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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel
Large and Mid-Size Business
Laguna Niguel
CC:LM:CTM:LN:
Attn: Kenneth C. Peterson, Attorney

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX & ACCOUNTING)
CC:ITA

SUBJECT: Partnership Losses from Carryover Basis in Debt

This Field Service Advice responds to your memorandum, dated December 21, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Foreign Bank A =
Business B =
Foreign Bank C =
$D =
$E =
$F =
LLC G =
Trust H =
Individual I =
Individual J =
Corp K =
Corp L =

Corp M	=
Corp N	=
P%	=
Corp Q	=
$R	=
S%	=
T%	=
$U	=
Corp V	=
$W	=
Corp Y	=
Corp Z	=
Corp AA	=
$BB	=
$CC	=
$DD	=
Foreign Bank EE	=
Corp FF	=
$GG	=
$HH	=
$JJ	=
$KK	=
Corp LL	=
Foreign Bank MM	=
$NN	=
$PP	=
Date QQ	=
Individual RR	=
Individual SS	=
$TT	=
$UU	=
$VV	=
$WW	=
$XX	=
Date YY	=
$ZZ	=
LLC AAA	=
$BBB	=
$CCC	=
DDD%	=
Corp EEE	=
$FFF	=
GGG%	=
$HHH	=

Entity III	=
$JJJ	=
$KKK	=
$LLL	=
$MMM	=
$PPP	=
$QQQ	=
$RRR	=
$SSS	=
$TTT	=
$UUU	=
$VVV	=
$WWW	=
$XXX	=
$YYY	=
$ZZZ	=
Business AAAA	=
$BBBB	=
$CCCC	=
$DDDD	=
$EEEE	=
Entity FFFF	=
$GGGG	=
Entity HHHH	=
$IIII	=
Entity JJJJ	=
Entity KKKK	=
Entity LLLL	=
$MMMM	=
$NNNN	=
$PPPP	=
$QQQQ	=
RRRR%	=
$SSSS	=
$TTTT	=
$UUUU	=
$VVVV	=
WWWW%	=
Foreign Bank XXXX	=
$YYYY	=
Corp ZZZZ	=
$AAAAA	=
LLC BBBBB	=
$CCCCC	=

$DDDDD	=
$EEEEE	=
$FFFFF	=
$GGGGG	=
Year 1	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=
Year 14	=
Year 15	=

ISSUES

1. Whether under the facts presented, a partnership has basis in notes contributed by a partner.

2. Whether a taxpayer can shift the recognition of inherent loss to a third party by contributing the property to a partnership, selling its interest in the partnership to the third party, and having the partnership sell the loss property (i.e. whether under the facts of this case the partnership anti-abuse rules, Treas. Reg. §1.701-2, prevent the new partner from recognizing the loss).

3. Whether I.R.C. § 731 and § 752 prevent the netting of an early gain caused by a decrease in a partner's share of partnership liabilities with a later increase in basis caused by an increase in that partner's share of partnership liabilities.

4. Whether the disguised sale rules, under section 707(a)(2)(B), apply to the transaction described.

CONCLUSIONS

1. If the notes were worthless, an argument could be made that LLC G acquired no basis in the notes because there was no contribution in the true sense of the word as nothing of value was transferred to it. Debt may be totally worthless within the meaning of the regulations when the taxpayer has no prospect of recovering more than a trivial amount. In addition, partnership basis should be reduced to the extent the Foreign Banks or their successors or related entities should have deducted the notes as bad debts in prior years. Also, a taxpayer may not have basis in debt that exceeds its fair market value when received. The advances by the Foreign Banks in this case

could be characterized as either theft losses or equity; if they are, the proper timing for deduction may be earlier.

2. Under the facts presented, the parties may not shift the recognition of inherent loss to a third party by contributing the property to a partnership, selling its interest in the partnership to the third party, and having the partnership sell the loss property. Under the the facts of this case, the partnership anti-abuse rules, Treas. Reg. §1.701-2, prevent the new partner from recognizing the loss. They apply to Trust H as well as to Corp EEE.

3. Under the facts presented, sections 731 and 752 prevent the netting of an early gain caused by a decrease in a partner's share of partnership liabilities with a later increase in basis caused by an increase in that partner's share of partnership liabilities.

4. The disguised sale rules, under section 707(a)(2)(B), do not apply to the transaction.

FACTS

Synopsis

During the late 1980s and early 1990s, Foreign Bank A, later renamed Foreign Bank MM, and Foreign Bank C advanced substantial funds which resulted in the purchase and operation of Business B , which was carried on by various named entities discussed below. Foreign Bank A is wholly owned by Foreign Bank C. Some of the notes pertaining to the advances were from or later transferred to a related corporation, Foreign Bank XXXX. A significant portion of Business B was sold. After the sale, the Foreign Banks held two notes with a face amount of $D and $E.[1] The Foreign Banks also retained stock with a basis of $F. Since the Foreign Banks could not benefit domestically from a bad debt deduction, they attempted to sell or otherwise transfer the tax losses to entities which could use them for their benefit.

In furtherance of this plan, the Foreign Banks contributed their high basis, low fair market value notes to LLC G and subsequently transferred its membership interest in LLC G to an unrelated entity, Trust H, which could use the capital losses. Then, each time LLC G sold a portion of the notes, Trust H, its main member, was allocated large flow-through capital losses which would offset unrelated capital gains. LLC G also engaged in similar transactions through the formation of an additional partnership.

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[1] Neither the amount or the bona fide nature of debt represented by the notes has been substantiated.

More detailed summary of facts

During the late 1980s and into the early 1990s, Foreign Banks A and C made various large advances in the form of loans to Individual I and Individual J, Corp K , Corp L and related entities.

Beginning at least as far back as Year 1, the Foreign Banks were advancing money to Corp K and related entities. Late in Year 6, Corp K obtained the financing from Foreign Bank A to acquire Business B, by purchasing Corp M. As part of this acquisition, Corp M merged into a Corp K subsidiary, and Corp M was the survivor corporation. Corp M then changed its name to Corp N.

Prior to the purchase, Foreign Bank C advanced $R to Corp Q. On the same day, Corp Q in turn advanced almost all of the amount to Corp K, retaining only a small portion as a fee. Corp K pledged S% of the stock of Corp N to Corp Q as security for the repayment of its advance and gave it T% of its Corp N stock as a fee for the transaction. Corp Q pledged the T% of Corp N stock to Foreign Bank C as security for its advance. Corp Q also assigned its right to receive S% of the Corp N stock to Foreign Bank C if Corp K defaulted on the purported loan.

Foreign Bank A advanced funds to Corp K and Corp N to help them avoid bankruptcy. In connection with this extension of credit, Corp K and certain related corporations pledged to Foreign Bank A all shares of Corp K owned by the corporations as security for repayment of the advances made by Foreign Bank A. All the shares of Corp K and Corp N owned by such entities were placed under voting trust agreements in favor of Foreign Bank A. The shares covered by these pledge agreements and voting trust agreements included almost all of the outstanding common stock of Corp N.

About the same time, Foreign Bank A, Corp K, and Corp N entered into an interim revolving credit agreement. A portion of this purported debt created under this agreement was later canceled in the Year 8 foreclosure; however, Foreign Bank A continued to extend credit under this agreement after that date. The balance was eventually consolidated into the $D note. Soon after, Foreign Bank A and Corp N also entered into a credit agreement for advances up to $U. This amount was eventually also part of the $D note.

In Year 8, because Corp K, Corp L, and Corp N could not pay their debts, Foreign Bank A foreclosed on Corp K's Corp N stock. Foreign Bank C created a wholly owned subsidiary called Corp V. Foreign Bank A sold to Corp V $W in notes receivable from Corp K and Corp L for $W. Corp V then purchased the Corp N stock from Foreign Bank A by giving $W in notes receivable back to Foreign Bank A. Corp V acquired P% of the shares of Corp N as a result of the foreclosure. Corp N changed its name to

Corp Y. Soon after, Foreign Bank A advanced money to Corp Y. This advance eventually became part of the $D note.

Subsequently, in Year 9 , Corp Y created a subsidiary, Corp Z. Corp Y changed its name to Corp AA. Corp Z changed its name to Corp Y. Corp AA gave substantially all of its assets and certain liabilities to the new Corp Y. Corp AA retained only limited assets and had very high liabilities. On the same date, Foreign Bank C and new Corp Y entered into a working capital agreement under which Foreign Bank C advanced a total of $BB. This amount eventually became the $E note.

Late in Year 9, Corp AA and Foreign Bank A entered into an agreement restructuring the purported debt of Corp AA to Foreign Bank A. Corp AA executed a note in which it promised to pay $CC and pledged all of the securities it owned to Foreign Bank A. In Year 10, Foreign Bank A advanced an additional $DD, which created a total purported debt of $D. In March of Year 11, Foreign Bank C created Foreign Bank EE and gave Foreign Bank EE its interest in the Corp V stock.

In Year 11, Corp Q assigned its right to receive $U from Corp K and its security interest in S% of the Corp N stock to Foreign Bank C. At the same time, Foreign Bank C purchased the T% of Corp AA (formerly Corp N) stock owned by Corp Q by cancelling the purported loan on which Corp Q owed a principal amount of $R plus $1.00. In December of year 11, Foreign Bank C gave this Corp AA stock to Corp V. Corp V then owned 100% of Corp AA (formerly Corp N). Corp V was liquidated in Year 12, leaving Foreign EE as the owner of Corp LL.

In Year 12, new Corp Y stock was sold to Corp FF. Corp FF agreed to pay $GG to Corp AA's creditors to pay off a portion of new Corp Y's debt. Various banks agreed to provide $HH of equity financing, $JJ of term debt, and $KK of revolving credit to Corp F. Just prior to the sale, Corp AA was renamed Corp LL. Foreign Bank A was renamed Foreign Bank MM.

At the time of the sale, new Corp Y was insolvent by an estimated $E and owed Foreign Bank C $NN in purported loans. $PP of the purchase price was paid to Bank C, which left a principal balance outstanding of $E . Corp AA (renamed Corp LL) assumed the obligation to pay the $E outstanding balance. After the sale, Corp AA (Corp LL) was left with almost no assets, because almost all of its assets had been in new Corp Y. Foreign Bank C gave the $E note to Foreign Bank EE. On or before Date QQ, Foreign Bank EE gave the $E note and the stock of Corp LL to Foreign Bank XXXX.

On Date QQ, Corp ZZZZ and Individual SS formed LLC G by contributing $TT and each acquiring a 50% common and preferred interest in LLC G. At that time, Individual SS was the president of Corp LL and he and Individual RR were partners in another venture. Individual RR was the grantor of Trust H. On the next day, Foreign Banks MM and XXXX contributed the $D plus $E in Corp LL notes and Foreign Bank XXXX's P%

ownership interest in Corp LL to LLC G in exchange for a 100% preferred interest. Their approximate capital accounts at the time of contributions were as follows: Foreign Bank MM - $UUUU tax/ $UU book and Foreign Bank XXXX - $VV/ $WW book. On the same date, Trust H contributed $XX and acquired a 99.5% common interest in LLC G, leaving Corp ZZZZ and Individual SS each with a .25% common interest. Approximately three weeks later, on Date YY, Foreign Banks MM and XXXX sold their 100% preferred interest to Trust H for $ZZ (the amount in the book capital accounts). The parties did not make a section 754 election. In December of Year 13, LLC G sold $R of the $D Notes due for Corp LL to Enity III for $CCCCC and $DDDDD in notes. No payments were made on the Entity III notes in Years 13 through 15.

In November Year 13, LLC AAA was created. LLC G acquired a WWWW% interest in LLC AAA by contributing $BBB in cash and $E in notes due from Corp LL to LLC AAA. Approximately one month later, LLC G sold a DDD% interest in LLC AAA to Corp EEE for $TT in cash and a $FFF note. In Year 14, LLC G sold an additional GGG% interest in LLC AAA to Corp EEE for $HHH and a $YYYY increase in Corp EEE's note to LLC G. In December of Year 13, LLC AAA sold $E of the Corp LL note receivables to Entity III for $JJJ cash and $KKK note. No payments were made on the Entity III notes in Year 13 or Year 15.

During December of Year 13, through the sale of $R of the Corp LL notes and its interest in LLC AAA, LLC G recognized approximately $LLL in capital losses, which flowed through to Trust H. In December of Year 13, Trust H made a $MMM capital contribution to LLC G in the form of an assignment of its 100% interest in LLC BBBBB, which held valuable marketable securities. As a result of this capital contribution, Trust H's grantor, Individual RR, was able to use $PPP of the losses to offset unrelated capital gains. The remaining losses, $QQQ, were carried over to Year 14. In Year 14, LLC G sold another $RRR of notes to Entity III for $SSS cash and $TTT in notes. LLC G recognized $CCC of losses, all of which flowed through to Individual RR from Trust H. Trust H contributed an additional $UUU in assets to LLC G and Individual RR used $VVV in losses in Year 14. The remaining $WWW loss from Year 14, plus the $QQQ from Year 13, were carried over to Year 15. In Year 15, Individual RR had $EEEEE in capital gains with which to offset the carryover losses.

Also in December of Year 13, through its sale of its Corp LL notes, LLC AAA recognized approximately $CCC in capital losses, $XXX of which flowed through to Corp EEE. At about the same time, Corp EEE purchased $GGGGG in Treasury Bills (T Bills) and financed them through the use of a repurchase agreement. Both the T Bills and the related liability, the repurchase agreement, were contributed to LLC AAA in order to give Corp EEE enough basis with which to use all of its allocated losses in that year. In January of Year 14, the repurchase agreement was closed out and LLC AAA was deemed to have distributed to Corp EEE $AAAAA, the amount of the partnership liability relief. Corp EEE did not recognize gain with respect to this deemed distribution as it should have, but instead attempted to create additional basis against which this

gain could be netted by contributing in December Year 14 T Bills and another repurchase agreement. The second repurchase agreement was closed out in January in Year 15 and in December in Year 15, Corp EEE contributed another set of T Bills and related repurchase agreement with the apparent purpose of attempting to delay the recognition of gain.

During Year 13 and Year 14, which were also its tax years, LLC G incurred no business expenses and earned no income directly related to the operation of the business. Rather, all of its income and expenses flowed through to it from LLC BBBBB. During those years, LLC G did not have any employees. In Year 15, LLC G's tax return shows $YYY in direct expenses, $ZZZ of which were related to Business AAAA expenses, and some salary and other expenses.

For the years Year 13 through Year 15, LLC AAA incurred no expenses and had only passive income. During the same period, all of its income (approx. $BBBB) and losses (approx. $CCCC) flowed through from investments. In Year 14, Corp EEE contributed $FFFFF to LLC AAA. In Year 15, LLC AAA deposited $DDDD of the $HHH contributed by Corp EEE into a money market account. During this time period, LLC AAA also invested $EEEE in Entity FFFF, $GGGG in Entity HHHH, $IIII in Entity JJJJ and approximately $FFF in Entity KKKK. Neither Entity JJJJ nor Entity KKKK were involved in the Business AAAA.

In Year 15, LLC G contributed the remaining Corp LL note receivables to Corp LL, and then Corp LL entered into a C reorganization with Entity LLLL wherein it obtained Entity LLLL stock in exchange for all of its assets and then it liquidated and distributed the Entity LLLL stock to its sole shareholder, LLC G. LLC G's Year 15 tax return show a $MMMM tax basis and a $NNNN book value in the Entity LLLL stock.

LAW AND ANALYSIS

Issue 1

Partnership basis in debt

If the notes were worthless, an argument could be made that LLC G acquired no basis in the notes because there was no contribution in the true sense of the word since nothing of value was transferred to it. Seaboard Commercial Corporation v. Commissioner, 28 T.C. 1034, 1054-55 (1957), acq. 1958-2 C.B. 7; Hayutin v. Commissioner, T.C. Memo 1972-127, aff'd 508 F.2d 462 (10th Cir. 1974).

Whether the debt was worthless when it was contributed to LLC G is a factual question which requires an examination of all the circumstances. See Boehm v. Commissioner,

326 U.S. 287, 293 (1945); Wedum Supply Co., Inc. v. Commissioner, T.C. Memo 1990-468. We defer to you on this factual issue, but can provide the following guidance. Treas. Reg. § 1.166-3(b) requires that the debt be totally worthless to be deductible as a bad debt under section 166(a). Debt may be totally worthless within the meaning of the regulations when the taxpayer has no prospect of recovering more than a trivial amount. Buchanan v. United States, 87 F.3d 197 (7th Cir. 1996), cert. denied, 519 U.S. 950 (1996); Washington Trust Co. of Pittsburgh v. Commissioner, 1 T.C.M. (CCH) 5 (1942); Rev. Rul. 71-577, 1971-2 C.B. 129. Further, these authorities show a trivial amount may be defined to be only cents on the dollar, that is, a very small percentage of the total amount, as is the situation here. However, there may be some issue whether reliance on the percentage of recovery is appropriate when amounts that could be received are substantial. See Los Angeles Shipbuilding & Drydock Corp. v. United States, 166 F. Supp. 914 (S.D. Cal. 1958), vacated on another issue, 289 F.2d 222 (9th Cir. 1961).

We may also examine whether the Foreign Banks' bases in the notes is correct or whether the bases should have been reduced by deductions in prior years. United States tax law is applied to determine a foreign entity's proper basis. Ahadpour v. Commissioner, 2002-1 USTC ¶50,274 (9th Cir.); Gutwirth v. Commissioner, 40 T.C. 666, 678-79 (1963), acq. in result, 1966-2 C.B. 5; Antuna v. Commissioner, T.C. Memo 1970-290. The taxpayer must establish basis in the notes for them to be recognized for tax purposes. See Grace v. Commissioner, T.C. Memo 1981-624; Antuna, supra.

The sale of the notes is properly a capital loss and is not governed by section 166. See Benedum v. Granger, 180 F.2d 564 (3d Cir.), cert. denied, 340 U.S. 817 (1950); J.E. Hawes Corp. v, Commissioner, 44 T.C. 705 (1965). However, partnership basis should be reduced to the extent Foreign Banks A or C or their successors or related entities should have deducted their bases in the notes as bad debts in prior years. A corporation has the option of deducting a debt when it becomes wholly worthless or partially worthless. I.R.C. § 166(a). The deduction of a partially worthless debt requires that the taxpayer charge off the loan in the year it is deducted. I.R.C. § 166(a)(2); Treas. Reg. § 1.166-3(a)(2).

The taxpayer may not delay the deduction of a debt that is totally worthless. Seiberling Rubber Co. v. Commissioner, 169 F.2d 595 (6th Cir. 1948); Seaboard Commercial, 28 T.C. at 1054; W.L. Moody Cotton Co. v. Commissioner, 2 T.C. 347 (1943), aff'd, 143 F.2d 712 (5th Cir. 1944). However, a taxpayer is not required to write off debt as partially worthless. Reed v. Commissioner, 129 F.2d 908 (4th Cir. 1942); American Cigarette & Cigar Co. v. Bowers, 92 F.2d 596 (2d Cir. 1937); Harlan v. United States, 312 F.2d 402 (Ct. Cl. 1963). For example, in American Cigarette, the taxpayer had loaned money to a corporation that had steadily declined over a number of years. The taxpayer delayed writing off all the debt until the corporation had gone out of business and the assets had been sold off. The government argued that because the debt was in the form of a number of notes, the notes should have progressively been found to be

worthless as the business died. The Second Circuit rejected this argument, finding that a creditor may allocate payments among notes as it pleases and could therefore wait until the entire debt was worthless before writing it off.

In addition, a taxpayer may not have basis in a debt acquired that exceeds its fair market value upon receipt. Thompson v. Commissioner, 22 T.C. 507 (1954), acq. 1954-2 C.B 6; Estate of Rapoport v. Commissioner, T.C. Memo 1982-584. This is true even if the taxpayer paid more for the notes than they were worth and the taxpayer is not found to have had a purpose of tax avoidance. See Thompson, supra. However, a taxpayer's tax avoidance purpose can be a factor in finding an acquirer's basis in debt should be reduced to fair market value. Mountain Wholesale Co. v. Commissioner, 17 T.C. 870, 875-76 (1951). See Emmen v. Commissioner, 77 T.C. 1326, 1349 (1981), acq. 183-2 C.B. 1. The absence of an arm's length transaction may also be considered in requiring basis to be reduced to fair market value. Lemmon, 77 T.C. at 1348; Bixby v. Commissioner, 58 T.C. 757, 776 (1972), acq. 1975-2 C.B. 1,2.

However, there is an exception to the rule found in Thompson when, as in this case, the acquirer takes a carryover basis in the asset that equals the basis of the transferor. See American Credit Corp. v, Commissioner, T.C. Memo 1973-33; Hayutin, supra. American Credit explicitly found such an exception in the context of a corporate reorganization. It also distinguished Mountain Wholesale, because it involved circumstances where the taxpayer acquired its own basis. The holding in Hayutin is less clear. Like the present case, Hayutin involves the contribution of a note to a partnership, where the note was arguably worth less than the partner's basis. The Tax Court allowed the partnership to have the partner's basis in the note. However, the reasoning of the court does not explicitly state the exception for carryover basis and instead relies in part upon limited arguments, concessions and stipulations of fact by the Commissioner. The Commissioner acquiesced in American Credit, 1973 AOD LEXIS 156, and Hayutin, 1973 AOD LEXIS 51, but neither Action on Decision discusses the carryover exception. In addition, specific partnership provisions also address the tax avoidance purpose in the context of the present case. The partnership provisions are discussed below in Issue 2.

Further, it appears that many of the loans were worthless when made and therefore do not comprise bona fide debt. See Garret v. Commissioner, 39 T.C. 316 (1962); Stark v. Commissioner, T.C. Memo 1982-639. Bona fide debt is made only when there is a reasonable expectation that it will be repaid. Litton Business Systems, Inc. V. Commissioner, 61 T.C. 367, 377 (1973), acq. 1974-2 C.B. 3; Klaue v. Commissioner, T.C. Memo 1999-151. To determine what portion of the loans are not bona fide, courts look to see if there was a reasonable expectation of repayment at the time individual advances were made. C. M. Gooch Lumber Sales Co. v. Commissioner, 49 T.C. 649(1968), remanded on another issue, 406 F.2d 290 (6th Cir. 1969); Weis v. Commissioner, T.C. Memo 1983-178; Stark, supra. Difficulty in determination of which part of a purported debt is bona fide does not mean that an "all or nothing

approach" must be adopted. Gooch Lumber, 49 T.C. at 651. Thus, portions of the debt in the present case may not be included in the basis of the notes contributed.

If the notes are not bona fide debt, then there is a question of how they should be characterized.[2] You have suggested that the loans may have been obtained fraudulently and there is evidence of criminal misconduct. If so, they may be embezzlement losses. They may also be characterized as equity. Although we have not analyzed either of these possibilities completely, we have provided some guidance for the possible development of these issues. As discussed below, the analysis of when the deduction for the notes should have been taken varies depending upon their characterization.

Treatment as a theft loss

Theft losses are allowed under section 165(a). Under section 165(e), they are treated as sustained during the taxable year in which the taxpayer discovers the loss.

Whether a theft loss has been sustained within the meaning of section 165 is determined under applicable local law. Viehweg v. Commissioner, 90 T.C. 1248, 1253 (1988); Luman v. Commissioner, 79 T.C. 846, 860 (1982); Rev. Rul. 72-112, 1972-1 C.B. 60. The word "theft" is "a word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property." Paine v. Commissioner, 63 T.C. 736 (1975), aff'd in an unpublished opinion, 523 F.2d 1053 (5th Cir. 1975), quoting, Edwards v. Bromberg, 232 F.2d 107, 111 (5th Cir. 1956). Under Treas. Reg. § 1.165-8(e), the term "theft" is defined to include embezzlement.

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[2] Even if the Service may have the option to challenge the notes as bona fide debt, the taxpayer may be held to a characterization of an amount as debt. See City of New York v. Commissioner, 103 T.C. 481 (1994), aff'd, 70 F.3d 142 (D.C. Cir. 1995); Litchfield v. Commissioner, T.C. Memo 1994-585, aff'd in an unpublished order, 97-2 USTC ¶50,536 (10th Cir. 1997). See also Taiyo Hawaii Co., Ltd. v. Commissioner, 108 T.C. 590 (1997); Miller v. Commissioner, T.C. Memo 1989-153, aff'd in an unpublished opinion, (6th Cir. April 17, 1990). Taxpayers have been held to have less opportunity to challenge the form of their transactions than the government. See Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1390 (9th Cir. 1977); Coleman v. Commissioner, 87 T.C. 178, 202 (1986), aff'd in an unpublished order, 833 F.2d 303 (3d Cir. 1987). This is particularly true where the parties clearly intended the transaction chosen and that form had an obvious tax purpose. McNulty v. Commissioner, T.C. Memo 1988-274. See also Coleman, 87 T.C. at 202; Juden v. Commissioner, T.C. Memo 1987-302, aff'd, 865 F.2d 960 (8th Cir. 1989).

If some of the advances are in fact embezzlements, they arguably should have been deducted when discovered. I.R.C. § 165(e). However, if there was a reasonable possibility that the embezzlements could be recovered at the time the were discovered, then it is possible that they could be treated as debts and become deductible when the debts subsequently become worthless. See Douglas County Light & Water Co. v. Commissioner, 43 F.2d 904 (9th Cir. 1930).

Treatment as equity

If certain of the advances are treated as equity rather than debt they are subject to section 165(a), which allows deductions for losses sustained during the year. Under Treas. Reg. § 1.165-1(d)(1), a loss is allowable only for the taxable year in which the loss is sustained. For this purpose, a loss is treated as sustained during the taxable year in which the loss is evidenced by closed and completed transactions and fixed by identifiable events occurring in the taxable year.

Any advances that were in fact equity in new Corp Y should have included any calculation for the sale of that stock in year 12. We would question the assumption of the remaining "liabilities" of Corp Y by Corp AA as worthless when made.

As to the stock in Corp LL (formerly Corp AA) and any advances determined to be equity in it, the question will be whether it was worthless under section 165(g), which allows for deductions for worthless securities. The question of worthlessness is again completely factual and under your jurisdiction. See, e.g., Boehm, 326 U.S. at 293; Klepetko v. Commissioner, T.C. Memo 1990-644, aff'd in an unpublished opinion, (2d Cir. January 7, 1992)

There is a two-part test for determining whether stock is worthless. First, the stock must cease to have liquidating value, i.e., the corporation has an excess of liabilities over assets. Second, the stock must lack potential value. Austin Co. v. Commissioner, 71 T.C. 955, 969-70 (1979), acq. 1979-2 C.B. 1; Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), nonacq. 1939-1 C.B. 57, aff'd, 112 F.2d 320 (7th Cir. 1940). The stock must be worthless under both factors before the loss is fixed. See Figgie International, Inc. v. Commissioner, 807 F.2d 59, 62 (6th Cir. 1986). The standard has been stated to be whether a prudent businessman would have considered the stock to be worthless. Steadman v. Commissioner, 50 T.C. 369, 377 (1968), aff'd, 424 F.2d 1 (6th Cir.), cert. denied, 400 U.S. 869 (1970); Flint Industries Inc. v. Commissioner, T.C. Memo 2001-276. See Ainsley v. Commissioner, 332 F.2d 555, 557 (9th Cir. 1954) ("prudent purchaser" test), which appears to control in the present case.

In regard to the two-part test, it is apparent that Corp AA (later, Corp LL) was insolvent. However, in determining whether a corporation is in fact insolvent, only loans that are bona fide and not in substance equity are counted. See Ditmar v. Commissioner, 23 T.C. 789, 798 (1955), acq. 1955-2 C.B. 5; Leuthold v.

Commissioner, T.C. Memo 1987-610; Wildes v. Commissioner, T.C. Memo 1980-298. Therefore in determining insolvency, advances will be considered as either debt or equity.

There are two ways of showing lack of potential value: 1) liabilities so exceed the assets that there is no hope for recovery, or 2) certain identifiable events have occurred that demonstrate the worthlessness of the stock. Morton, 38 B.T.A. at 1279. Even if some of the advances are reclassified as equity, it still appears that Corp LL was so insolvent that there was no hope of recovery in years prior to the contribution to LLC G. See Steadman v. Commissioner, 50 T.C. at 377; Corona v. Commissioner, T.C. Memo 1992-406, aff'd without opinion, 33 F.3d 1381 (11th Cir. 1994), cert. denied, 513 U.S. 1094 (1995). Otherwise, worthlessness must be shown by the occurrence of certain identifiable events "such as the bankruptcy, cessation from doing business, or liquidation of corporation, or the appointment of a receiver" which either evidence or cause the worthlessness of the stock. Morton 38 B.T.A. at 1278. See Steadman, 50 T.C. at 376-77.

Issue 2

Application of the anti-abuse rules

The Service may apply Treas. Reg. § 1.701-2 to challenge the losses reported by Trust H and Corp EEE.[3]

Section 1.701-2, the partnership anti-abuse rule, in pertinent part provides 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.

However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the

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[3] We agree with your analysis that section 704 does not prevent the shifting of these losses.

proper reflection of income requirement is treated as satisfied with respect to a transaction that satisfies requirements 1 and 2 to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by the provision.

Section 1.701-2(b) provides that 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 Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of subchapter K. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner 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.

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. Treas. Reg. §1.701-2(c). Section 1.701-2(c) lists various factors that may be considered in making the determination.

Section 1.701-2(d), Example 8, provides an example of a plan to duplicate losses through the absence of a 754 election through the use of a partnership that is not consistent with the intent of subchapter K. In Example 8, A wanted to sell land to B with a basis of $100x and a fair market value of $60x. A and B devised a plan a principal purpose of which was to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. A, C, and, W formed a partnership ("PRS"). A contributed the land and C and W each contributed $30x. PRS invested the $60x in an investment asset. In year 3, at a time when the values of the partnership's assets had not materially changed, PRS agreed with A to liquidate A's interest in exchange for the investment asset held by PRS. Under 732(b), A's basis in the asset was $100x. A sold the investment asset to X, an unrelated party, recognizing a $40x loss.

PRS did not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remained at $100x. PRS sold the land to B for $60x, its fair market

value. Thus, PRS recognized a $40x loss that was allocated equally between C and W, and they each reduced the bases in their partnership interests to $10x. Thus, upon liquidation of PRS (or their interests therein), each of C and W would recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely.

In Treas. Reg. § 1.701-2(d), Example 8, PRS was used with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707), the Commissioner can recast the transaction as appropriate under Treas. Reg. § 1.701-2. Compare, § 1.701-2(d), Example 9, in which the use of a partnership for which no election under section 754 had been made is consistent with the intent of subchapter K.

a. Trust H

Here, the Foreign Banks' contribution of the Corp LL notes and stock to LLC G and the sale of their partnership interest three weeks later to Corp ZZZZ or a related entity appear to be part of a plan to transfer losses through the absence of a section 754 election. The notes and stock had a $PPPP basis and the related partnership interests were sold for $ZZ. Since the partnership did not make an election under section 754, its adjusted basis in the notes and stock remained at $PPPP. On December 19, Year 13, LLC G sold $R of $D notes to Entity III for $CCCC and the $DDDDD note, LLC G reported substantial losses, all of which were allocated to Trust H and flowed through to Individual RR, in accordance with Treas. Reg. §1.704-3(a)(7). Trust H used the losses to offset unrelated capital gains. The same type of transactions occurred in Year 14, creating more losses with which Individual RR could offset against more of his unrelated capital gains.

The transactions here are subject to recharacterization under Treas. Reg. § 1.701-2, based on the following factors: First, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. It appears that there may have been no business purpose to these transactions because in fact there were no business activities directly carried on by LLC G during Year 13 and Year 14. Its tax returns reflect no income or expenses from its operations, but only flow through income and losses from Trust H. In Year 15, LLC G purports to have incurred $YYY in expenses (and no income) directly related to Business AAAA. It is unclear, however, the relationship such business activity has to the transfer of the notes and stock, and any purported business purpose for the transactions (the transfer of the notes and stock) seem insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. It should be noted that it is LLC G's business activities, not Corp LL or Trust H which should be scrutinized and

determined if any business purpose was served by contributing the property to the partnership rather than selling it directly to Trust H.

Second, the present value of the partner's aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. If the Foreign Banks and Trust H had conducted their activities directly rather than through LLC G, the Foreign Banks would have sold the notes and stock directly to Trust H rather than contributing them to LLC G and selling their partnership interest to Trust H. Upon the sale of the notes and stock, the Foreign Banks would have recognized a loss. Trust H would have taken a cost basis in the notes and stock equal to their purported fair market value ($ZZ). Trust H would then have contributed the notes and stock to the partnership and the partnership would have received a basis equal to Trust H's cost and the property's FMV. Upon the subsequent sale of the notes at fair market value, LLC G would not have recognized any loss and none would have flowed through to Trust H and Individual RR. Conducting the activities through LLC G allowed Individual RR to claim a total of $QQQQ in capital losses, to which he would not otherwise have been entitled. Because the Foreign Banks and Trust H conducted their activities through LLC G, Individual RR's aggregate federal tax liability was substantially less than it would have been if Trust H had dealt directly with the Foreign Banks.

Third, the present value of the partner's aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. As discussed above, the present value of Trust H's federal tax liability was substantially less than would be the case if the transactions were integrated into a direct sale of the Corp LL notes and stock to Trust H.

Accordingly, we conclude that a strong argument could be made that the contribution by the Foreign Banks of the notes and stock to LLC G, and the subsequent sale of their partnership interest to Trust H, were in substance a sale by the Foreign Banks of the notes and stock to Trust H and a contribution by Trust H of the notes and stock to LLC G. Consequently, Trust H would have a cost basis ($ZZ) in the notes and stock and LLC G would have a carryover basis ($ZZ) in the notes and stock. When the notes are subsequently sold, no loss would be recognized.

We note that the anti-abuse arguments would be even stronger if additional evidence could be developed with respect to the benefit the Foreign Banks received as a result of the capital loss they sustained. If the Foreign Banks received some tax benefit, either foreign or domestic, from the loss the facts would more closely resemble the doubling of losses found in Example 8 of the anti-abuse rules and would strengthen the anti-abuse arguments.

b. Corp EEE

The anti-abuse arguments with respect to Corp EEE are even stronger than those discussed above because of the clear doubling of losses and related tax benefits. As a result, the facts relating to LLC AAA fit squarely within Example 8 of Treas. Reg. § 1.701-2. LLC G contributes $CCC in notes to LLC AAA and the following month sold RRRR% of its interest in LLC AAA to Corp EEE for $ZZZ. LLC G recognized approximately a $XXX loss as a result of its sale of a portion of its interest in LLC AAA to Corp EEE. That same month LLC AAA sold the underlying notes and recognized almost $CCC in losses, approximately $XXX of which was allocated to Corp EEE. Thus, as a result of these transactions, LLC G and Corp EEE were able to duplicate the $XXX loss and the related tax benefits.

As discussed above, the transactions are also subject to recharacterization because any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. The facts show that for the years in question, Year 13 through Year 15, LLC AAA had no business operations of its own and that all of its income and losses flowed through from its passive investments.

In addition, the transactions could be recharacterized because the present value of the partner's aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. If LLC G had conducted the activities directly rather than through LLC AAA, LLC G would have sold the notes directly to Corp EEE rather than contributing them to LLC AAA and selling its partnership interest to Corp EEE. Upon the sale of the notes LLC G would have recognized a loss. Corp EEE would have taken a cost basis in the notes equal to their purported fair market value and contributed them to LLC AAA, with a carryover basis. Upon the subsequent sale of the notes at fair market value, LLC AAA would not have recognized any capital loss and none would have flowed through to Corp EEE. Conducting the activities through LLC AAA allowed Corp EEE to claim a total $XXX in capital losses, which it would not otherwise have been entitled. Because LLC G conducted the activities through LLC AAA, Corp EEE's aggregate federal tax liability was substantially less than it would have been if it had dealt directly with LLC G.

Moreover, the present value of the partner's aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. As discussed above, the present value of Corp EEE's federal tax liability was substantially less than would be the case if the transactions were integrated into a direct sale of the Corp LL notes and stock from LLC G.

Accordingly, we conclude that a strong argument could be made that the contribution by LLC G of the $CCC notes to LLC AAA, and the subsequent sale of its partnership interest to Corp EEE, were in substance a sale by LLC G of the notes to Corp EEE and a contribution by Corp EEE of the notes to LLC AAA. Consequently, LLC AAA would

have a cost basis of $ZZZ in the notes and no loss would be recognized upon the sale of the notes to a third party.

Issue 3

Netting of early gain

Sections 731 and 752 prevent the netting of an early gain caused by a decrease in Corp EEE's share of partnership liabilities with a later increase in basis caused by an increase in Corp EEE's share of partnership liabilities.

Section 731(a)(1) provides that when there is a distribution by a partnership to a partner, gain shall not be recognized to that partner, except to the extent that any money distributed exceeds the adjusted basis of that partner's interest in the partnership immediately before the distribution.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of the individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 1.752-1(b) provides that any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership.

Section 1.752-1(c) provides that any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner.

Section 1.752-1(f) provides that if, as a result of a **single** transaction, a partner incurs both an increase in the partner's share of partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership's liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.

Here, absent the effects of the anti-abuse rules, LLC AAA incurred $CCC in losses in December Year 13. $XXX of these losses were allocated to Corp EEE at year end. Prior to the end of Year 13, Corp EEE contributed $CCC in Treasury Bills and related repurchase agreement. As a result of this contribution, Corp EEE's outside basis increased by $SSSS ($CCC increase from contribution of T Bills - $CCC partnership

assumption of Corp EEE's liability + $SSSS allocation of partnership liabilities to Corp EEE). Thus, Corp EEE was able to take the full $XXX of losses.

On January 7, Year 14, when LLC AAA closed out the repurchase agreement, Corp EEE was relieved of $SSSS of liabilities and such relief of liabilities was deemed to constituted a $XXX distribution under Treas. Reg. §1.752-1(c). Because Corp EEE had little outside basis to offset the distribution, the excess over its basis would constitute gain under section 731(a)(1). In December Year 14, Corp EEE contributed $VVVV million in T Bills and a related repurchase agreement. The effect of such transaction was treated as a contribution of money (due to an increase in partnership liabilities) to the partnership under section 1.752-1(b).

Corp EEE erroneously netted these two transactions together (the January closing of the repurchase agreement and the December contribution of the T Bills and repurchase agreement) and did not recognize gain on the January transaction, as it should have. Section 1.752-1(f) only permits the netting of liabilities when they are part of the same transaction, not when they occur as a result of separate transactions. For example, netting would be permitted when Corp EEE contributed the T Bills and repurchase agreement, where the contribution of the repurchase agreement results in both a decrease in Corp EEE's liabilities and an increase in Corp EEE's share of partnership liabilities. Netting is not allowed, however, to offset gain resulting from a decrease in liabilities with basis cause by a subsequent increase in liabilities. Section 1.752-1(f). See also Rev. Rul. 81-242, 1981-2 C.B. 147, wherein it was held that the condemnation of a building (subject to a mortgage) and the subsequent reinvestment of the proceeds into a new building (subject to a mortgage) were separate transactions that did not occur simultaneously; thus, the liabilities associated with each transactions could not be netted to avoid gain under section 731.

Issue 4

Application of the disguised sale rules

The disguised sale rules of section 707(a)(2)(B) do not prevent the shifting of losses at issue in this case.

Section 707(a)(2)(B) provides 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, and 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 as a transaction where a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

Section 707(a)(2)(B) provides treatment when there is a direct or indirect transfer of money or other property by a partner to a partnership and a related direct or indirect transfer of money or other property by the partnership to the partner. None of the facts in this case indicate that there was a transfer of any property (either directly or indirectly) from LLC G to the Foreign Banks in connection with their contribution of the notes and stock. In fact, the only distributions made by LLC G during the years at issue were in Year 14 when LLC G distributed $TTTT in assets to Trust H and $ZZZ to Individual SS.

There is no evidence tying either of these distributions to unrelated parties back to the contributions of the notes and stock by the Foreign Banks. Rather, the transactions appear to have been entered into for the sole purpose of shifting losses, not to disguise a sale of property. It is also difficult to argue that these transactions are a disguised sale of the notes and stock when the Foreign Banks **actually** sold their interest in the partnership to Trust H three weeks later, well before any distributions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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