Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 200450001

Release Date: 12/10/04
CC:PSI:2GL-159877-01
DYatrakis

UILC: 701.01-00, 708.01-00, 732.03-00

date: April 04, 2003

to: CC:SB:4:MIL

from: Matthew Lay
Senior Technician Reviewer (CC:PSI:2)

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subject:

This Memorandum responds to your request for advice. In accordance with I.R.C. § 6110(k)(3), this Memorandum should not be cited as precedent.

We recommend the following revisions in your draft Form 886A, Explanation of Items, relating to .

(A) Miscellaneous comments

[redacted].

Delete or explain the phrase "Per the tax return for " at the bottom of page 2. It is our understanding that this paragraph relates to financial reporting rather than tax reporting.

In the seventh paragraph on page 3, delete the phrase "Section 755 regulations" and insert the phrase "Section 708(b)(1)(B) regulations".

Retitle Exhibit A to refer to "Limited Partner Interest Detail" and revise any references to the Exhibit. Because all but one of these interests confers an interest of

more than %, they are not minority interests. Revise the fifth paragraph on page 3 accordingly (and any other references to "minority interests").

Add to the end of the sixth full paragraph of page 2: [redacted]

In your discussion of regulations under section 1060, refer to section 1.1060-1T rather than section 1.1060-1.

(B) The following text should be inserted at the beginning of the section titled "Other Items of Analysis:", which begins on page 5.

Other Items of Analysis

1. Validity of partnerships prior to

should not be recognized as valid partnerships prior to . First, lacked the intent to form a partnership. Accordingly, he was not a bona fide partner, and no partnerships were formed. The primary inquiry as to whether individuals have joined together as partners is whether the parties had the intent to join together to operate a business and share in its profits and losses. Commissioner v. Tower, 327 U.S. 280 (1946); Commissioner v. Culbertson, 337 U.S. 733 (1949). In Commissioner v. Culbertson, the court asserted that test "is not whether the service or capital contributed by a partner are of sufficient importance to meet some objective standard . . . but whether, considering all the facts-- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purpose for which it is used, and any other facts throwing light on their true intent–the parties in good faith and acting with a business purpose intended to join together in the present conduct of an enterprise." 337 U.S. at 742. Federal law controls for income tax purposes irrespective of how the parties are treated for state law purposes. The inquiry is factual and all relevant facts and circumstances should be taken into account.

In this case, did not intend to share in the ' profits, losses, or business operations. The Schedule K-1 issued to indicates a contribution of only $ of capital to the each of the . Immediately after the % transfers of general partnership interests, his interest was extinguished. , thus, did not share in the risk of the enterprise: he was redeemed early on in the transaction and made only a de minimis capital contribution. His inconsequential

capital contribution and his redemption within a few weeks clearly indicates that he did not intend to be a partner who would share in the profits and losses of the . In fact, the allocated no income, gain, loss, deduction, or credit to .

2. Partnership anti-abuse regulation

Even if were a bona fide partner, the anti-abuse provisions of § 1.701-2 of the Income Tax Regulations would apply.

Section 1.701-2 provides that where 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.

The participated in the transaction in order to artificially increase the basis of partnership assets through the application of §§ 732(c) and 708(b)(1)(B). As Taxpayer's financial statements reveal, Taxpayer was aware of the transaction's tax benefits. Taxpayer intended to avail itself of these tax benefits many times over. The transaction was mirrored by many transactions all of which would have produced identical tax benefits. However, only three transactions were able to take advantage of the interaction between section 732(c), prior to its amendment for distributions after August 5, 1997, and the regulations under section 708(b)(1)(B), prior to their amendment on for transactions after May 8, 1997.

In the three relevant transactions, the were terminated approximately within months, months, and from their respective formations. In , partnership assets were sold and, due to the assets unusually high basis, Taxpayer claimed an inflated § 1231 loss of $, and large depreciation deductions. Taxpayer's clear recognition of the tax benefits, the many identical transactions, the rapid termination of the , and the sales of assets having inflated bases soon after the transactions all indicate that a principal purpose of the transaction was to reduce the Taxpayer's federal tax liability by artificially inflating the basis of the assets.

Under § 1.701-2, the should be disregarded, and the transfer of the general partnership interests on should be treated as a transfers of a % interest in each of the assets held by the partnerships on that date.

A summary of the Taxpayer's points addressing the validity of the is attached as Exhibit "C".

(C) The sentence on page 7, which begins “A summary of the taxpayer’s points addressing the validity of the partnership . . .” should be deleted.

(D) Item 1 should be renumbered as Item 3 and retitled and should begin as follows:

3. Application of section 1060 transfers

If the were not recognized as valid partnerships prior to , or the transfers of interests therein on are recharacterized under section 1.701-2 as transfers of assets, then I.R.C. section 1060 requires the use of the residual method to value the assets that were the subject of the transfers....

(E) Add to the end of section 3 the following language:

If § 1060 applies to the purchases by then a majority of the purchase prices would required to be allocated to goodwill or other intangibles. When an interest in the partnerships is later purchased, triggering a technical termination of the partnerships under section 708(b)(1)(B), §§ 732(b) and (c) would result in an allocation of the partners’ bases in their partnership interests among the assets deemed to be received.

As required by the statute, the regulations under § 1060 adopt the same residual method of allocation as prescribed under the § 338 regulations. See Temp. Reg § 1.1060-1T. Section 1060(a) generally requires that the allocation of consideration be made using the “residual method” in connection with “applicable asset acquisitions” occurring after May 6, 1986. Under the residual method, any portion of the transferee’s initial basis that is in excess of the fair market value of identifiable tangible and intangible assets (other than goodwill and going concern value) must be allocated to goodwill and going concern value. See Temp. Reg. § 1.1060-1T(d).

If § 1060 applies to the purchase by then the consideration paid by in each deemed transfer of an undivided percentage interest in assets (represented by the sale of a general partnership interest in form) would be allocated among the assets pursuant to the allocation rules of § 1.1060-1T(d). The four classes described in the regulations prior to February 14, 1997 were as follows. “Class I” assets were cash, deposits in banks, and similar items. “Class II assets” were certificates of deposit, U.S. government securities, certain marketable stocks and securities, foreign currency, and similar items. “Class IV Assets” were Intangible assets in the nature of goodwill and going concern value. All assets not described above, specifically including

accounts receivable, were "Class III Assets." Temporary regulations published in 1997 provided that goodwill and going concern value will be assigned to a true residual class, Class V. T.D. 8711, 1997-1 C.B. 85.

For transfers occurring before February 14, 1997, if § 197 does not apply to any of the transferred assets, the provisions of the regulations in effect prior to February 14, 1997 (allocating among four classes of assets), apply. For transfers occurring before February 14, 1997, if § 197 applies to any of the transferred assets, the taxpayer may consistently (A) apply the provisions of the § 1.1060-1T(d) as in effect for transfers on or after February 14, 1997 (allocating among five classes of assets); (B) apply the provisions of § 1.1060-1T(d) as in effect before February 14, 1997; or (C) apply the provisions of § 1.1060-1T(d) as in effect before February 14, 1997, but treat all amortizable § 197 intangibles as Class IV assets. See § 1.1060-1T(a)(2)(ii) (1997).

Under any of these rules, a majority of the purchase price would be allocated to goodwill or other intangible assets.

(F) Item 2 should be renumbered as Item 4 and should be replaced with the following language:

4. Effect on the subsequent purchases of partnership interests

For distributions on or before May 8, 1997, § 1.708-1(b)(1)(iv) provided that the following is deemed to occur when a partnership terminates by a sale or exchange of an interest. First, the partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties. Second, immediately thereafter, the purchaser and the other remaining partners contribute the property to a new partnership. The distribution of property deemed to occur under § 1.708-1(b)(1)(iv) is treated like an actual distribution for federal tax purposes. Therefore, the basis rules of § 732 apply to the deemed distribution.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction. For distributions on or before August 5, 1997, section 732(c) provided that the basis of distributed properties to which subsection (b) is applicable shall be allocated (1) first to any unrealized receivables and inventory items in an amount equal to the adjusted basis of each such property to the partnership, and (2) to the extent of any remaining basis, to any other distributed properties in proportion to their adjusted basis to the partnership.

Under these rules, when additional interests in the were purchased between (the date of the original purchases) and August 5, 1997, § 708(b)(1)(B) technical terminations would be triggered. As a result of the technical terminations, the relevant would be deemed to distribute all of their assets to the remaining partners, followed immediately by a recontribution of the assets to new partnerships. Section 732 would determine the basis of the distributed assets. Pursuant to § 732(c), to the extent that there is basis remaining after the allocation to unrealized receivables and inventory items, that excess would be allocated among other distributed properties in proportion to their adjusted bases. Goodwill or other intangibles would have received a large basis when a share of these items were deemed purchased on . Accordingly, goodwill or other intangibles would receive the majority of the partners' outside bases.

(F) Section 197

[redacted] Under § 197(f)(9), these intangibles are not amortizable § 197 intangibles if they were held or used at any time on or after July 25, 1991 by the taxpayer or a related person. Section 197(f)(9)(C)(i) provides that a person is related to any person if the related person bears a relationship to such person specified in § 267(b) or § 707(b)(1). In applying § 267(b) or § 707(b)(1), 20 percent is substituted for 50 percent. Section 197(f)(9)(C)(i)(II) provides that a person is related to any person if the related person and such person are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of § 41(f)(1). See also section 41(f)(5) (defining "controlled group of corporations" as having the same meaning as given to such term in § 1563(a), except that "more than 50%" shall be substituted for "at least 80 percent" each place it appears in § 1563(a)(1); and section 197(f)(9)(E) (providing that with respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations under section 197(f)(9) shall be made at the partner level, and each partner shall be treated as having owned and used such partner's proportionate share of the partnership's assets).

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By:

MATTHEW LAY
Senior Technician Reviewer, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)