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LEGAL ALERT

April 3, 2013

A Trend Emerging? District Court Disallows $1 Billion of Deductions

Earlier this year, the United States District Court for the Middle District of Louisiana upheld the Internal Revenue Service's disallowance of $1 billion of deductions claimed by Dow Chemical in relation to two transactions that the court ruled lacked economic substance and involved sham partnerships. *Chemtech Royalty Associates, L.P. v. United States*, 05-cv-00944. While much of the court's analysis focused on the common law tests of economic substance and sham partnership, the court also included a debt-equity analysis of the partnership interests, a trend that has started to emerge over the last year in tax litigation throughout federal courts.

The transactions, called Chemtech I and Chemtech II, were special limited investment partnership (SLIPS) transactions, a type of lease-strip transaction developed by Goldman Sachs. The transactions involved the creation of foreign limited partnerships to which Dow contributed physical assets and patents with a near-zero basis, which were then leased or licensed back to Dow. Because of the nature of the property contributed, the partnerships could not earn income from third parties, and the partnerships' income was limited to the payments from Dow. Dow's use of the property did not change. The general partner was a Dow foreign subsidiary. The limited partners were foreign banks. The limited partnership interests carried the right to a fixed payment of 6% to 7%. Limited partnership distributions were funded with approximately 10% of the royalty and rental payments made by Dow, and all remaining cash in the partnerships was loaned back to Dow. These transactions were similar to the transaction involved in *Castle Harbour*, which involved a partnership owning fully depreciated aircraft. *See TIFD III - E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006).

For tax purposes, the partnerships allocated approximately 80% of the rental or royalty income to the foreign banks even though they received only 10% of the income as cash distributions. The remaining 20% of the rental or royalty income was allocated to Dow. The effect of the transactions was that Dow deducted the full royalty and rental payments, received the bulk of the payments back in the form of nontaxable loans, and reported income only in the amount of its 20% partnership allocation. The court viewed the circular nature of the cash flows and the mismatch between the cash flows and the tax effects very unfavorably.

The court devoted a significant section of its opinion to the question of whether the foreign banks held true equity interests in the partnerships or whether their interests were more like debt. The debt-equity characterization was important because it provided a basis, independent of business purpose or economic substance, for disregarding the partnerships. The court followed the approach of the government's economic expert, who testified that the banks were insulated from all likely risks and rights to manage the partnerships. Accordingly, the court concluded that the banks were creditors rather than partners. The debt-equity analysis used by the court has been employed in numerous other recent cases. *See TIFD III - E, Inc.*; *Hewlett-Packard Co. v. Commissioner*, T.C. Memo. 2012-135 (May 14, 2012); *NA General Partnership & Subsidiaries v. Commissioner*, T.C. Memo. 2012-172 (June 19, 2012); *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012); *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269 (Sept. 20, 2012); and *H&M, Inc. v. Commissioner*, T.C. Memo. 2012-290 (Oct. 15, 2012). This recent trend will need to be monitored closely in the future.

The court also concluded that the transactions lacked economic substance and that Chemtech I and Chemtech II were sham partnerships. The court held that the transactions did not have objective

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economic substance because they did not change Dow's financial position, and off-balance-sheet financing produced no quantifiable benefits. The court rejected Dow's asserted business purpose of sustaining its credit rating through off-balance sheet financing, noting that Dow's documents focused almost solely on the tax benefits of the transactions. The circular flow of funds and the lack of risk for the foreign banks made it "obvious" to the court that the parties did not intend to enter into a partnership to generate any additional revenue. Nor were the foreign banks true partners in Chemtech because the court found that they were "essentially guaranteed" a return on their investment, and the actual operations of Chemtech supported the payments which were "reasonably anticipated" at the partnerships' inception.

The court imposed the negligence and substantial understatement penalties, citing internal Dow documents focused on tax consequences as undermining the "contrived" business objectives as well as the similarity of the Chemtech transactions to "tax shelters" described in Congressional reports. Projections showing the net present value per share of the tax benefits of the transactions led the court to believe that Dow viewed its tax department as a profit center. For Chemtech I, because the transaction occurred before the 2004 amendments to section 6662(d), Dow could rely on the substantial authority exception. However, the court held that the determination that the transaction lacked economic substance conclusively determined that the taxpayer also lacked substantial authority. It is important to note that under present law, the lack of economic substance would result in a strict liability penalty. For the transition period from Chemtech I to Chemtech II, and for Chemtech II, the substantial authority defense was precluded because the transactions occurred after the 2004 amendments and were tax shelters. The court, applying the rule in *Heasley v. Commissioner,* 862 F.2d 540 (5th Cir. 1988), declined to impose the gross valuation misstatement penalty because it determined that the underpayment was attributable to claiming an improper deduction rather than to a valuation overstatement. The U.S. Supreme Court recently granted certiorari to resolve a split among the circuit courts regarding whether the valuation misstatement penalties can apply when a transaction is completely disallowed. *See United States v. Woods*, No. 12-562, *cert. granted* (March 25, 2013).

Because this was a TEFRA proceeding, any partner-level defenses to the negligence penalty must await a separate proceeding. Partners who wish to assert certain defenses, including reasonable cause, must bring a separate refund proceeding after assessment and payment of the penalty. Under the Treasury Regulations, partner-level defenses are generally limited to those that are "personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level." While the partners of Chemtech I and Chemtech II were precluded from asserting a reasonable cause defense in this proceeding, it is important to note that under some circumstances, such as in a case involving actions taken by a managing partner, courts have permitted a reasonable cause defense to be asserted in a partnership proceeding. *See Klamath Strategic Investment Fund v. U.S.*, 568 F.3d 537 (2009).

The decision is noteworthy in two additional respects. First, the court viewed very unfavorably the fact that the transactions were designed by third parties. That view is consistent with the approach taken by a number of other courts that noted the role played by third parties in designing complex transactions that were ultimately disregarded for a lack of economic substance or on debt-equity grounds. *See TIFD III - E, Inc.*; *Historic Boardwalk Hall, LLC*; *Pitired 1, LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 2011); and *Bank of New York Mellon Corp. v. Comm'r.*, 140 T.C. 2 (2013). By contrast, two of the more noteworthy recent taxpayer victories made no mention of any third-party involvement. *See Pepsico Puerto Rico, Inc.* and *NA General Partnership*. These cases, read together, could be viewed as drawing an implicit distinction between tax planning conducted by a taxpayer and its advisors on one hand, and structured transactions created by third parties on the other. Although the involvement of a third party may have no impact on the technical merits of any particular case, it may be coloring the courts' views of the transactions from the outset, a potential trend that taxpayers facing possible litigation should closely follow.

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Second, in analyzing whether the partnership was a sham, the court rejected the taxpayer's attempt to invoke the Supreme Court decision in *Moline Properties v. Comm'r*, 319 U.S. 436 (1943). The court noted that the "*Moline Properties* test conflicts with the Fifth Circuit's holding in *Merryman*." Under Fifth Circuit jurisprudence, the formation of a partnership must be driven by a "genuine business purpose," whereas *Moline Properties* provides that a partnership must be respected for tax purposes if it was formed for a business purpose or actually carried on a business activity. Although it cannot be said that the entire outcome of the case hinged on whether to apply *Moline Properties* or not, the court's willingness to side-step the Supreme Court precedent could be viewed as an example of an outcome driven by the court's view of the transaction.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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