the fact that the true purpose for the Partnership is the reduction of tax liability. Thus, the Partnership entity should be disregarded.

In cases in which an operating Partnership engages in a Son of Boss loan premium transaction it may not be appropriate to disregard the Partnership. In these cases, § 1.701-2 applies to permit the Service to recast the transaction in a manner consistent with the intent of subchapter K.

A Son of Boss loan premium transaction, whether engaged in through a Partnership formed primarily for use in the transaction or through a previously operating Partnership, reduces substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. The fact that such reduction was a principal purpose of engaging in the transaction is apparent from the lack of legitimate economic purpose for the transaction. As noted above, a comparison of the tax gain generated by the transaction to the economic benefit that the transaction could be reasonably expected to generate, as well as the fact that the exposure to risk is limited in a Son of Boss loan premium transaction are significant factors indicating that the principal, if not sole, purpose for engaging in a Son of Boss loan premium transaction is the tax reduction generated by the transaction.

It follows from this that the Service may recast the transaction by, among other things, disregarding the assumption of the obligation by the Partnership, or, reducing the partner's basis to reflect the full amount of the § 752 liability. In either case, the purported tax loss generated by the Son of Boss loan premium transaction will be eliminated.

4. <u>Individual taxpayers may not claim losses from investments in Partnerships unless such investments are made with an economic profit objective.</u>

Section 165(a) allows as a deduction any loss sustained during the year and not compensated by insurance or otherwise.

Losses claimed by individuals, other than casualty losses, are limited by § 165(c) to (1) losses incurred in a trade or business and (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business. The requirements of § 165(c)(2) were applied to certain straddle transactions in <u>Fox v. Commissioner</u>, 82 T.C. 1001 (1984). The Tax Court there found that § 165(c)(2) required that the taxpayer enter into the transaction "primarily for profit." 82 T.C. at 1019-21. <u>See</u> <u>also</u> <u>Dewees v. Commissioner</u>, 870 F.2d 21, 33 (1st Cir. 1989), and the cases cited therein. This "primarily profit" motive test has its origins in the Supreme Court decision, <u>Helvering v. National Grocery Co.</u>, 304 U.S. 282 (1938), which interpreted a predecessor of § 165(c).

The application of § 165(c) does not require a finding that the transaction lacks economic substance. For example, the Tax Court in <u>Fox</u> found that because the taxpayer did not meet the requirements of § 165(c)(2), it did not have to find that the transaction was a sham. See also Smith v. Commissioner, 78 T.C. 350 (1982), aff'd without published opinion, 820 F.2d 1220 (4th Cir. 1987), where the Tax Court found certain straddles not to be shams, but at the same time disallowed the resulting losses because the taxpayers lacked the requisite economic profit objective under § 165(c)(2). In applying § 165(c), we may look to the individual taxpayer's motivation for entering the partnership, see Howell v. Commissioner, 41 T.C. 13 (1963), aff'd, 332 F.2d 428 (3d Cir. 1964), or we may look at the motivation for entering into the specific transactions. See Andros v. Commissioner, T.C. Memo 1996-133.

If an individual invests in a Son of Boss loan premium transaction, any loss generated either through the disposition of the Partnership interest or through the disposition of assets distributed to the individual in complete liquidation of the individual's Partnership interest may be limited or denied under § 165(c)(2) because of the lack of an economic profit objective.

5. The losses that a taxpayer sustains and deducts are limited by § 465 to the amount for which the taxpayer is at risk.

Section 465(a)(1) provides that in the case of an individual engaged in an activity identified in § 465(c), any loss from the activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at-risk for such activity at the close of the taxable year. Section 465(c)(3) provides that § 465 applies to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income.

Section 465(b)(1) provides that a taxpayer is considered at-risk for an activity with respect to amounts including the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and amounts borrowed with respect to such activity. Under § 465(b)(2), a taxpayer is considered at risk for an activity with respect to amounts including amounts borrowed for use in an activity to the extent that the taxpayer either is personally liable for the repayment of such amounts, or has pledged property, other than property used in such activity, as security for such borrowed amount.

Section 465(b)(4) provides that notwithstanding the other provisions of § 465, a taxpayer is not considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. Under § 465(b)(4) the legislative history provides that in evaluating the amount at-risk, it should be assumed that a loss-protection guarantee, repurchase agreement or other loss limiting mechanism will be fully paid to the taxpayer. Id. (citing S.Rep. No. 938, 94th Cong., 2d Sess. 50 n.6 (1976)); see also, Moser v. Commissioner, 914 F.2d 1040 (8th Cir. 1990) (A theoretical possibility that the taxpayer will suffer economic loss is insufficient to avoid the applicability of [465(b)(4)].; Levien v. Commissioner, 103 T.C. 120 (1994)).

The case law is not in complete accord on this issue. In Emershaw v. Commissioner, 949 F.2d 841, 845 (6th Cir. 1991), the court adopted a worst-case scenario approach and determined that the issue of whether a taxpayer is "at risk" for purposes of § 465(b)(4) "must be resolved on the basis of who realistically will be the payor of last resort if the transaction goes sour and the secured property associated with the transaction is not adequate to pay off the debt." quoting Levy v. Commissioner, 91 T.C. 838, 869 (1988).

In contrast, the Second, Eighth, Ninth, and Eleventh Circuits look to the underlying economic substance of the arrangements under § 465(b)(4). Waters v. Commissioner, 978 F.2d 1310, 1316 (2nd Cir. 1992) (citing American Principals, 904 F.2d at 483; Young v. Commissioner, 926 F.2d 1083, 1089 (11th Cir. 1991); Moser, 914 F.2d at 1048-49.) The view, as adopted by the Second, Eighth, Ninth, and Eleventh Circuits is that, in determining who has the ultimate liability for an obligation, the economic substance and the commercial realities of the transaction control. See Waters, 978 F.2d at 1316; Levien, 103 T.C. 120; Thornock v. Commissioner, 94 T.C. 439, 448 (1990), Bussing v. Commissioner, 89 T.C. 1050, 1057 (1987). To determine whether a taxpayer is protected from ultimate liability, a transaction should be examined to see if it "is structured - by whatever method - to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable." American Principals, 904 F.2d at 483, see Young, 926 F.2d at 1088, Thornock, 94 T.C. at 448-49, Owens v. United States, 818 F. Supp. 1089, 1097 (E.D. Tenn. 1993), Bussing, 89 T.C. at 1057-58. "[A] binding contract is not necessary for [465(b)(4)] to apply." American Principals, 904 F.2d at 482-83. In addition, "the substance and commercial realities of the financing arrangements presented . . . by each transaction" should be taken into account under § 465(b)(4). Thornock, 94 T.C. at 449. To avoid the application of § 465(b)(4), there must be more than "a theoretical possibility that the taxpayer will suffer economic loss." American Principals, 904 F.2d at 483.

In the Son of Boss loan premium transaction, the Taxpayer borrows money in exchange for a Note with a stated principal amount lower than the amount of money received and contributes the money to the Partnership subject to the Note. The terms of the Note state that Bank may only collect against those assets identified in the loan documents, which assets are limited to the amount of cash received by Taxpayer from Bank. Under the terms of Note, the Taxpayer is required to leave the borrowed funds in an account with Bank and is limited in the types of investments which may be purchased with the funds.

At no time is the Taxpayer at risk for the amount borrowed from Bank. Under § 465(b)(2)and (b)(4), because the Taxpayer is not personally liable for the nonrecourse Note, the Taxpayer is not at risk for that amount. The assumption of the Note by the Partnership rather than exposing Taxpayer to greater risk of loss, provides further insulation. In addition, the terms of the borrowing require Taxpayer to leave the borrowed funds in an account with Bank and limit Taxpayer in the types of investments that may be purchased with the funds. Thus, the protection afforded by the nonrecourse nature of the Note is augmented by the fact that the borrowed funds are, at all times, in the possession of Bank. These protections against loss limit Taxpayer's at-risk amount under § 465(b)(4).

This notice may be updated in accordance with future published guidance.

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