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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL (FIP) CC:FIP

SUBJECT: EQUITY STRIPPING TRANSACTION

This Chief Counsel Advice responds to your memorandum dated March 21, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

Parent =

Third Party =

A =

B =

C =

D =

E =

F =

G =

H =

I	=
J	=
K	=
Year W	=
Year X	=
Year Y	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Custodian	=
Custodian 2	=
Money Market Fund	=
Money Market Fund 2	=
Custodial Dividend Receipts	=

Custodial Share Receipts = [1]

ISSUES:

The issues taken from your request for Field Service Advice (FSA) are as follows:

1. Whether the Taxpayer is entitled to a deduction of $B for losses claimed on the sale of the Custodial Share Receipts in Year X.

2. Whether the Parent is required to report income in Year X from holding the Custodial Share Receipts.

CONCLUSIONS

1. No. The Taxpayer is not entitled to claim a deduction of $B for "losses" on the "sale" of the Custodial Share Receipts in Year X, provided, however, that further factual development, as specified below, supports one or more of a number of potentially applicable legal theories addressed herein.

2. Yes. The Parent is required to report income in Year X from holding the Custodial Share Receipts in Year X, subject to the same caveat noted above concerning the outcome of further factual development.

FACTS

Issue 1

The facts, are summarized as follows: On Date 1, the Taxpayer Purchased $A shares of the Money Market Fund[2] for $A. From the date of purchase until Date 2,

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[1]

[2] The Money Market Fund, a regulated investment company (RIC), is designed for institutional investors. The fund has all the characteristics of a typical money market mutual fund. The fund invests in short-term market obligations, including securities issued or guaranteed by the United States or its agencies or instrumentalities,

the Taxpayer received dividend income from these shares in the amount of $H. On or about Date 2, the Taxpayer placed the shares in a formal custodial arrangement with Custodian, a third party trust company. In exchange for the shares, the Taxpayer received four Custodial Receipts. Of the four, two were “Custodial Dividend Receipts” (CDRs) and two were “Custodial Share Receipts” (CSRs), described as follows:

> 1. One CDR represented the right to receive a stream of payments equal to the value of the dividends paid on I shares of the Money Market Fund for J years,
>
> 2. One CDR represented the right to receive a stream of payments equal to the value of the dividends paid on I shares of the Money Market Fund for K years.
>
> 3. One CSR represented the right to receive I shares of the Money Market Fund in J years.
>
> 4. One CSR represented the right to receive I shares of the Money Market Fund in K years.

The Taxpayer sold both of the above-described CDRs to its parent (Parent), for $C. The Taxpayer reported no gain on the sale of the CDRs to the Parent in Year W. Because the Taxpayer and the Parent are members of the same consolidated group, the Taxpayer treated the gain from the intercompany sale as deferred. Treas. Reg. § 1.1502-13(c). Approximately three months later, the Taxpayer sold the above described CSRs to the Third Party for $D.

For accounting purposes, the Taxpayer allocated the $A basis in the shares between the CDRs and CSRs based on their fair market values. For tax purposes, however, the Taxpayer allocated all of its basis ($A) to the CSRs and

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certificates of deposit, time deposits, bankers’ acceptance and other short-term obligations issued by domestic banks or London branches of domestic banks, repurchase agreements and high grade commercial paper and other corporate obligations. The Money Market Fund seeks to maintain a net asset value of one dollar per share for purchase and redemption. Dividends declared each day are payable at the end of each month and are automatically reinvested in additional fund shares, or at the investor’s option, paid in cash. If an investor redeems all shares in its account at any time during the month, all dividends to which the investor is entitled will be paid along with the proceeds of the redemption. According to the prospectus, dividends derived from net investment income paid by the fund are taxable as ordinary income. No portion of the dividends qualified for the dividends received deduction allowable to certain U.S. Corporations.

claimed a loss in the amount of $B in Year X , when it sold the CSRs to the Third Party.

Issue 2

The second issue involves several transactions that are similar, but unrelated to the CSRs discussed in Issue 1. The Parent purchased CSRs from various unrelated third parties. The custodial arrangements involved with these purchases were formed on various dates, some prior to January 1, 1997, and some after that date. For example, on Date 3 and Date 4 Parent purchased of CSRs issued by Custodian 2. The Parent reported no income with respect to the period in Year X during which it held the CSRs. However, Money Market Fund 2 Custodial Receipts were grouped together with other assets and taxed as a partnership. The partners were the Parent and the Taxpayer.

LAW AND ANALYSIS

Among the potentially applicable legal theories we have considered in our analysis of this transaction are the following: 1) Artificial Loss Theory (applying economic substance theories and Treas. Reg. § 1.165-1(b)); 2) Economic Substance and the "Sale" of Custodial Receipts (various arguments under the economic substance doctrine addressing whether the Custodial Receipts were "sold" for tax purposes and, if so, to whom); 3) Entity Classification (applying Treas. Reg. § 301.7701-4, I.R.C. § 707); and 4) Basis Allocation (applying Treas. Reg. § 1.61-6 and common law).

1. Artificial Loss Theory (Economic Substance/Treas. Reg. § 1.165-1(b))[3/]

The transaction in issue is designed, in part, to produce an artificial loss for the Taxpayer by attempting to separate from the Money Market Fund shares, part or all of the income produced by that asset. However, the separation of income from the underlying asset arguably does not result in any economic loss. The purported loss resulting from the sale of the CSRs does not represent a bona fide loss reflecting actual economic consequences and, therefore, is not allowable as a deduction for federal income tax purposes. See ACM Partnership v. Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) ("Tax losses such as

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[3/] This approach has been utilized by the Service in a number of recent Notices and one or more revenue rulings and revenue procedures . See, for example, Notice 2001-17, 2001-09 I.R.B. 730 (Contingent Liability Tax Shelter); Notice 2000-60, 2000-2 C.B. 568 (Stock Compensation Corporate Tax Shelter); Notice 2000-44, 2000-2 C.B. 255 (Tax Avoidance Using Artificially High Basis); Rev. Rul.2000-12, 2000-1C.B. 744 (Section 1275.--Other definitions and special rules); Rev. Proc. 99-51, 1999-2 C.B. 760 (Rulings and Determination Letters); Notice 99-59,1999-2 C.B. 761 (Tax Avoidance Using Distributions of Encumbered Property).

these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); Scully v. United States, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); Shoenberg v. Commissioner, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"); Treas. Reg. § 1.165-1(b) ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

Accordingly, under this theory, in Issue 1, the Taxpayer would not be entitled to its claimed loss. This theory does not, however, address the question presented in Issue 2: Whether the Parent is required to report income with respect to the period during which it held the CSRs in Year X.

2. Economic Substance and the "Sale" of the Custodial Receipts[4/]

The purported loss from a transaction, such as the transaction in issue, may be subject to challenge by characterizing the transaction in accordance with its economic substance. Depending upon the facts, a taxpayer might be treated as having sold its entire interest in the RIC shares, including the right to all future dividends, in exchange for the cash received and additional payments equal to the dividends on the RIC shares. Alternatively, a taxpayer might be treated as not having sold the RIC shares, with the amount received from the purported sale of the RIC shares instead treated as a loan to the taxpayer.

Under the assignment of income doctrine, the holder of income-producing property is prevented, for federal income tax purposes, from separating the income from the underlying income-producing property. See Lucas v. Earl, 281 U.S. 111 (1930) and Helvering v. Horst, 311 U.S. 112 (1940). Therefore, the dividend stream represented by the CDRs, arguably, cannot be stripped or separated from the underlying Money Market Fund shares unless specifically permitted under the Code or regulations. See I.R.C. §§ 305(e) and 1286.

When a taxpayer gives away earnings from income-producing property, the "crucial question" is whether the property or only the income from the property has been transferred. Caruth Corporation v. U.S., 865 F.2d 644, 648-649 (5th Cir. 1989). If the taxpayer transfers the entire property, the assignment of income doctrine does not apply. See Blair v. Commissioner, 300 U.S. 5 (1937)(the taxpayer did not anticipatorily assign income where the taxpayer transferred a beneficial interest in income-producing property itself.) If, however, the taxpayer retains the income-

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[4/] The "deemed financing" approach, one of the approaches discussed in this section, also is utilized in I.R.C. I.R.C. § 636 (concerning the income tax treatment of mineral production payments), Prop. Treas. Reg. § 1.7701(l)-2 (the proposed lease-stripping regulations), and Treas. Reg. § 1.7701(l)-3 (the fast-pay preferred regulations).

producing property and carves income or a partial interest out of the property, the assignment of income doctrine applies. See Commissioner v. P.G. Lake, 356 U.S. 260, 265 (1958)(lump sum consideration received by the taxpayers in return for an assignment of oil payment rights was “essentially a substitute for what would otherwise be received at a future time as ordinary income” and is taxable as ordinary income.)

The issue in the instant case turns on whether the Taxpayer transferred ownership of the Money Market Fund shares upon the sale of the CSRs to the Third Party. If the Taxpayer (or its Parent) retained ownership of the shares, then the Parent on its consolidated return is taxed on all dividend income earned on the shares. If the Taxpayer transferred ownership of the shares, then the Third Party is taxed on all dividend income earned on the shares. Under both of these scenarios, the payment of $D to the Taxpayer by the Third Party must be characterized according to the substance of the transaction.

In general, a "sale" is a transfer of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). The test for determining whether a transaction is a sale, as opposed to either a lease or a mere financing arrangement, is whether the benefits and burdens of ownership have passed to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987), aff'd in relevant part, rev'd in part sub nom. Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990). Thus, whether a transaction is a sale, lease, or financing arrangement is a question of fact that must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955).

The Tax Court generally considers the following factors when determining whether the benefits and burdens of ownership have passed to a purchaser: (1) whether legal title passed to the purported purchaser; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the contract of sale created an obligation on the part of the seller to execute and deliver a deed and an obligation on the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays income and property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the operation, retention and sale of the property. See Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981).

Although no single factor under the Grodt test determines whether a sale has occurred, the relative importance of each factor is determined by the facts and circumstances of the particular transaction. For example, whether the buyer has acquired an equity interest in the property is the most significant factor that distinguishes a bona fide sale from a mere financing arrangement. Thus, the acquisition of an equity interest may be considered substantive evidence of a sale,

especially when the form of the transaction is a sale. See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976). However, a taxpayer who does not acquire an equity interest in a property will not have a depreciable interest in that property either and, thus, will be viewed as having attempted to acquire mere tax benefits. See Houchins v. Commissioner, 79 T.C. 570, 602 (1982).

Another important factor in determining whether the property or only the income from the property has been transferred is who has control over the income flow. See Thibodaux v. Commissioner, 915 F.2d 992 (5th Cir. 1990). See also United States v. Pirro, 212 F.3d 86 (2d. Cir. 2000) ("It is a fundamental axiom, even in the criminal context, that tax consequences flow from the substance rather than the form of a transaction, and that "control over property, rather than documentary title" marks the real owner for federal tax purposes"); United States v. Atkins, 869 F.2d 135, 140 (2d Cir. 1989) (citing Corliss v. Bowers, 281 U.S. 376, 378 (1930), "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed.").

If, under the facts and circumstances, the Third Party is the owner of the shares, then the transfer of the CSRs constitutes a sale of the Money Market Fund shares to the Third Party in consideration for $D in cash upfront and a series of payments over the following E years. An indebtedness is defined, for federal income tax purposes, as an unconditional obligation to pay a sum certain at a fixed maturity date. Gilbert v. Commissioner, 248 F.2d 399, 402 (2nd Cir. 1957), cert. denied 359 U.S. 1002 (1959). The CDRs retained by the consolidated group including the Taxpayer and the Parent could represent a debt instrument issued by the Third Party, which would have original issue discount (OID), or a contract subject to I.R.C. § 483.

If, under the facts and circumstances, the consolidated group has retained ownership of the shares, then the transfer of the CSRs does not constitute a sale of the Money Market Fund shares to the Third Party. The transfer of $D in cash from the Third Party to the Taxpayer is treated as a loan transaction for which the Money Market Fund shares serve as collateral. An indebtedness is defined, for federal income tax purposes, as an unconditional obligation to pay a sum certain at a fixed maturity date. Gilbert v. Commissioner, 248 F.2d 399, 402 (2nd Cir. 1957), cert. denied 359 U.S. 1002 (1959). In the instant case, the Third Party transferred $D to the Taxpayer in return for the Taxpayer's unconditional promise to repay the amount in about E years by transferring to the Third Party the Money Market Fund shares or an amount equal to the value of the Money Market Fund shares in about E years. Because the value of the shares is always approximately $1.00 per share, the value of the Money Market Fund shares in about E years is reasonably certain to be $A. Therefore, the CSRs held by the Third Party represent a debt instrument issued by the Taxpayer which arguably would have OID.

Under either scenario, further factual development is necessary in order to determine whether the deemed lender must include in gross income imputed

interest or OID. We suggest that further assistance be requested on the operation of the OID and other interest imputation rules.

3. Entity Classification Approach

Issue 1

The classification of the custodial arrangement as a partnership may result in the denial of Taxpayer's claimed deduction of $B for losses in Year X. Further factual development, however, is necessary to determine whether the Year X sale of the CSRs to the Third Party should be treated as a sale of a partnership interest.

The custodial arrangement involved in Issue 1 was entered into on or about Date 2. However, the year involved is Year X, when the Taxpayer sold the CSRs to the Third Party for a loss.

Effective January 1, 1997, the classification of an entity is determined under the "check-the-box" regulations. The check-the-box regulations generally provide that unless the entity elects otherwise, an eligible entity in existence prior to January 1, 1997, will have the same classification that the entity previously claimed, assuming the entity had a reasonable basis for its claimed classification. Treas. Reg. § 301.7701-3(b)(3) and (h). However, if no classification was previously claimed and an election was not made under Treas. Reg. § 301.7701-3, a domestic eligible entity is properly classified as a partnership by default if it has two or more members. Treas. Reg. § 301.7701-3(b)(1)(i).

In the instant case, it can be argued that the custodial arrangement claimed a classification that was neither that of a corporation, a partnership, or a trust. Basically, the custodial arrangement was not treated as an entity. Whether this was reasonable for this pre-January 1, 1997, arrangement is determined under the tests and standards set out in Treas. Reg. §§ 301.7701-2, 301.7701-3, and 301.7701-4, as in effect prior to January 1, 1997. Alternatively, it can be argued that no classification was previously claimed and no election was made under Treas. Reg. § 301.7701-3, so the entity is properly classified as a partnership by default under the check-the-box regulations because it has at least two members. Treas. Reg. § 301.7701-3(b)(1)(i).

I.R.C. §§ 761(a) and 7701(a)(2) provide that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, a trust or estate or a corporation.

Treas. Reg. § 301.7701-4 defines trusts. In general, the term "trust" refers to an arrangement created either by will or by an intervivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries. The fact that any organization is technically cast in the trust form, by

conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if, applying the principles set forth in Treas. Reg. §§ 301.7701-2 and 301.7701-3**,** the organization more nearly resembles an association or a partnership than a trust. The determination of whether a trust is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. Treas. Reg. § 301.7701-2(a)(2).

Former Treas. Reg. § 301.7701-2(a)(2) provided that an organization that has associates and an objective to carry on business and divide the gains therefrom may be classified as a partnership or an association taxable as a corporation.[5/] That classification depends on whether the entity has the corporate characteristics of centralization of management, continuity of life, free transferability of interests, and limited liability. Former Treas. Reg. § 301.7701-2(a)(3) provided that if an unincorporated organization possesses more corporate characteristics than noncorporate characteristics, it constituted an association taxable as a corporation. The Tax Court, in Larson v. Commissioner, 66 T.C. 159 (1976), interpreted Treas. Reg. § 301.7701-2 and concluded that equal weight must be given to each of the four corporate characteristics. In determining whether these corporate characteristics exist, all of the agreements and the totality of the circumstances must be considered.

An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of, or claims against, the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of the organization are insufficient to satisfy the creditor's claim. Former Treas. Reg. § 301.7701-2(d)(1).

An organization has the corporate characteristic of continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause dissolution of the organization. Former Treas. Reg. § 301.7701-2(b)(1). If under local law, a member has the power to dissolve the organization despite the terms of the agreement, the organization lacks continuity of life. Former Treas. Reg. § 301.7701-2(b)(3). Section 6.2 of the Custody Agreement provides that the agreement shall terminate on the date on which no custodial receipts remain outstanding.

An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of the other members, to

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[5/]Issue 2 contains a discussion of the multiple classes of ownership interests involved with the custodial arrangement and why the arrangement appears to have associates and an objective to carry on business and divide the gains therefrom.

substitute for themselves in the same organization a person who is not a member of the organization. Former Treas. Reg. § 301.7701-2(e)(1). The Purchase Agreement for the CSRs between the Third Party and the Taxpayer seems to indicate that the arrangement between the parties lacks the characteristic of free transferability. Paragraph 13 of this agreement provides that neither the agreement nor its rights, interests or obligations may be assigned by any party hereto; provided, however, that Buyer may assign the Agreement to one or more of its subsidiaries or affiliates without Seller's consent. Accordingly, the arrangement between the parties appears to lack the characteristic of free transferability.

An organization has the corporate characteristic of centralized management if any person (or any group of persons that does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Former Treas. Reg. § 301.7701-2(c)(1). Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by other members of the organization. The persons who have such authority may or may not be members of the organization. Section 2.5 of the Custody Agreement provides that the holder of the CSRs has the right to vote the shares, with some limitation. Under the agreements, the Custodial Dividend Receipt holder does not have the right to vote or other similar management power. Thus, we believe that the corporate characteristic of centralized management exists.

Courts have looked at various factors in considering whether a partnership exists. In determining whether a partnership exists for federal income tax purposes, the Supreme Court stated:

> The question is . . . whether, considering all the facts -- the agreement, the conduct of the parties in execution of its provision, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

The hallmarks of a partnership are the sharing of profits, the contribution of capital and its risk of loss, and the sharing of control over the enterprise. Reinberg v. Commissioner, 90 T.C. 116, 137 (1988). In Luna v. Commissioner, 42 T.C. 1067, 1077-1078 (1964), the Tax Court articulated the following particular factors, none of which is conclusive, which tend to indicate whether a partnership or joint venture has been formed:

> [t]he agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to

> make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

If after further development you determine that the custodial arrangement is properly classified as a partnership, an argument can be made that under I.R.C. § 707, the Taxpayer would be treated as having contributed approximately E% (valued at about $D) of the Money Market Fund shares to the partnership in exchange for its partnership interest and as having sold approximately F% (valued at about $B) of the Money Market Market Fund share to the Parent in a disguised sale under I.R.C. § 707. Under I.R.C. § 707, this transaction is treated as if the Parent contributed about $B to the partnership, and the partnership used the approximately $B to buy F% of the Money Market Fund shares from the Taxpayer. Thus, upon the formation of the partnership, the Taxpayer would have a capital account balance and basis in the partnership of approximately $D and the Parent would have a capital account balance and basis in the partnership of approximately $B. On the disguised sale, there would be no gain or loss because the Taxpayer would be selling F% of the Money Market Fund shares with a basis of approximately $B for approximately $B. When the Taxpayer sells the CSRs in Year X to the Third Party, the Taxpayer would be treated as selling its partnership interest with a basis of approximately $D to the Third Party in exchange for approximately $D, so there should be no gain or loss.

Furthermore, the allocations of income during the operation of the partnership would have to comport with the rules in I.R.C. § 704. Issue 2, below, contains a discussion as to how I.R.C. § 704 may operate in this situation.

Issue 2

The classification of the custodial arrangement as a partnership may require Parent to report income in Year X. The purchase of CSRs held by custodial arrangements entered into on or after January 1, 1997, may be treated as the purchase of various partnership interests. Further factual development, however, is necessary to determine whether the purchase of various CSRs held by custodial arrangements entered into prior to January 1, 1997, should be treated as the purchase of various partnership interests.

The custodial arrangements involved in Issue 2 appear to have been entered into on various dates, some prior to January 1, 1997 (the effective date of the “check-

the-box" regulations), and some after that date. The incoming memorandum requests advice on the Parent's Date 3 and Date 4 purchases of CSRs issued by Custodian 2.

The same analysis described in Issue 1 would apply to those custodial arrangements entered into prior to January 1, 1997. However, the classification of the custodial arrangements entered into on and after January 1, 1997, is determined solely under the check-the-box regulations. Under the check-the-box regulations, a business entity that is not classified as a corporation under Treas. Reg. §§ 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in Treas. Reg. § 301.7701-3.

Under Treas. Reg. § 301.7701-2(a), a business entity is any entity recognized for federal tax purpose that is not properly classified as a trust under Treas. Reg. § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or partnership.

A partnership is defined as a business entity that is not a corporation under Treas. Reg. § 301.7701-2(b) and that has at least two members. Treas. Reg. § 301.7701-2(c)(1). For federal tax purposes, the term corporation means (1) a business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; (2) an association (as determined under Treas. Reg. § 301.7701-3); (3) a business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association; (4) an insurance company; (5) a State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute; (6) a business entity wholly owned by a State or any political subdivision thereof; (7) a business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than I.R.C. § 7701(a)(3); and (8) certain specified foreign entities.

Treas. Reg. § 301.7701-4 defines trusts. This regulation 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. <u>See</u> <u>Commissioner v. North American Bond Trust</u>, 122 F. 2d 545 (2d Cir. 1941), <u>cert.</u> <u>denied</u>, 314 U.S. 701 (1942). 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 will be ordinarily classified as a business entity under Treas. Reg. § 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. Treas. Reg. § 301.7701-4(c)(1).

From the information you provided, the CDR holder and the CSR holder tend to have different rights and obligations with respect to the shares. CDRs purport to evidence dividend rights which entitle the holder to receive distributions (other than in respect of return of capital) on the shares paid by the Issuer for a specified period of time. CSRs purport to evidence the right to the shares along with distributions in respect of a return of capital, exclusive of the right to dividends paid by the issuer on or prior to a specified date. Furthermore, assuming, without concluding that the CSR represent equity rather than debt, in some cases, only one holder has the right to vote. Thus, the share and dividend receipts represent two different classes of ownership interests.

The multiple classes of ownership interest are designed to permit investors, by transferring one of the certificates and retaining the other, to fulfill their varying investment objectives of seeking primarily either dividend income or capital appreciation from the stock. The arrangement creates investment interests that differ from the interests that would be obtained by direct investment in the assets. Thus, the arrangement was not formed to facilitate direct investment in the assets and the existence of multiple classes of ownership interests is not merely incidental to that purpose. Therefore, the custodial arrangement is classified as a business entity under Treas. Reg. § 301.7701-2.

Under Treas. Reg. § 301.7701-2, the custodial arrangement is not a corporation as defined under Treas. Reg. § 301.7701-2(b) and, thus, in the absence of an election otherwise, it is a partnership by default. Treas. Reg. § 301.7701-2(c). As a partnership, the custodial arrangement must make allocations of income that have substantial economic effect under the rules in Treas. Reg. § 1.704-1(b)(2). Unless the allocation of income to the holder of the dividend receipts during the term of the custodial arrangement has substantial economic effect under the rules in Treas. Reg. § 1.704-1(b)(2), the income will be reallocated between the parties for federal income tax purposes.

For example, assume the Parent paid approximately $D for the right to receive the Money Market Fund shares approximately E years later, as the Third Party did in Issue 1. Also, assume that the party holding the right to a stream of income equal to the dividend income paid approximately $B. The Parent would have a capital account and basis of about $D in the partnership, and the dividend holder would have a capital account and basis of approximately $B in the partnership. Under this arrangement, at the end of E years, the Parent will receive the Money Market Fund shares valued at $A in return for its capital account of approximately $D. (Essentially the Parent will receive its capital account and that of the dividend holder as well; the dividend holder will not receive anything at the end of E years.)

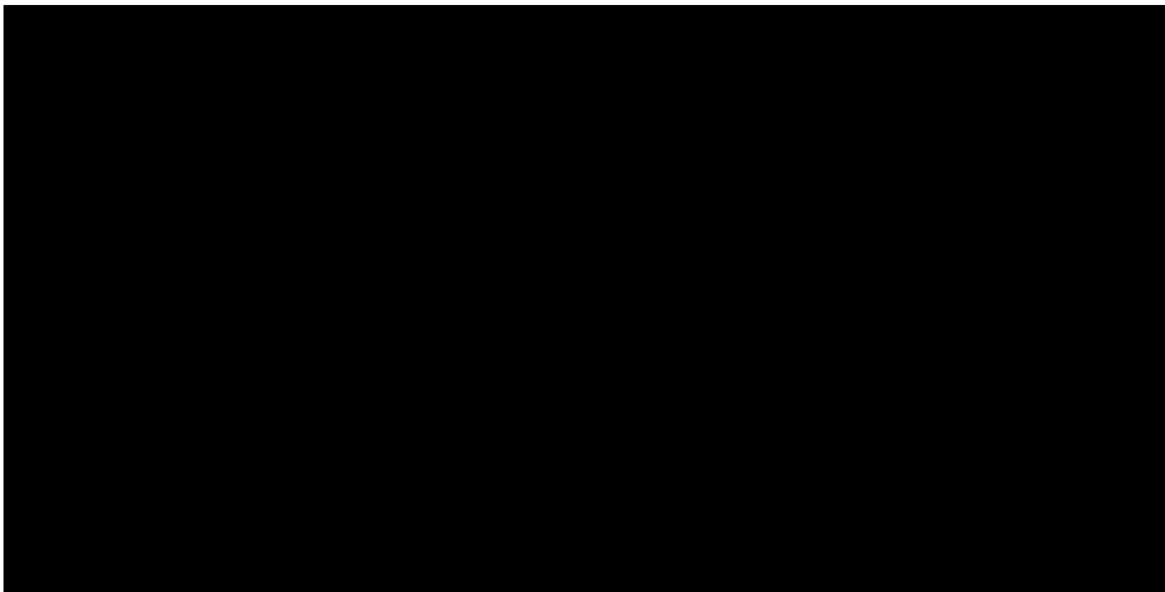
Thus, upon liquidation of the partnership, the liquidating distributions are not being made in accordance with the positive capital account balances of the partners. The allocations of income (for example, the dividend income that the dividend holder is being allocated) would have to be reallocated to comport with the rules in I.R.C. § 704. The reallocation would be done in a manner that would essentially reduce the dividend holder's capital account balance to G by the end of the E-year period. For a more detailed discussion of I.R.C. § 704(b), we suggest that further assistance be requested on the operation of I.R.C. § 704(b).

4. Basis Allocation

I.R.C. § 1012 states that the basis in property shall be the cost of that property. Treas. Reg. § 1.61-6(a) of the Income Tax Regulations states that when a part of a larger property is sold, the cost or other basis in the entire property shall be equitably apportioned among the several parts. The gain or loss on the sale of the part is the difference between the selling price and cost or other basis allocated to that part. The sale of each part is to be treated as separate transactions, and the gain or loss is to be computed separately on each part. Gain or loss is to be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

This approach prevents the Taxpayer from recognizing it's claimed loss of $C by allocating Taxpayer's original basis in the Money Market Fund shares ($A) between the CDRs and the CSRs according to their relative fair market values when the Money Market Fund shares are exchanged with the Custodian for the Custodial Receipts.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call if you have any further questions.

By: ALICE BENNETT
Chief, Branch 3
Associate Chief Counsel (FIP)