DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR ASSOCIATE AREA COUNSEL(SAN FRANCISCO)
CC:LM:CTM:SF

FROM: Eliana Dolgoff, CC:INTL:4
Assistant to the Branch Chief

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated July 19, 2001. In accordance with I.R.C.§ 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Company =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8	=	
product line	=	
Country 1	=	
Country 2	=	
Law Firm	=	
CFC1	=	
CFC2	=	
UTP	=	
LTP	=	
CFC2-DE	=	
a	=	
b	=	
c	=	
d	=	
e	=	
f	=	
g	=	
h	=	
i	=	

ISSUES

1. Does the step-transaction doctrine apply to recharacterize this transaction as a sale of partnership interests?

2. Should this transaction be treated, in substance, as a sale of a partnership interest?

CONCLUSIONS

1. The parties originally agreed to a sale by CFC1 of its partnership interests in UTP and LTP to CFC2 (or an affiliate). To avoid subpart F income, the sale was restructured into a three-step transaction that culminated in the transfer of UTP and LTP to CFC2, and the receipt of the purchase price by CFC1. Applying the step- transaction doctrine, this transaction will be recharacterized as a sale of partnership interests by CFC1.

2. This transaction was structured, in form, as a sale of partnership assets, followed by a liquidating distribution. However, an analysis of the substance of the transaction indicates that it is more appropriately treated as a sale of a partnership interest by CFC1.

FACTS

Taxpayer is an affiliated group of companies engaged in the marketing of product line. On Date 1, Taxpayer and Company entered into an agreement to form an international venture as equal partners. One component of the venture was a facility to produce product line located in Country 1. This facility was owned through a tiered structure involving two entities formed under the laws of Country 2 and classified as partnerships for U.S. federal tax purposes. We assume for purposes of this Chief Counsel Advice that the entities were correctly classified as partnerships. Taxpayer's controlled foreign corporation (CFC1) and Company's controlled foreign corporation (CFC2) formed an upper-tier partnership (UTP), with CFC1 owning a percent and CFC2 owning b percent. CFC1, CFC2, and UTP then formed a lower-tier partnership, LTP, with interests of c, d, and e percent, respectively, to hold the facility.

Taxpayer entered into an agreement with Company on Date 2 to terminate the international joint venture. This agreement called for CFC1 to sell its interests in UTP and LTP to CFC2, or a subsidiary of CFC2. The agreement called for this to be treated as a sale and purchase of partnership interests for U.S. Federal income tax purposes.

The agreement called for a purchase price of $f, allocated $g to UTP interest and $h to LTP interest.

On Date 3, just prior to entering into the Date 2 agreement, Taxpayer received advice proposing an alternative transfer structure that would not result in any subpart F income. The alternative transfer structure called for three separate steps. First, CFC1 and CFC2 would contribute their interests in LTP to UTP (which would cause UTP to be the sole owner of LTP, which would then be disregarded for U.S. federal tax purposes). Second, UTP would sell its assets (the interests in LTP) to CFC2. Third, UTP would terminate, making liquidating distributions to CFC1 and CFC2. On Date 4, Taxpayer and Company modified their earlier agreement to provide that they would undertake all three steps. A schedule accompanying the Date 4 amendment to the agreement lists CFC2 as the purchaser of the LTP interests. However, a Date 8 memorandum by an attorney at Law Firm indicates that a subsidiary of CFC2, classified as a disregarded entity for U.S. tax purposes, would purchase the LPT interests from UPT.

The facts submitted indicate that the three-step transaction as set forth in the Date 4 agreement was carried out, with some modification. CFC2-DE, an entity owned by CFC2 and possibly classified as a disregarded entity, purchased UTP's assets (the interests in LTP) in exchange for two notes, Note 1, issued by Company with a principal amount of $f, and Note 2, issued by CFC2 with a principal amount of $i. CFC1 claims to have received Note 1 in a liquidating distribution from UTP. Note 2 was distributed to CFC2. The Date 4 agreement specifies that the total purchase price to Company is $f, not the $f plus $i that the form of the transaction requires.

LAW AND ANALYSIS

1. Applying the step-transaction doctrine, this transaction will be recharacterized as a sale of partnership interests.

If the purportedly separate steps are given effect for tax purposes, CFC1 would not be treated as selling its partnership interests, and thus § 954(c)(1)(B)(ii) would not apply to the transaction. However, it is not enough that the taxpayer could conceive a multi-step process to achieve the same result as a direct sale of partnership interests. Under the judicial step-transaction doctrine, an interrelated series of transactions will be treated as component parts of an overall plan rather than being evaluated separately. The step- transaction doctrine has been described as another rule of substance over form that "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). See also Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

There are three distinct formulations of the step-transaction doctrine. The three formulations are as follows: (1) the end result test, (2) the mutual interdependence test, and (3) the binding commitment test. Under the end result test, a series of transactions are stepped together if they are prearranged parts of a single transaction intended from the outset to reach a specific end result. Penrod, 88 T.C. at 1429. The end result test focuses on the actual intent of the parties at the beginning of the series of transactions. Under the binding commitment test, a series of transactions will be stepped together if there is a binding commitment to undertake the later steps. Commissioner v. Gordon, 391 U.S. 83 (1968). Under the mutual interdependence test, the separate steps are analyzed to determine if the legal relationships created by one transaction would be fruitless without the completion of the entire series of transactions. Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981).

In the present case, the Date 2 contract indicates the intent of Taxpayer and Company to engage in a sale of CFC1's partnership interests in UTP and LTP. For U.S. Federal tax purposes, such a transaction would have caused UTP to be wholly owned by CFC2 (and so disregarded), and which in turn would have caused LTP to be treated as wholly owned by CFC2 (and also disregarded). For U.S. Federal tax purposes, the single transaction originally contemplated by the parties would have resulted in CFC2 holding the LTP assets directly. See Rev. Rul. 55-68, 1955-1 C.B. 372 (Where one of the partners purchases the partnership interests of all of the other partners, he becomes the owner of the assets of the partnership, by purchase with respect to the fractional interests in the assets attributable to the purchased partnership interests and by in kind distribution through liquidation of his own interest in the partnership.); Rev. Rul. 67-65, 1967-1 C.B. 168 (Where a surviving partner in a two person partnership purchases the other deceased partner’s interest, the partnership terminates under § 708(b)(1)(A) at the time the sale is consummated and the surviving partner is deemed to have acquired by purchase the assets attributable to the deceased partner’s interest in the partnership.); see also, McCauslen v. Commissioner, 45 T.C. 588 (1966). In the transaction as originally contemplated, CFC1 would be treated as selling partnership interests. See generally, Rev. Rul. 99-6, 1999-1 C.B. 432.

Instead of undertaking this single transaction that would result in CFC2 holding the assets of LTP for U.S. Federal tax purposes, Taxpayer and Company entered into a binding commitment on Date 4 to undertake three purportedly independent steps relating to the facility owned through LTP. In the first step, CFC1 and CFC2 contributed their interests in LTP to UTP. This caused LTP, an eligible entity within the meaning of § 301.7701-3(a), to have a single owner, UTP, and thus, to become disregarded as an entity apart from UTP. See § 301.7701-3(f). In the second step, UTP sold its interests in LTP to CFC2. Because LTP was now a disregarded entity, this step would be treated as a sale of the operating assets held through LTP. In the third step, UTP made liquidating distributions of the sale proceeds to CFC1 and CFC2. The result of these transactions is that CFC2 would be treated as holding LTP's assets directly for U.S. Federal tax purposes. Accordingly, these three transactions reached the same end result for U.S. Federal tax purposes as the single transaction that was originally contemplated and are appropriately recharacterized under step transaction principles as the sale by CFC1 of its partnership interests in UTP and LTP to CFC2. Indeed, in the instant case, under any of the step transaction formulations, the transaction would be recharacterized as a sale of the partnership interests.

2. Despite the form of the transaction, in substance it should be treated as a sale of partnership interests.

CFC1 and CFC2 recast a transaction that was originally negotiated as a sale of CFC1's partnership interests in UTP and LTP into an agreement between CFC1 and CFC2 to take three steps: (1) to contribute their interests in LTP to UTP thereby causing LTP to become a disregarded entity; (2) to cause UTP to sell LTP to CFC2; (3) to cause UTP to make a liquidating distribution of its assets to CFC1 and CFC2. Even if the step- transaction doctrine did not apply, and the putative separate steps were given independent significance, we believe that the substance of the second and third steps is a sale of CFC1's partnership interest in UTP.

The inquiry into whether a partner has sold its interest in a partnership or the partnership has redeemed the partner's interest is not uncommon in the context of applying §§ 736 and 741. A departing partner often has the opportunity either to sell its partnership interest or to have its partnership interest redeemed.[1] As a general point of comparison, the departing partner should receive the same proceeds (fair market value) in both cases, but the tax treatment of the two alternatives can be significantly different. As noted by the Tax Court in Coven v. Commissioner, 66 T.C. 295, 305 (1976), *acq.* 1976-2 C.B. 1, if a retiring partner is entitled to capital gains treatment for sale of his interest to another partner, the buying partner gets no deduction for the payments. If a retiring partner must report the payments as ordinary income resulting from guaranteed payments for liquidation of his interest by the partnership, then the

[1]In 1993, certain amendments to § 736 limited the choice available to departing partners in structuring the tax consequences of liquidating payments.

partnership deducts the payments made to the retiring partner. See generally Miller v. U.S., 181 Ct. Cl. 331, 337-341 (1967); Foxman v. Commissioner, 41 T.C. 535, 549-552 (1964), *aff'd.* 352 F.2d 466 (3d Cir. 1965). Consequently, the substance over form analysis is traditionally applied to determine whether a partner has, in substance, sold a partnership interest or received a liquidating distribution. Those precedents provide a meaningful guide for the present case.

For instance, in Coven, the taxpayer, who was one of five partners in an accounting firm, decided to withdraw from the accounting firm for medical reasons. Although the taxpayer initially agreed to sell his partnership interest to another partner in the accounting firm, the taxpayer and purchasing partner subsequently entered into a "consultant agreement" that superseded the original sales agreement. The consultant agreement provided that the taxpayer would receive certain cash payments from the purchasing partner as a consultant to the accounting firm. The Tax Court allowed the taxpayer to disregard the form of the consultant agreement, and ruled that, in substance, the taxpayer had sold his partnership interest rather than received a liquidating distribution. The court based its decision on the following six factors: (1) the partnership was not a party to the agreement and had no liability to make payments; (2) the taxpayer and the purchasing partner testified that they intended a sale between them; (3) the payments came from the purchasing partner, and not the partnership; (4) when the obligation to pay was assumed by another partnership, the other partnership did not indicate any understanding that it was assuming an obligation of the first partnership; (5) no payments were made by the partnership to the taxpayer; and (6) the evidence indicated that the transaction had originally been negotiated as a sale of a partnership interest.

When the Coven factors are applied to this case, it becomes evident that, despite Taxpayer's characterization of the transaction as an asset sale by UTP, the substance of the transaction was a sale of CFC1's partnership interest in UTP. Neither UTP nor LTP were parties to the Date 4 agreement that purported to bind UTP to sell its interest in LTP to CFC2. The agreement was signed by Taxpayer and Company (the respective owners of CFC1 and CFC2). In Coven, the court placed considerable weight on the fact that the partnership was not a party to the agreement that the government argued should be treated as providing for redemption payments. Likewise, here, UTP was not a party to the agreement that purported to bind UTP to sell its assets to CFC2.

The court in Coven also placed considerable weight on the source of the funds and the identity of the party committed to provide the funds. In Coven, the payments to the departing partner came from another partner, as opposed to the partnership itself. The court refused to find a liquidating distribution where the partnership neither made payments nor was obligated to do so. In the present case, Taxpayer claims UTP sold its assets, and distributed a portion of the proceeds to CFC1 as a liquidating distribution. Significantly, however, the Date 4 agreement that purported to effectuate the sale of all of UTP's assets involved only a commitment from Company (CFC2's owner) to tender an amount that had previously been agreed was sufficient to purchase CFC1's partnership interest. Thus, the facts indicate that Company was prepared to offer only consideration sufficient to purchase CFC1's partnership interest (Note 1). Note 2, issued by CFC2, purportedly was consideration for the assets attributable to CFC2's interest. Note 2 should be disregarded. Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. U.S., 364 U.S. 361 (1960); Battelstein v. Internal Revenue Service, 631 F.2d 1182 (5th Cir. 1980), *cert denied*, 451 US 938 (1981).

In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions. Similarly, in the present case, the note issued by CFC2 for a principal value of $i represents a circular cash flow that lacks economic significance where that note is immediately distributed back to CFC2. The only real consideration in the present case is Note 1 with the principal value of $f issued by Company, which corresponds with the amount Company had previously committed to pay for CFC1's partnership interests.

The substance over form analysis relies heavily on the fact that the alleged purchaser of the UTP's assets had previously negotiated to purchase CFC1's partnership interests and committed to tender the amount previously agreed upon as the purchase price for those interests. Thus, despite Taxpayer's claims, we do not believe that CFC2, acting as a third party, purchased UTP's assets. However, if such a showing could be made, we believe that the substance of the transaction would still be the sale of a partnership interest under the sale of a going concern doctrine. Under this doctrine, the sale of an entire continuing partnership business will be taxed as a sale of a partnership interest, even though the form of the transaction is an asset sale. For instance, in Estate of Hatch v. Commissioner, 198 F.2d 26 (9th Cir. 1952), three partners operated a car dealership through a partnership. The partners signed an agreement with a buyer providing for the sale of the business of the partnership. The bulk of the partnership assets were sold to the buyer, who continued to operate the business. While the sale agreement was structured as a sale of the business and the assets of the partnership, the court ruled it was the expressed intention of the taxpayers to sell their business as a going concern and not just a specified list of the partnership's assets. Therefore, it was more appropriate to view the partners as selling their partnership interests. See also LaRue v. Commissioner, 90 T.C. 465 (1988) (recent application of the doctrine). See generally, McKee, Nelson, and Whitmire, Federal Taxation of Partnerships and Partners, 3rd ed., 1997 & 2000 cum. supp. No. 1, ¶ 15.03[2] and the cases cited therein.

The sale of a going concern doctrine is a specialized substance over form argument that is applicable when a partnership sells its operating assets to a third party buyer and makes liquidating distributions to the existing partners. We believe that the facts of this case as currently developed do not support an asset sale and so do not advance the sale of a going concern doctrine as a primary substance over form analysis. However, Taxpayer has claimed a form that purports to achieve a complete sale of partnership operating assets to a partner acting as a putative third party. Accordingly, we encourage the use of the sale of a going concern doctrine as an alternative theory.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted] The application of the doctrine is complicated slightly by the presence of the disregarded entities. As originally structured, the transaction would have resulted in CFC2 holding the operating asset through two tiers of disregarded entities, UTP and LTP. As restructured, CFC2 apparently holds the operating assets through two tiers of disregarded entities, CFC2 DE and LTP. We recognize that the insertion of CFC2 DE as the upper-tier disregarded entity (in place of UTP) in the restructured transaction causes the restructured transaction to have a slightly different result from a nontax perspective. However, where the two results are identical for U.S. Federal tax purposes, we do not believe that the insertion of a disregarded entity can defeat the application of the step- transaction doctrine. Furthermore, Taxpayer's claimed tax treatment is dependent upon an aggressive utilization of a disregarded entity. We believe that Taxpayer faces greater hazards in arguing that disregarded entities are transparent for one step of the transaction, but not another.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

As a final note, we also considered analyzing the case as a disguised sale of a partnership interest analysis under § 707(a)(2)(B). We decided not to include this argument because we did not feel it added anything to the substance over form analysis. [redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call Mark Pollard at (202) 622-3860 if you have any further questions.

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