Check-the-Box Milestone

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2007 marks the 10-year anniversary of the issuance of the revolutionary check-the-box regulations. Before these regulations were issued, the taxation of LLCs (and other entities) was far from certain. Obtaining limited liability in an entity that could be assured of passthrough tax characteristics could be difficult and expensive. The check-the-box regulations changed that completely, enabling LLCs and partnerships to choose to be taxed as a corporation or a partnership. The check-the-box regulations brought tremendous flexibility to basic tax planning.

Over the past decade, much of the public commentary surrounding these historic regulations concerned solely the classification of LLCs. Yet, the reach of the check-the-box regulations is far greater. One little-discussed aspect of the check-the-box regulations is their ability to create entities out of thin air. That's right, the regulations authorize the IRS to create an entity for tax purposes, when legally, no entity exists. If you are wondering how the IRS can assert this magical power, read on.

Two years ago, the IRS issued TAM 200540010 (Feb. 25, 2005) which concerned the creation of just such an entity for tax purposes. Recently, TAM 200540010 was revoked, and the IRS issued TAM 200701032 (Sept. 20, 2006) in its place. All that occurred was that the IRS deleted a few sentences from the earlier TAM that it believed were incorrect. It did not alter the conclusions of the original TAM. This suggests the IRS considers this subject matter to be important. After all, for two years it pondered the meaning of the first TAM before issuing the corrected one.

Background

In TAM 200701032, Taxpayer was a U.S. corporation that was part of a complex corporate structure involving many U.S. and foreign companies. Taxpayer filed a consolidated U.S. income tax return with its wholly owned Sub, a foreign corporation. Apparently, Sub must have made an election to be treated as a U.S. entity for tax purposes (*e.g.*, a Code Sec. 953(d) election).

In a vastly complicated financial transaction (discussed only in a simplified form here), Sub deposited funds with a bank, which used the funds to buy mutual funds. The bank then issued A and B certificates to Sub backed by the mutual funds. Generally speaking, the B certificates represent the right to receive the dividends on the underlying shares up until date X, as well as a decreasing percentage up to date X of any unscheduled distributions representing a return of capital.

In contrast, the A certificates represent the rights to receive the dividends after date X, plus an increasing percentage up to date X of any unscheduled distributions representing a return of capital. The holder of the A certificates is also entitled to the underlying mutual fund shares after date X. Indeed, on date X, the B certificates will cease to be valid and will be cancelled, and the underlying mutual fund shares will be transferred to the holders of the A certificates. Besides these differences, the A and B certificates had various other differing rights concerning dissolution, voting, *etc.*

After receiving the certificates from the bank, Sub immediately sold the A certificates to Counterparty corporation. To execute the sale, Sub and Counterparty entered into a written agreement providing that Sub would deliver the A certificates to Counterparty, along with custody agreements for the certificates, and termination agreements.

Investment Ownership

The Taxpayer took the position that this contractual arrangement for the sale of the A

certificates resulted in the complete ownership transfer of the underlying mutual fund shares for federal tax purposes. The IRS disagreed. Taxpayer's primary argument—here's a role reversal for you—was the assignment of income doctrine. It argued that since the assignment of income doctrine required Sub to allocate its entire basis to the A certificates that were sold to Counterparty, there was a full transfer of ownership.

According to Taxpayer, no portion of the basis was allocable to the B certificates not sold, because the B certificates represented only the right to future income. Consequently, it argued that the A certificates represented the entire ownership interest in the underlying mutual fund shares. Taxpayer relied on three cases for support.

In the granddaddy of assignment of income cases, *Helvering v. Horst*, SCt, 40-2 USTC ¶9787, 311 US 112, 61 SCt 144 (1940), a father owned a bond. He attempted to transfer taxable interest income to his son by detaching a negotiable interest coupon before the bond's maturity date and giving it to his son, who ultimately collected the interest payment. The Court held that the father was the owner of the interest coupon, notwithstanding his assignment of the interest and his son's ultimate receipt of the interest payment.

In *P.G. Lake, Inc.*, SCt, 58-1 USTC ¶9428, 356 US 260 (1958), a corporate taxpayer paid off a debt owed to its corporate president through an assignment of an "oil payment right." The corporation reported the assignment as a capital gain transaction. The "oil payment right" entitled the holder to payment of $600,000 out of a portion of oil revenues due to the corporation, plus an additional three percent per year on the unpaid balance. The Supreme Court held that the corporation did not convert a capital asset. Instead, what the corporate president received was "essentially a substitute for what would otherwise be received at a future time as ordinary income."

In *F.D. Stranahan Est.*, CA-6, 73-1 USTC ¶9203, 472 F2d 867 (1973), a taxpayer sold the right to future dividend income to his son in an attempt to accelerate income to the tax year of the sale so as to utilize an unused interest deduction. The taxpayer claimed the entire amount realized as ordinary income without any basis recovery. The court upheld the taxpayer's characterization of the transaction and treated the sale of dividend rights as generating ordinary income in the year of sale.

These cases involved the assignment of future income without a transfer of any rights in the underlying asset. Here, however, both the interests retained and the interests sold by Sub included various rights in the underlying assets. Thus, the IRS found these cases to be distinguishable.

Termination Agreements

In addition to these assignment of income stalwarts, Taxpayer argued that Sub transferred all rights to the underlying assets because it believed the terms and conditions of the certificate custody agreements as well as the certificates themselves reflected a complete transfer of the underlying assets. Taxpayer also argued that the termination agreements were independent side agreements that should be ignored when evaluating the overall transaction. The IRS, however, disagreed, asserting that the termination agreements were integral parts of the overall transaction.

An analysis of whether and to what extent property has been transferred depends upon a determination of the rights and obligations of the certificates. The IRS found the termination agreements to be akin to put options. If certain triggering events occurred, Counterparty had to purchase the B certificate from Sub. The price of the put decreased over time, and by date X, no value was ascribed to the B certificates. As we'll see below, up until the day before the termination of the contractual arrangement, Sub was entitled to receive at least some small amount representing a return of principal upon the occurrence of a specified triggering event.

Taxpayer argued that the likelihood of an occurrence of a triggering event (and hence payment under the termination agreements) was remote and should be disregarded. However, the IRS found the fact that Sub and Counterparty entered into the termination agreements indicated that the likelihood of a triggering event was not considered so remote that the termination agreements were considered unnecessary. Thus, Sub's

own actions indicated that the termination agreements were necessary and integral parts of the overall transaction.

Bundle of Rights?

Quite apart from the fact that the contractual arrangement did not result in a full and complete transfer of the underlying mutual fund shares, there were serious questions whether Sub actually transferred *any* ownership interest in the underlying shares.

The key to identifying the tax owner is determining who has the substantial benefits and burdens of ownership. In making this determination, legal title or legal form is a relevant starting point, but is not determinative. [*R. Coleman*, 87 TC 178, 201, Dec. 43,193 (1986).] The benefits and burdens of ownership include the power to dispose of property and the ability to exercise rights attendant to ownership of property.

The custody agreements together with the B certificates gave Sub the power to proceed against the issuer of the underlying mutual fund shares for nonpayment. Moreover, the custody agreement together with the A certificates gave Counterparty the same power. Under the custody agreements, Sub had the power to remove the custodian of the shares and appoint a successor with the consent of a majority of the A and B certificates. Counterparty had similar power, but only with the consent of Sub. Furthermore, Sub was obligated to pay, and indeed did pay, all custodian fees. The IRS found it telling that the custodian assessed its fees solely to Sub, the entity that claimed it was not the owner of the underlying mutual funds.

Few items supported the contention that Sub effected a complete ownership transfer of the shares to Counterparty. In fact, only one document supported this assertion, *viz.*, the actual A certificates held by Counterparty, which represented ownership of the underlying shares to which the A certificates related, exclusive of the right to receive dividend distributions on those shares. Thus, the IRS concluded that the contractual arrangement did not result in a full and complete transfer of the entire ownership of the underlying mutual fund shares.

Separate Entity

Given that there was not a complete ownership transfer, what had occurred? According to the IRS, the contractual relationship between Sub and Counterparty created a separate entity. Indeed, the entity classification regulations provide that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law. Joint undertakings and other contractual arrangements can create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide its profits.

Thus, a separate entity may result from an organization, arrangement or other undertaking of investors grouped to carry out an investment program. The arrangement need not be cast in any particular form. [*See North American Bond Trust*, CA-2, 41-2 USTC ¶9644, 122 F2d 545 (1941), and *Brooklyn Trust*, CA-2, 36-1 USTC ¶9049, 80 F2d 865 (1936).] However, mere co-ownership does not necessarily create a separate federal tax entity. For example, if an individual owner or tenants in common lease farm property to a farmer for a cash rental or share of the crops, the owners do not necessarily create a separate entity for federal tax purposes. [Reg. §301.7701-1(a)(2).]

In general, the term "co-ownership" means "tenants in common" or other ownership arrangements in which each owner has a right to, and the responsibility for, an undivided fractional interest in each asset that is owned. For example, Rev. Rul. 75-374, 1975-2 CB 261, describes as co-ownership the situation where the two owners each owned an undivided one-half interest in the underlying asset. In *G.W. Bergford*, CA-9, 94-1 USTC ¶50,004, 12 F3d 166 (1993), the court describes the facts as involving "ownership interests as tenants-in-common" and refers to return positions taken by an individual investor in the transaction as stemming from the "co-ownership interest" in the underlying assets.

Rev. Rul. 99-5, 1999-1 CB 434, describes a situation where an unrelated person B purchases a 50-percent ownership interest in an LLC from A, and then A and B continue to operate the business of the LLC as co-owners. B's purchase of 50-percent of A's ownership interest in the

LLC is treated as the purchase of a 50-percent interest in each of the LLC's assets.

Here, the contractual arrangements did not result in mere co-ownership interests in the underlying mutual fund shares. The A and B certificates did not merely represent the rights to differing fractional amounts of the undivided underlying mutual fund shares. Rather, the B certificates (together with the other agreements) represented rights to all dividends on the underlying shares, and a decreasing right to any non-dividend payments received through date X.

In contrast, the A certificates (together with the other agreements) represented rights to an increasing amount of any nondividend payments made through date X, and the entirety of the underlying mutual funds after date X. Because the contractual arrangements in this case resulted in ownership interests that were *not* mere co-ownership interests, the contractual arrangements formed a separate entity. [Reg. §301.7701-1(a)(2).]

Business Entity

Since the IRS planned to treat the contractual arrangement as an entity separate from Sub, the next question was whether the A and B certificates created multiple classes of ownership in the underlying assets, so the entity would be classified as a business entity. The check-the-box regulations provide a general discussion of the term "trust." A business trust is excluded from the category of trust because joint enterprises and other arrangements for the conduct of business are treated as associations or partnerships, even if technically cast in a trust form.

An investment trust with multiple classes of ownership interests is ordinarily classified as a business entity. An investment trust with multiple classes of ownership, however, is classified as a trust for tax purposes if (1) there is no power under the trust agreement to vary the investment of the certificate holders, and (2) the trust is formed to facilitate direct investment in the trust assets and the existence of multiple classes of ownership interests is incidental to that purpose.

Here, there were two types of certificates. The B certificates entitled Sub to all dividend distributions until date X, as well as a declining percentage of any unscheduled distributions representing a return of principal. The A certificates entitled Counterparty to payments of dividends only after the B certificates had been retired, and an increasing percentage of any unscheduled distributions representing a return of principal before date X. There were no subordination rights as between the two.

The contractual arrangements created investment interests with respect to the underlying shares that differed significantly from direct investment. As a result, the IRS found the multiple classes not to be incidental to any purpose of the arrangement to facilitate direct investment in the assets. Therefore, the contractual arrangement was classified as a business entity.

Consequences

What are the consequences of treating the contractual arrangement as a business entity? Based on the default classification rules, the business entity will be disregarded for the period in which it has one owner, and will be treated as a partnership for any periods in which it has multiple owners. In addition, the IRS concluded that through the retention of income rights (coupled with the other agreements), the benefits and burdens of ownership associated with the underlying mutual fund shares continued to reside with Sub even after Sub transferred the A certificates to Counterparty.

The identity of a partner for federal tax purposes is not dependent on legal title. Rather, it is dependent on an analysis of the benefits and burdens of ownership. [*See, e.g., Red Carpet Car Wash, Inc.*, 73 TC 676, Dec. 36,717 (1980), *acq.*, 1980-2 CB 2.] Benefits associated with the principal of the underlying mutual fund shares flowed to Sub, so the IRS concluded that this right to a portion of the principal of the underlying shares actually served to define the nature of Sub's partnership interest. Because the contractual arrangement was treated as a business entity, the transfer of the interest to Counterparty should be analyzed in accordance with Situation One of Rev. Rul. 99-5.

That ruling describes the federal tax consequences when a single-member LLC that is disregarded becomes an entity with more than one owner, that is then classified as a partnership. Since the contractual arrangement was treated as a business entity, it has to be a single member business entity when it was formed by Sub. When the A certificates were transferred away by Sub, a partnership was created.

Situation One of Rev. Rul. 99-5 addresses a fact pattern where A transfers a portion of the ownership interest in the disregarded entity to B for consideration. The ruling concludes that the disregarded entity is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from A. B's purchase of 50 percent of A's ownership interests in the LLC is treated as the purchase of a 50 percent interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes.

Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership. Under Code Sec. 1001, A recognizes gain or loss from the deemed sale of the 50-percent interest in each asset of the LLC to B. Under Code Sec. 721(a), no gain or loss is recognized by A or B as a result of the contribution of their separately held assets to the partnership.

The contractual arrangement falls within Situation One of Rev. Rul. 99-5. When interests are transferred away from Sub, it is equivalent to the sale to B in the ruling. Accordingly, Sub was treated as disposing of an appropriate proportion of the underlying assets in a Code Sec. 1001 transaction. Sub was treated as if it disposed of some, but not all, of the right to principal payments on the underlying mutual fund shares, as well as the rights to later year income payments. Unfortunately, the TAM doesn't discuss the valuation ascribed to the transfer, though presumably that must have been more complicated than the entity creation analysis.

Conclusion

It is unclear if two financial companies undertaking this kind of sophisticated financial transaction—perhaps even undertaking a transaction to derive tax benefits—would give much thought to whether the transaction could create a tax partnership. Even though we typically assume that transfers of property to a partnership are tax-free, there are a host of corollary rules surrounding partnerships. For example, a partnership may be required to withhold on distributions to foreign partners. Another trap is the investment partnership rules.

Given the dearth of authority on the subject of entity creation, TAM 200701032 should be a wake-up call for practitioners. The check-the-box rules may have made many issues easier, but there are still plenty of twists and turns to keep us on our toes.

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