

**INTERNAL REVENUE SERVICE**  
**NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

January 9, 2003

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CASE MIS No.: TAM-161564-02/CC:FIP:B3

Area Counsel

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No:  
Years Involved:  
Date of Conference:

LEGEND:

Shareholder =  
Individual =  
Corporation A =  
Corporation B =  
Execution Date =  
Option Date =  
Exchange Date =  
Partnership =  
Trust =  
Initial Purchasers =

Financial Instruments =  
State A =  
Date 1 =  
Date 2 =  
Date 3 =  
a =  
b =  
c =  
d =  
e =

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<u>f</u>	=
<u>g</u>	=
<u>h</u>	=
<u>i</u>	=
<u>j</u>	=
<u>k</u>	=
<u>l</u>	=
<u>m</u>	=
<u>n</u>	=
<u>o</u>	=
<u>p</u>	=
<u>q</u>	=
<u>r</u>	=
<u>s</u>	=
<u>t</u>	=
<u>u</u>	=
<u>v</u>	=
<u>w</u>	=

ISSUES:

1. Whether the conveyance by Shareholder of e shares of Corporation A common stock to Trust, through Partnership, constitutes a taxable sale or exchange of the Corporation A common stock by Shareholder for federal income tax purposes.

2. Whether the sale of the Financial Instruments to third-party investors constitutes a bona fide sale of the Corporation A common stock for federal income tax purposes.

3. Whether the contributions by Shareholder of c and d shares of Corporation A common stock to Partnership on the Execution Date and the Option Date, respectively, and Partnership's subsequent distributions to Shareholder of \$t and \$u on the Execution Date and the Option Date, respectively, are disguised sales under § 707(a)(2)(B) of the Internal Revenue Code?

4. In what manner should the parties treat the following transfers of cash for tax purposes:

(A) \$q from Trust to Partnership?

(B) \$s from Partnership to Shareholder?

CONCLUSIONS:

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1. The conveyance by Shareholder of e shares of Corporation A common stock to Trust, through Partnership, does not constitute a taxable sale or exchange of the Corporation A common stock by Shareholder for federal income tax purposes.

2. The sale of the Financial Instruments to third-party investors does not constitute a bona fide sale of the Corporation A common stock for federal income tax purposes.

3. The contributions by Shareholder of c and d shares of Corporation A common stock to Partnership on the Execution Date and the Option Date, respectively, and Partnership's subsequent distributions to Shareholder of \$t and \$u on the Execution Date and the Option Date, respectively, are not disguised sales under § 707(a)(2)(B).

4(A). The transfer of \$q to Partnership from the Series A Sub-Trust represents proceeds derived from the forward sale of the Corporation A common stock in the Series A Sub-Trust. It is a distribution from a grantor trust to the owner of the trust, and therefore, has no tax consequences.

4(B). The aggregate distributions of \$s from Partnership to Shareholder are distributions under § 731.

#### FACTS:

Shareholder, wholly owned by Individual, owned approximately a% of Corporation A on Date 3. Shareholder desired to reduce its direct ownership interest in Corporation A below b% so that it could use pooled accounting if Corporation A acquired another company or was acquired by another company. To reduce its direct ownership in Corporation A below b%, Shareholder engaged in the transaction (the "Transaction"), described below.

Shareholder contributed c and d shares of Corporation A common stock to Partnership on the Execution Date and the Option Date, respectively, and received in return a non-managing member interest in Partnership and cash distributions of \$t and \$u. Partnership created a trust (the "Trust") that consisted of two sub-trusts. The sub-trusts, the "Series A Sub-Trust" and the "Financial Instruments Sub-Trust," each represented a separate series of beneficial ownership interests in the Trust, the "Series A Interest" and the "Financial Instruments Interest," respectively. Partnership transferred e shares of Corporation A common stock to the Series A Sub-Trust in exchange for the Series A Interest in the Trust. The Series A Interest, held by Partnership, represented a beneficial ownership in the Corporation A common stock, including the right to direct Trust to vote the shares, receive any ordinary dividends paid thereon, and to receive any proceeds derived from the sale, exchange, or liquidation of the Corporation A common stock. The Series A Interest was subject to the Trust Obligation, as described below.

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The Financial Instruments Sub-Trust issued e Financial Instruments in two stages; c Financial Instruments Interests were issued on the Execution Date and d Financial Instruments were issued on the Option Date, to an underwriting syndicate of several brokers (the "Initial Purchasers") for a discount. The Initial Purchasers subsequently sold the Financial Instruments Interests to third party investors (the "Financial Instruments Holders") for full value. The Financial Instruments Interests represented a beneficial ownership of the Trust Obligation, as described below, and of treasury securities held by the Financial Instruments Sub-Trust (the "Treasury Securities").

The Series A Sub-Trust agreed to deliver to the Financial Instruments Sub-Trust one of the following in an amount determined by the formula described below: Corporation A common stock, a combination of Corporation A common stock and cash, or cash. The purchase price was to equal the aggregate purchase price paid for Financial Instruments Interests by the Initial Purchasers, reduced by the purchase discount for the Financial Instruments and the cost of the Treasury Securities that the Financial Instruments Sub-Trust was obligated to purchase for the benefit of the Initial Purchasers. However, the Financial Instruments Sub-Trust would not actually receive the Corporation A common stock, combination of Corporation A common stock and cash, or cash until the Exchange Date. On the Exchange Date, the Financial Instruments Holders are entitled to receive from the Financial Instruments Sub-Trust, in retirement of their Financial Instruments, an amount of Corporation A common stock, combination of Corporation A common stock and cash, or cash based on the following formula (the "Exchange Formula"): (i) if the Applicable Market Price (as defined below) of the Corporation A common stock is greater than or equal to \$f per share (the "Threshold Price"), each Financial Instrument will be exchangeable for g of a share of the Corporation A common stock; (ii) if the Applicable Market Price is less than the Threshold Price, but greater than \$w (the "Initial Price"), each Financial Instrument will be exchangeable for a fraction of a share of the Corporation A common stock equal to the quotient of the Initial Price and the Applicable Market Price; and (iii) if the Applicable Market Price is less than or equal to the Initial Price, each Financial Instrument will be exchangeable for h share of the Corporation A common stock. The Applicable Market Price means the average closing price per share of the Corporation A common stock for the i trading days immediately prior to, but not including, the Exchange Date. This obligation of the Series A Sub-Trust to deliver, and the right of the Financial Instruments Holders to receive, on the Exchange Date (or earlier in certain limited circumstances) all or a portion of the Corporation A common stock, marketable securities of another company if certain adjustment or liquidation events occur with respect to Corporation, or an equivalent amount of cash if the Series A Holder exercises the cash settlement option discussed below, is the "Trust Obligation."

In lieu of delivery of the Corporation A common stock, the Trust may elect, at the request of Partnership as the holder of the Series A Interest, to pay cash to the Financial Instruments Holders on the Exchange Date in an amount equal to the

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Applicable Market Price multiplied by the number of shares of Corporation A common stock determined under the Exchange Formula (the “Cash Settlement Alternative”). Shareholder, which will control Partnership’s decision whether to exercise the Cash Settlement Alternative, is not permitted to cause Partnership to exercise the Cash Settlement Alternative if, as a result of such exercise and after the liquidation of Partnership, Shareholder would own b% or more of the outstanding common stock of Corporation A.<sup>1</sup> The terms of the Trust Obligation provide for adjustments to the Initial Price and the Threshold Price upon the occurrence of certain events affecting or relating to Corporation A or the receipt of certain dividends or other distributions, including stock dividends and stock splits. Additionally, adjustments are to be made upon receipt by the Trust of Marketable Securities in exchange for the Corporation A common stock. The Financial Instruments are also subject to early settlement or partial liquidation in certain limited circumstances.

On the Execution Date, the Financial Instruments Sub-Trust received \$k from the Initial Purchasers in exchange for its issuance of c Financial Instruments. On the Option Date, the Financial Instruments Sub-Trust received \$l from the Initial Purchasers in exchange for its issuance of d Financial Instruments. Therefore, the Financial Instruments Sub-Trust received a total of \$m from the Initial Purchasers (net of approximately \$n of purchase discount) in exchange for its issuance of the Financial Instruments Interests. The Financial Instruments Sub-Trust used these funds to purchase \$o of Treasury Securities, to pay the Trustee a fee of \$p and to pay \$q to the Series A Sub-Trust. The Treasury Securities purchased by the Financial Instruments Sub-Trust had staggered maturity dates to enable the Financial Instruments Sub-Trust to make quarterly distributions to the Financial Instruments Holders. The Series A Sub-Trust then transferred this \$q to Partnership. With the funds it received from the Series A Sub-Trust, Partnership purchased approximately \$r of Treasury Securities and distributed the remaining \$s to Shareholder.

Shareholder treated the Transaction as the entry into a variable prepaid forward contract and did not report any taxable income or loss as a result of its participation in the Transaction on its federal income tax return for the taxable year ended Date 2.

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<sup>1</sup> As of the Execution Date, Shareholder was precluded from exercising the Cash Settlement Alternative because as a result of such exercise and after the liquidation of Partnership, Shareholder would own more than b percent of the outstanding common stock of Corporation A. Subsequently, however, Shareholder’s ownership in Corporation A was diluted by Corporation A’s issuance and sale of j shares of Corporation A common stock to Corporation B on Date 1. As a result of this dilution of Shareholder’s interest in Corporation A, as of Date 1, Shareholder was not precluded from exercising the Cash Settlement Alternative. In addition, as of the Option Date, Shareholder was not precluded from exercising the Cash Settlement Alternative.

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LAW AND ANALYSIS:

Issues 1 and 2

Rev. Rul. 2003-7, 2003-5 I.R.B. 1, considered a fact pattern similar to the facts in the instant case. Under the facts of Rev. Rul. 2003-7, an individual ("Investor") held shares of common stock in Y corporation, which was publicly traded. Investor's basis in the shares of Y corporation was less than \$20 per share. On September 15, 2002 (the "execution date"), Investor entered into an arm's length agreement (the "Agreement") with Investment Bank, at which time a share of common stock in Y corporation had a fair market value of \$20. Investor received \$z of cash upon execution of the Agreement. In return, Investor became obligated to deliver to Investment Bank on September 15, 2005 (the "exchange date"), a number of shares of common stock of Y corporation to be determined by a formula. Under the formula, if the market price of a share of Y corporation common stock is less than \$20 on the exchange date, Investment Bank will receive 100 shares of common stock. If the market price of a share is at least \$20 and no more than \$25 on the exchange date, Investment Bank will receive a number of shares having a total market value equal to \$2000. If the market price of a share exceeds \$25 on the exchange date, Investment Bank will receive 80 shares of common stock. In addition, Investor has the right to deliver to Investment Bank on the exchange date cash equal to the value of the common stock that Investor would otherwise be required to deliver under the formula.

In order to secure Investor's obligations under the Agreement, Investor pledged to Investment Bank on the execution date 100 shares (that is, the maximum number of shares that Investor could be required to deliver under the Agreement). Investor effected this pledge by transferring the shares in trust to a third-party trustee, unrelated to Investment Bank. Under the declaration of trust, Investor retained the right to vote the pledged shares and to receive dividends.

Under the Agreement, Investor had the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the Agreement. Investor was not otherwise economically compelled to deliver the pledged shares. At the time Investor and Investment Bank entered into the Agreement, however, Investor intended to deliver the pledged shares to Investment Bank on the exchange date in order to satisfy Investor's obligations under the Agreement.

Under the above-described facts, Rev. Rul. 2003-7 holds that Investor has neither sold stock currently nor caused a constructive sale of stock if Investor receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right

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to substitute cash or other shares for the pledged shares, and is not economically compelled to deliver the pledged shares.

Similar to the facts of Rev. Rul. 2003-7, in the instant case, pursuant to the Transaction, Shareholder, the purported seller of e shares of Corporation A common stock to the Financial Instruments Holders, received a fixed payment of \$s without any restriction on its use. Simultaneously, the Series A Sub-Trust entered into an agreement with the Financial Instruments Sub-Trust to deliver on a future date a number of shares of Corporation A common stock that varies significantly depending on the value of Corporation A common stock pursuant to the Exchange Formula. Shareholder pledged the maximum number of shares of Corporation A common stock for which delivery could be required under the Trust Obligation. Moreover, the facts do not indicate that Shareholder is economically compelled to deliver the pledged shares.

A significant factor in determining whether a sale occurred is whether Shareholder retained the right, unrestricted by agreement or economic circumstances, to reacquire the stock by delivering cash or other shares of stock. Shareholder did not retain the right to reacquire the shares of Corporation A common stock by substituting shares of Corporation A common stock other than the shares pledged. However, Shareholder retained the right, through Partnership, to reacquire the shares of Corporation A common stock by substituting cash in lieu of the pledged shares. There is some question, however, whether this right to reacquire the shares of Corporation A common stock by substituting cash in lieu of the pledged shares (the Cash Settlement Alternative) is unrestricted by agreement or economic circumstances.

Shareholder, which controls Partnership's decision whether to exercise the Cash Settlement Alternative, is not permitted to cause Partnership to exercise the Cash Settlement Alternative if, as a result of such exercise and after the liquidation of Partnership, Shareholder would own b percent or more of the outstanding common stock of Corporation A. Accordingly, Shareholder's right to reacquire the shares of Corporation A common stock by substituting cash in lieu of the pledged shares is restricted by agreement. There is some question, however, concerning the weight to be given to this restriction in light of the facts and circumstances.

As of the Execution Date, Shareholder was precluded from exercising the Cash Settlement Alternative because as a result of such exercise and after the liquidation of Partnership, Shareholder would own more than b percent of the outstanding common stock of Corporation A. However, immediately after the Execution Date (on the next business date and prior to the Option Date), Shareholder's ownership in Corporation A was diluted by Corporation A's issuance and sale of j shares of Corporation A common stock to Corporation C on Date 1. As a result of this dilution of Shareholder's interest in Corporation A, as of Date 1, Shareholder was not precluded from exercising the Cash Settlement Alternative. In addition, as of the Option Date, Shareholder was not precluded from exercising the Cash Settlement Alternative.

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Accordingly, because the dilution of Shareholder's ownership occurred nearly simultaneous with the first contribution (and prior to the second contribution) of the shares of Corporation A, and for the reasons stated above, we conclude that the restriction, pursuant to which Shareholder is not permitted to cause Partnership to exercise the Cash Settlement Alternative if, as a result of such exercise and after the liquidation of Partnership, Shareholder would own b percent or more of the outstanding common stock of Corporation A, should be given little weight for purposes of determining whether a sale of Corporation A common stock occurred. Thus, Shareholder effectively retained the right, unrestricted by agreement or economic circumstances, to reacquire the stock by delivering cash.

Based on the above analysis, we conclude that the conveyance by Shareholder of e shares of Corporation A common stock to Trust, through Partnership, does not constitute a taxable sale or exchange of the Corporation A common stock by Shareholder to the Financial Instruments Holders. The sale of the Financial Instruments to third-party investors was merely one component of the Transaction. Therefore, for the same reasons stated above, we conclude that the sale of the Financial Instruments to third-party investors does not constitute a bona fide sale of the Corporation A common stock to the Financial Instruments Holders for federal income tax purposes.

### Issue 3

#### 1. Section 707: Disguised Sale Analysis

The issue presented is whether the aggregate contributions by Shareholder of e shares of Corporation A common stock to Partnership and Partnership's subsequent aggregate distributions to Shareholder of \$s are disguised sales under § 707(a)(2)(B). The purpose of the disguised sale provision is to prevent parties from characterizing a sale or exchange of property as a contribution to a partnership followed by (or preceded by) a distribution from the partnership with the object of deferral or avoidance of tax. H.R. Rep. No. 98-861, at 861 (1984).

Section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as occurring between the partnership and one who is not a partner, or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

Section 1.707-3(c) of the Income Tax Regulations provides that if within a two-year period a partner transfers property to a partnership and the partnership transfers

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money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

Shareholder's transfer of c shares of Corporation A common stock to Partnership occurred simultaneously with a cash distribution by Partnership of \$t to Shareholder. Shareholder's transfer of d shares of Corporation A common stock to Partnership occurred simultaneously with a cash distribution by Partnership of \$u to Shareholder. Therefore, the transfers are presumed to be a sale of property from Shareholder to Partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale or an exception to the disguised sale rule applies.

## 2. Application of the Safe Harbor Under Treas. Reg. § 1.707-5(b)(1)

Shareholder argues that the safe harbor from the disguised sale rules found in § 1.707-5(b)(1) applies to the Transaction, and therefore, the aggregate contributions by Shareholder of the e shares of Corporation A common stock to Partnership followed by Partnership's aggregate distributions to Shareholder of \$s were not sales under § 1.707-3(c).

Section 1.707-5(b)(1) provides that for purposes of § 1.707-3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under § 1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

Section 1.163-8T(c)(1) provides that debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in § 1.163-8T(m), interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in § 1.163-8T(m), debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest.

The rationale behind the safe harbor is found in the committee reports to the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 494, which indicate that a partner should be able to get distributions of cash funded by partnership debt to the extent such distributions do not exceed the distributee partner's share of the debt, since in this case, the partner has merely ". . . borrowed through the partnership." H.R. Rep. No. 98-861, at 862 (1984). To the extent a partner is allocated an amount of debt assumed by

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a partnership, the receipt of such funds produces no net economic benefit and thus is not treated as a taxable event.

For Shareholder to meet the safe harbor under § 1.707-5(b)(1), the following must be satisfied: (1) the Trust Obligation must constitute a liability of Partnership, (2) all or a portion of the proceeds of the Trust Obligation liability must be allocable under § 1.163-8T to the aggregate transfers of \$s to Shareholder, (3) the transfers to Shareholder must have been made within 90 days of Partnership incurring the Trust Obligation liability and (4) the aggregate transfers of \$s must not exceed Shareholder's share of the Trust Obligation liability. To the extent that the aggregate transfers of \$s exceed Shareholder's share of the Trust Obligation liability, the excess amount will be taken into account under § 1.707-3(c).

A liability for purposes of § 1.707-5(b)(1) is a liability for purposes of § 752. Section 1.707-5(b)(2) provides that § 1.707-5(a)(2) determines a partner's share of a liability under § 1.707-5(b)(1). Section 1.707-5(a)(2) refers to the regulations under § 752 to determine a partner's share of liability.

Rev. Rul. 88-77, 1988-2 C.B. 128, holds that partnership liabilities for purposes of § 752 include an obligation only if, and to the extent that, incurring the obligation 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) (relating to noncapital, nondeductible expenditures of a partnership) currently decreases a partner's basis in the partner's partnership interest. Rev. Rul. 95-26, 1995-1 C.B. 131, cites Rev. Rul. 88-77, and holds that short sales of securities by partnerships create partnership liabilities for purposes of § 752. Rev. Rul. 95-26 states:

A short sale creates an obligation on the part of the seller to return the borrowed securities. See, e.g., Deputy v. du Pont, 308 U.S. 488, 497-98 (1940), 1940-1 C.B. 118 (a short sale creates an obligation although not an indebtedness). In addition, the cash received in the short sale is an asset of the partnership. Thus, the basis of the partnership's assets is increased. Therefore, PRS's short sale creates a liability under § 752, and the adjusted bases of the partnership interests of A and B are increased under § 722 to reflect their shares of the liability under § 752.

Under the Trust Obligation the Series A Sub-Trust is obligated to deliver to the Financial Instruments Sub-Trust a variable number of shares of stock and/or cash on a fixed date in the future. Thus, under Rev. Rul. 88-77 and Rev. Rul. 95-26, the Trust Obligation creates a liability. The Trust Obligation liability is treated as a liability of Partnership because Partnership is treated as the owner of the Series A Sub-Trust. Furthermore, the \$g that is received by the Series A Sub-Trust and that is subsequently

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transferred to Partnership, is treated as an asset of Partnership, which increases the basis of Partnership's assets. Thus, the Trust Obligation liability creates a liability under § 752, and the adjusted bases of the partnership interests of Partnership's partners are increased under § 722 to reflect their shares of the liability under § 752.

Section 1.163-8T(c)(1) provides that debt is allocated to expenditures in accordance with the use of the debt proceeds. Section 1.707-5(b)(1) requires that all or a portion of the proceeds of the liability incurred by the partnership be allocated under § 1.163-8T to the distribution to the partner. The Financial Instruments Sub-Trust received a total of \$m from the Initial Purchasers (net of approximately \$n of purchase discount) in exchange for its issuance of the Financial Instruments. The Financial Instruments Sub-Trust used these funds to purchase \$o of Treasury Securities, to pay the Trustee a fee of \$p and to distribute \$q to the Series A Sub-Trust. The Series A Sub-Trust then distributed this \$q to Partnership. With the funds it received from the Series A Sub-Trust, Partnership purchased approximately \$r of Treasury Securities and distributed the remaining \$s to Shareholder. Therefore, \$s of the proceeds of the Trust Obligation liability are directly allocable under § 1.163-8T to the aggregate distributions of \$s to Shareholder.

Partnership's distributions of \$t and \$u to Shareholder occurred on the Execution Date and the Option Date, respectively. On the Execution Date, the Trust Obligation liability was incurred by the Series A Sub-Trust, and is treated as a liability of Partnership. Therefore, the distributions to Shareholder were made within 90 days of Partnership's incurrence of the Trust Obligation liability.

Further, in order to meet the safe harbor of § 1.707-5(b)(1), the aggregate distributions of \$s to Shareholder must not exceed Shareholder's share of the Trust Obligation liability. To the extent that it does, the excess amount will be taken into account under § 1.707-3(c).

Partnership treats the Trust Obligation liability as a nonrecourse liability. Section 1.707-5(a)(2)(i) provides that a partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752-1(a)(1), which provides that a liability is a recourse liability to the extent that a partner or related person bears the economic risk of loss for that liability under § 1.752-2. Under § 1.752-2(a), the determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under §§ 1.752-2(b) through (j). Under § 1.752-2(b)(3), in determining the extent to which a partner bears the economic risk of loss for a partnership liability, all statutory and contractual obligations relating to the partnership liability are taken into account, such as payment obligations imposed by state law, including the governing state partnership statute.

Partnership was formed as a State A limited liability company under and pursuant to the Limited Liability Company Act of State A, which provides generally that

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the debts, obligations and liabilities of a limited liability company shall be solely the debts, obligations and liabilities of the limited liability company, and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company solely by reason of being a member or acting as a manager of the limited liability company; however, under a limited liability company agreement or under another agreement, a member or manager may agree to be obligated personally for any or all of the debts, obligations and liabilities of the limited liability company. The information submitted does not indicate that Shareholder has agreed to be obligated personally for any or all of the debts, obligations and liabilities of Partnership. Therefore, the Trust Obligation liability is a nonrecourse liability.

Section 1.707-5(b)(2) provides that a partner's allocable share of a partnership liability for purposes of § 1.707-5(b)(1) equals the amount obtained by multiplying the partner's share of the liability as described in section 1.707-5(a)(2) by the fraction determined by dividing (A) the portion of the liability that is allocable under § 1.163-8T to the money or other property transferred to the partner by (B) the total amount of the liability.

Section 1.707-5(a)(2)(ii) provides that a partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3).

Section 1.752-3(a)(3) provides that the partner's share of excess nonrecourse liabilities (those not allocated under § 1.752-3(a)(1) and § 1.752-3(a)(2)) of the partnership is determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all the facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the § 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.

Section 3.8 of Partnership's LLC Agreement allocates  $\underline{v}$ % of the Trust Obligation liability to Shareholder "in accordance with Regulations Sections 1.752-3(a)(3) and 1.707-5(a)(2)(ii)." In addition, Partnership's LLC Agreement provides that Partnership's net loss on the Trust Obligation will be allocated  $\underline{v}$ % to Shareholder. Therefore, the allocation of  $\underline{v}$ % of the Trust Obligation to Shareholder will be respected under § 1.752-3(a)(3) because it is in accordance with the manner in which it is reasonably expected that the deductions attributable to the Trust Obligation liability will be allocated.

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Following the formula provided by § 1.707-5(b)(2), and using  $v\%$  as the partner's share of the liability as described in § 1.707-5(a)(2), results in the partner's allocable share of the partnership liability for purposes of § 1.707-5(b)(1) as being  $\$s$  ( $v\%$  of the liability amount,  $\$q$ , multiplied by the amount of the distribution that is allocable under § 1.163-8T to the money transferred to the partner,  $\$s$ , divided by the total amount of the liability,  $\$q$ ). Therefore, the aggregate distributions of  $\$s$  to Shareholder fall under the safe harbor in § 1.707-5(b)(1) and a disguised sale under § 707(a)(2)(B) did not occur.

#### Issue 4

#### The Cash Distribution of $\$q$ from the Trust to Partnership.

Section 301.7701-4(c) provides that an "investment" trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders. An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under § 301.7701-2; however, an investment trust with multiple classes of ownership interests, in which there is no power under the trust agreement to vary the investment of the certificate holders, will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.

The Trust and each sub-trust of the Trust, the Series A Sub-Trust and the Financial Instruments Sub-Trust, are investment trusts that are classified as trusts for purposes of § 301.7701-4(c). Therefore, the characterization of the Trust as a grantor trust with grantor sub-trusts should be respected and all income, deductions, and credits of the sub-trusts will be included in computing the taxable income of the respective grantors under §§ 671-678.

Section 1.671-2(e)(1) provides that for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of § 1.671-2(e)(2)) of property to a trust.

Section 1.671-2(e)(2) provides that a gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

Section 1.671-2(e)(3) provides that a grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in

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certain investment trusts described in § 301.7701-4(c), liquidating trusts described in § 301.7701-4(d), or environmental remediation trusts described in § 301.7701-4(e).

Partnership created the Trust and transferred the Corporation A common stock to the Series A Sub-Trust. In exchange, Partnership received the Series A Interest in the Trust. Therefore, Partnership is the grantor of the Series A Sub-Trust. The Initial Purchasers contributed \$q to the Financial Instruments Sub-Trust in exchange for the Financial Instruments Interests in the Trust, and therefore, the Initial Purchasers were grantors of the Financial Instruments Sub-Trust. However, the Initial Purchasers subsequently sold the Financial Instruments Interests in the Trust to the Financial Instruments Holders. As stated in § 1.671-2(e)(3), a grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in § 301.7701-4(c). Therefore, the Financial Instruments Holders became the grantors of the Financial Instruments Sub-Trust upon the purchase of the Financial Instruments Interests from the Initial Purchasers.

Section 671 provides that where it is specified in §§ 673 through 678 that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual.

Section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be: (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)). Section 677(a) shall not apply to a power or exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under § 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that if a grantor is treated as the owner of the entire trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes.

Partnership, as the grantor of the Series A Sub-Trust, is entitled to receive the dividends on the Corporation A common stock and any proceeds derived from the sale,

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exchange or liquidation of the Corporation A common stock in the Series A Sub-Trust. Therefore, Partnership is treated as the owner under § 677 of the Series A Sub-Trust and of the Corporation A common stock. Income received by the Series A Sub-Trust with respect to the Corporation A common stock will be treated as income of Partnership.

The Financial Instruments Holders, as grantors of the Financial Instruments Sub-Trust, will receive quarterly distributions from the Treasury Securities and under the Trust Obligation will receive shares of Corporation A common stock or cash on the Exchange Date. Therefore, the Financial Instruments Holders are treated as the owners under § 677 of the Financial Instruments Sub-Trust and each Financial Instruments Holder will be treated as the owner of its pro rata portions of the Treasury Securities and the Trust Obligation. Income received by Trust with respect to the Treasury Securities will be treated as income of the Financial Instruments Holders, including any original issue discount income.

The transfer of \$g to Partnership from the Series A Sub-Trust represents proceeds derived from the forward sale of the Corporation A common stock in the Series A Sub-Trust. It is a distribution from a grantor trust to its owner, and therefore, has no tax consequences. Rev. Rul. 85-13.

### 3. The Cash Distribution of \$s from Partnership to Shareholder.

Section 721 provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 731 provides that in the case of a distribution by a partnership to a partner: (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and (2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in § 731(a)(2)(A) and (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of: (A) any money distributed, and (B) the basis to the distributee, as determined under § 732, of any unrealized receivables (as defined in § 751(c)) and inventory (as defined in § 751(d)). Any gain or loss recognized under § 731(a) shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

As described earlier, the aggregate distributions of \$s to Shareholder fall under the safe harbor in § 1.707-5(b)(1) and a disguised sale under § 707(a)(2)(B) did not occur. Therefore, the aggregate contributions of e shares of Corporation A common stock to Partnership are contributions under § 721 and the aggregate distributions of \$s from Partnership are distributions under § 731.

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CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.