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Tax Court Rejects Service's Economic Substance Attack on Partnership Transaction

Overview

The Internal Revenue Service (the "Service") has lately enjoyed great success using the economic substance doctrine against transactions the principal purpose of which was the reduction of tax. The Service overreached, however, in *Countryside Partnership v. Commissioner*, T.C. Memo. 2008-3. There, the Tax Court reaffirmed that the economic substance doctrine does not preclude a taxpayer from choosing the form of its transaction, even where that form was motivated entirely by tax planning.

The Deal

In 1993, Countryside Partnership ("Countryside") had purchased a large residential property (the "Property"). In the spring of 2000, Countryside began negotiating with a third party ("Stone Ends") to sell it the Property. At that time, the four partners in Countryside were Winn, who owned about 69 percent; Curtis, who owned about 25 percent; and Wollinger and CLP Holdings, who together owned 5 percent and 1 percent, respectively. In order to avoid the gain that would result from the sale of the Property, the parties took the following steps:

- Countryside formed a subsidiary partnership ("CLPP") in which it owned a 99 percent interest, borrowed $8.55 million from an unrelated bank (the "Bank"), and contributed those funds to CLPP. CLPP then formed a subsidiary partnership of its own ("MP") in which it owned a 99 percent interest, and contributed $8.5 million to MP.
- MP then borrowed $3.4 million from the Bank, and used its $11.9 million in cash to buy four privately issued notes from a subsidiary of AIG (the "Notes"). Each of the Notes was redeemable by the holder 2.5 years after issuance. The interest rate on the Bank loans was 230 basis points higher than the interest rate MP earned on the Notes.
- In late December 2000, Countryside distributed its 99 percent interest in CLPP to Winn and Curtis in complete liquidation of their interests in Countryside.
- Countryside sold the Property to Stone Ends in April 2001 and then repaid the Bank the $8.55 million it had borrowed.
- MP had the Notes redeemed by AIG at the earliest redemption date and then repaid its $3.4 million loan to the Bank.

The Goal

By taking these steps, the parties intended that (i) Winn and Curtis not be subject to tax upon the distribution of the CLPP partnership interest, (ii) Countryside not be subject to tax upon the sale of the Property (*i.e.*, because of its basis step-up under Sections 754 and 734(b)), and (iii) MP not recognize any gain when it redeemed the Notes. The decided case, however, dealt only with whether the distribution of the CLPP partnership interest to Winn and Curtis was a recognition event for them.

The tax treatment of a partnership's distribution to a partner is governed by Section 731. Under Section 731(a), gain generally is not recognized to the recipient partner on such distribution "except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution." Section 731(c) provides, however, that, for purposes of Section 731(a), the term "money" includes "marketable securities." Treasury

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regulations under Section 731(c) include a look-through rule, under which the partnership interests in CLPP and MP would be treated as "marketable securities" if 90 percent of their assets were marketable securities. Given this look-through rule, the Tax Court simply ignored the lower-tier partnerships and treated the liquidating distribution as a distribution of the Notes. Thus, the distribution to Winn and Curtis would be treated as a distribution of "marketable securities," and hence currently taxable to the extent it exceeded their basis in their partnership interests in Countryside, if, and only if, the Notes were marketable securities.

The Service's View

Because the Notes were not "marketable securities" within the meaning of Section 731(c) (*i.e.*, they were not "actively traded" as of the date of distribution), the Service relied principally on the economic substance doctrine. In particular, the Service was troubled by the fact that the interest rate on the Bank loans was 230 basis points higher than the interest rate MP earned on the Notes. It argued from this fact that these transactions made no "economic sense," and analogized them to the disregarded transactions at issue in *Goldstein v. Commissioner*, in which a taxpayer's interest deductions had been disallowed when the taxpayer had borrowed at one rate and invested at a lower rate.

The Tax Court's Approach

The Tax Court, though, rejected the Service's analogy to *Goldstein*. Instead, it described the pertinent question as whether the Bank loans and the deemed purchase and distribution of the Notes by Countryside must be disregarded for lack of economic substance with the result that the liquidating distribution must be treated as equivalent to a cash distribution to Mr. Winn and Mr. Curtis. To resolve that question, the Court first cited *Gregory v. Helvering* as requiring an inquiry into whether "what was done, apart from the tax motive, was the thing that the statute intended." It further cited *Coltec Indus. Inc. v. United States* and *Boca Investerings P'ship v. United States,* both in support of the proposition that the economic substance doctrine is a tool of statutory interpretation, not a mechanical rule that permits the Service to recharacterize at will any transaction not entered into to earn a pre-tax profit.

Having thus laid out the pertinent standard, the Court was able easily to decide that "what was done" was the thing that the statute intended. Thus, "[w]hile the employed means were designed to avoid recognition of gain to Mr. Winn and Mr. Curtis, those means served a genuine, nontax business purpose; viz, to convert Mr. Winn's and Mr. Curtis's investments in Countryside into 10-year promissory notes, two economically distinct forms of investment." Under this reasoning, while Countryside may not have been entitled to deduct the interest expense on the Bank loans because of a lack of a profit potential, the fact remains that Winn and Curtis simply did not receive cash or marketable securities, but instead received the illiquid Notes. The Tax Court also rejected various other arguments put forth by the Service, concluding by stating that

> In short, respondent, in finding a lack of economic substance, has erroneously focused on the tax-motivated means instead of the business-oriented end. The transaction requiring economic substance is Countryside's redemption of Mr. Winn's and Mr. Curtis's partnership interest therein. That the redemption of a partnership interest in exchange for bona fide promissory notes issued by an independent third party can serve a legitimate business purpose is beyond cavil. The question is whether such a redemption may be respected for tax purposes if the means undertaken to accomplish it are chosen for their tax advantage. On the facts before it, we conclude that the answer is yes.

Conclusion

The Tax Court in *Countryside Partnership* was clearly motivated by the fact that Winn and Curtis actually did alter their underlying investment from residential real property to an illiquid promissory note. The decision represents a well-reasoned endorsement of the taxpayer's right to incur substantial (and arguably noneconomic) pre-tax costs in the course of achieving a tax benefit, provided that the overall purpose of the transaction is to accomplish a business objective. Still, the decision should not be over-read. The outcome of the next phases of the transaction to be litigated will turn on whether the two lower-tier partnerships should be respected or disregarded, rather than on whether the nonmarketable Notes should be treated as marketable securities or cash. In these proceedings, the Service's invocation of the economic substance doctrine will have a far greater likelihood of success.

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