

Tax Trends

TAX SHELTER TRANSACTIONS DISREGARDED • TAXPAYER NOT ALLOWED TO DEFER INCOME ON SALE OF PARTNERSHIP INTEREST



GAINS & LOSSES

Tax Shelter Transactions Disregarded

The Fifth Circuit joined the majority of circuits and held that a lack of economic substance will invalidate the results of a transaction even if a taxpayer had a genuine motive other than tax avoidance for entering into the transaction.

Background

Cary Patterson and Harold Nix represented the state of Texas in litigation against the tobacco industry, and each

man earned around \$30 million from the litigation between 1998 and 2000. Patterson and Nix invested the earnings from the case in an investment strategy known as a Bond Linked Issue Premium Structure (BLIPS) marketed by Presidio Advisory Services (Presidio) and facilitated by large loans from National Westminster Bank (NatWest). The shelter was ostensibly a three-stage series of foreign currency investment transactions, with most of the risk and the potential for gains or losses coming in the second and third stages. Patterson and Nix believed the purpose of the strategy was to profit from the devaluation of certain foreign currencies. However, as they would later learn, Presidio and NatWest instead intended the strategy solely as a vehicle to secure large tax losses for investors and never intended that the strategy be continued after the first stage.

To implement the strategy for Patterson and Nix, Presidio formed Klamath and Kinabalu as limited liability companies (LLCs) taxed as partnerships. Patterson owned 90% of Klamath through a disregarded entity; Nix owned 90% of Kinabalu, also through a disregarded entity. The other 10% partners of Klamath and Kinabalu were Presidio Resources LLC and Presidio Growth LLC. Presidio Growth was the managing partner of both LLCs.

To fund Klamath and Kinabalu, Patterson and Nix (acting through the disregarded entities) made two distinct contributions. First, they each contributed \$1.5 million to their respective LLCs. Second, they entered into loan transactions with NatWest, in which the bank loaned each man \$66.7 million (which they also contributed to the LLCs). These loans consisted of \$41.7 million denominated as the “stated principal amount” and \$25 million as a “loan premium.”

Klamath and Kinabalu deposited the funds into accounts controlled by NatWest. Presidio directed the LLCs to use these funds to purchase very low risk contracts on U.S. dollars and euros. They also made small, 60- to 90-day forward contract trades in foreign currencies. These were the only investments the partnerships ever made, and Patterson and Nix elected to withdraw from Klamath and Kinabalu (for reasons unrelated to the investment strategy) before the end of the first stage. They received cash and euros on liquidation, and they sold the euros in 2000, 2001, and 2002.

Upon liquidation of the partnerships, Patterson and Nix claimed that their basis in the partnerships (and, by extension, the property distributed to them in their liquidation) was \$26.5 million, the total amount contributed to the partnerships (the \$1.5 million of their own money plus the \$66.7 million loaned by

NatWest) less the amount of the liabilities the partnerships assumed, which they limited to the \$41.7 million stated principal amount portion of the NatWest loan. They did not reduce the basis amount by the loan premium portion of the NatWest loan because they contended it was not a liability for purposes of Sec. 752 (dealing with treatment of partners' liabilities). This meant that when Patterson and Nix sold the euros they received when the partnerships liquidated, the sales resulted in losses of over \$25 million, which they deducted from their taxable income in 2000, 2001, and 2002.

The IRS disagreed with Patterson's and Nix's calculation of their losses from the euro sales. The Service claimed that under Sec. 752, the taxpayers should have treated the full amount of the \$66.7 million loans from NatWest as liabilities in calculating the basis of Klamath and Kinabalu and that the basis in the euros should have been reduced by \$25 million, thus eliminating most of the loss Patterson and Nix claimed on their eventual sale. In the alternative, the IRS argued that the transactions should be disregarded because they were sham transactions or lacked economic substance.

The IRS issued final partnership administrative adjustments (FPAAs) disallowing the losses. The FPAAs also made adjustments to the expenses claimed by the partnerships and asserted accuracy penalties against the partnerships. Patterson and Nix paid the taxes owed based on the FPAAs and then challenged the IRS's adjustments in district court.

District Court's Decision

The district court initially granted summary judgment for the taxpayers on the basis issue, holding that under the law in effect at the time the transactions occurred, the loan premium portion of each of the NatWest loans was a contingent liability that was not treated as a liability for purposes of Sec. 752. However, in a bench trial, the court held that the transactions lacked economic substance and must be disregarded (*Klamath Strategic Investment Fund, LLC*, No. 5:04-CV-278 (E.D. Tex. 1/31/07)).

In determining whether the transactions had economic substance, the court followed the decision in *Compaq Computer Corp.*, 277 F.3d 778 (5th Cir. 2001), in which the Fifth Circuit held that there must be a reasonable possibility of profit from a transaction for it to have economic substance. The court also stated that it must judge the economic substance of the transactions based on all the evidence, as opposed to only the terms of the written agreements. Despite the literal terms of the documents, the court found that Presidio, as the agent of and on behalf of Klamath and Kinabalu, entered into additional understandings and agreements with NatWest concerning the expected duration of NatWest's lending relationship with individual investors, including Nix and Patterson. In addition, Presidio and NatWest understood that none of the \$66.7 million contributed to the partnerships would be used to provide leverage for foreign currency transactions.

Finally, the court found that Presidio's fee structure strongly suggested that Presidio's goal was not to earn a profit but rather to secure large tax losses for its investors. Therefore, although Nix and Patterson intended to make a profit through trading in foreign currencies, Presidio and NatWest did not intend that the LLCs would use the NatWest loans for foreign currency trades that had a profit objective. Consequently, the court held the loan transactions lacked economic substance.

Fifth Circuit's Decision

The Fifth Circuit affirmed the district court's holding that the transactions must be disregarded but followed a slightly different path than the district court in making its decision. According to the Fifth Circuit, "[t]he economic substance doctrine allows courts to enforce the legislative purpose of the Code by preventing taxpayers from reaping tax benefits from transactions lacking in economic reality." To determine whether a transaction lacks economic reality, the court applied the test from *Frank Lyon Co.*, 435 U.S. 561 (1978). In that case, the Supreme Court held that a transaction lacks economic

reality if it does not have three characteristics. The transaction must (1) have economic substance compelled by business or regulatory realities, (2) be imbued with tax-independent considerations, and (3) not be shaped totally by tax-avoidance features. Thus, a transaction that lacks economic substance will fail the test, even if the taxpayer had a genuine non-tax business purpose for entering into the transaction.

Analyzing the strategy that Presidio implemented through Klamath and Kinabalu, the Fifth Circuit found that it did not pass the economic reality test. It found that the Presidio and NatWest had specifically designed the loan transactions and the investment strategy not to make a profit but to generate a large tax loss for the investors with little or no risk to the investors or Presidio or NatWest. Although Patterson and Nix had a genuine profit motive for engaging in the transactions, Presidio and NatWest controlled the transactions, and they had not structured or implemented the transactions to make a profit. Therefore, the transactions lacked economic substance. Because they lacked economic substance, the court held that the transactions failed the economic reality test and must be disregarded.

Reflections

In a side issue, the Fifth Circuit reversed the district court on whether Patterson and Nix could deduct the operating expenses and fees of Klamath and Kinabalu. Under Sec. 212, a business must have a profit motive to deduct operating expenses. The district court held that Klamath and Kinabalu had a profit motive because Patterson and Nix had a profit motive with respect to the LLCs. Thus, the expenses were deductible to Patterson and Nix as members.

The Fifth Circuit disagreed, stating that while the district court had correctly held that the deductibility of the expenses of an LLC taxed as a partnership was determined at the LLC level, it had not correctly identified how to determine if the LLC had a profit motive. According to the Fifth Circuit, whether an LLC had a profit motive depended on whether the controlling members of the

LLC had a profit motive with respect to it, not the members who ultimately paid and deducted the expenses. The court found that Presidio Growth controlled both Klamath and Kinabalu under the terms of their LLC agreements and it did not have a profit motive with respect to the LLCs. Therefore, the court held that the operating expenses and fees of the LLCs were not deductible to any of their members.

Klamath Strategic Investment Fund, No. 07-40861 (5th Cir. 5/21/09)

TAX ACCOUNTING

Taxpayer Not Allowed to Defer Income on Sale of Partnership Interest

A partner in a consulting partnership who received restricted stock in the sale of her interest in the partnership to a corporation and agreed by contract to report the full value of the stock in income in the year the stock was transferred could not defer including part of the value of the stock in income until the year the restrictions on the stock were lifted.

Background

In 2000, the public accounting firm Ernst & Young sold its information-technology consulting group to a French corporation, Cap Gemini. In exchange for their partnership interests in Ernst & Young, the consulting partners in the group (the ex-partners) received shares in Cap Gemini. The ex-partners agreed to take the shares of Cap Gemini stock subject to restrictions that lasted for almost five years in order to ensure their loyalty to Cap Gemini. Under these restrictions, if an ex-partner quit, was fired for cause, or went into competition with Cap Gemini, some or all of the shares the ex-partner received could be forfeited.

Ernst & Young, Cap Gemini, and the consulting partners agreed by contract to report the transaction as a partnership-for-shares swap in 2000, fully taxable in that year. This agreement, which the IRS accepted, ensured consistent tax treatment of all the parties. Approximately 25% of the shares were sold in 2000 to generate cash that was distributed to the partners to pay their taxes on the transaction. Merrill Lynch held the remainder of

the shares in separate accounts for each ex-partner subject to instructions from Cap Gemini until the restrictions lapsed.

Cynthia Fletcher, one of the ex-partners, voted for the transaction, signed the contract, and went to work for Cap Gemini. She and her husband reported the value of all the shares she received in the transaction as income in 2000, as required by the contract. Fletcher quit cap Gemini in 2003. Although she left before the five years required by the contract to avoid forfeiture of her Cap Gemini shares, the company waived its rights and directed Merrill Lynch to lift all restrictions on the stock in her account. At this point, the price of the stock had fallen dramatically, which in hindsight made Fletcher's agreement to be subject to tax on the transfer of all the shares in 2000 a very costly decision.

To avoid the results of this decision, in 2003 Fletcher filed an amended tax return for 2000, taking the position that only the value of the shares that were sold in 2000 was includible in income in 2000. She claimed that the value of the rest of the shares that Cap Gemini deposited with Merrill Lynch should not be included in income until the restrictions on the shares were lifted in 2003. Because the value of the shares when the restrictions were lifted was much lower than in 2000, Fletcher's overall tax on the transfer of the shares would be much lower under this scenario. Without bothering to determine if Fletcher was entitled to the refund she claimed on the amended return, the IRS issued her the refund. Subsequently, the Service sued Fletcher to force her to return the refund.

The Parties' Arguments

The IRS argued (citing *Danielson*, 378 F.2d 771 (3d Cir. 1967)) that a taxpayer could not avoid the tax consequences of a contract except in cases of fraud, duress, or undue influence. According to the Service, having agreed to the form of the transaction with the goal of minimizing taxes, Fletcher and the other ex-partners must adhere to it even though market movements had later made it disadvantageous.

Fletcher argued that, as several circuit courts have held, a taxpayer is allowed to

disregard the form of a transaction where the taxpayer can show "strong proof" that the economic reality of the transaction was different than what was set out in the agreement. She also contended, in response to the IRS's assertion of the *Danielson* standard, that she did not "really" agree to the structure that Ernst & Young and Cap Gemini (and most of her partners) wanted in 2000. She stated that she signed the transaction agreement under undue influence or duress because if she had voted no and refused to sign, she would have been excluded from the economic benefits of the sale and might have been fired.

The District Court's Decision

The district court held that Fletcher should include the value of all the shares transferred in the sale of her partnership interest in income in 2000 (*Fletcher*, No. 06 C 6056 (N.D. Ill. 1/15/08)). According to the court, the intent of the contract itself was ambiguous because, while it provided for reporting the gain on the transaction in 2000, it also provided that a portion of the stock would be held in escrow until later years, indicating that the parties did not actually intend that the entire gain be taxable in 2000. However, the court found that whether it applied the *Danielson* standard or the strong proof standard, Fletcher must include the value of all the shares in income in 2000 because there was no proof in the record outside the contract that the parties to the transaction intended that the ex-partners were to treat the income as being received over time rather than in the year of the transaction.

The court also rejected Fletcher's arguments that she had been forced to sign the agreement under undue influence or duress, finding that it was unclear that the concept of undue influence even applied in a contract case and, in any event, Fletcher had failed to prove that she had signed the contract under undue influence or duress.

The Seventh Circuit's Decision

The Seventh Circuit affirmed the district court. It found that while the transaction agreement may have been extremely complex and the decision to sign it may have been difficult, Fletcher's arguments were frivolous and that the only thing that

mattered was “the tax consequences of the contracts she signed.”

The court focused on the doctrine of constructive receipt, holding that Fletcher must include the value of all the stock received in the sale in income in 2000 because she constructively received the stock in that year. The court pointed to three facts that indicated constructive receipt in 2000: (1) Fletcher, not Cap Gemini, bore all gain and loss on the shares from the moment of the transaction in 2000; (2) Fletcher had the authority to direct the disposition of the stock and did so by signing the contract that restricted her access to part of the stock; and (3) the value of the stock was discounted from fair market value in the contract to take account of the restrictions.

With respect to the forfeiture contingencies in the contract, the court held that they did not disturb its finding of constructive receipt because a forfeiture was not likely to occur. The court stated that a finding of constructive receipt was appropriate if it was highly likely that Fletcher would

meet the conditions and the chance that she would forfeit her stock was remote. Because the contingencies were in Fletcher’s control, she had agreed to only a small (5%) valuation discount on the stock, and she had acknowledged in testimony that the risk of forfeiture was small, the court found that the risk of forfeiture was small enough that the forfeiture contingencies did not prevent the conditions of constructive receipt from being satisfied in 2000.

Reflections

The Cap Gemini transaction has already generated several judicial decisions (see, e.g., *Culp*, No. 3:05-cv-0522 (M.D. Tenn. 12/29/06); *Bergbauer*, No. RDB-05-2132 (D. Md. 8/18/08); and *Berry*, No. 06-CV-211-JD (D.N.H. 10/2/08)), and reportedly “scores” of other cases have been filed but not yet decided (Willens, “Taxation Without Receipt?” *BNA Daily Tax Report* J-1 (February 12, 2008)).

This case illustrates a lesson that many taxpayers learned the hard way in the early 2000s: The IRS and the courts will gener-

ally not ignore or rewrite tax law to aid taxpayers who are the victims of their own poor financial or tax decisions. Therefore, when advising a client on any transaction that is motivated in whole or in part by tax considerations, it is critical that a practitioner clearly inform the client of any potential downsides to the transaction, whether these downsides are or should be obvious (for example, that a fall in stock prices may eliminate the tax benefits of a transaction or make it impossible for a taxpayer to raise the money needed to pay the tax caused by the transaction) and whether the chance of these downsides occurring seemed remote at the time of the transaction. Thoroughly discussing the worst-case scenario for a transaction may save a client from making a decision he or she later regrets and may also prevent the client from claiming that the practitioner gave incomplete or inadequate advice if the results of the transaction are not favorable.

Fletcher, No. 08-2173 (7th Cir. 4/10/09)