A PARTNERSHIP, A SHAM, OR A LOAN?

Paul J. Brennan, Minnesota State University, Mankato

CASE DESCRIPTION

This case was an adapted version of a tax case heard in U.S. Federal District Court and the US Court of Appeals. The case involved a partnership set-up by a large US corporation with its own subsidiaries as managing partners and foreign partners as outside investors. The formation of the partnership resulted from a stated objective of finding an alternative to debt financing, but provided far more significant tax savings benefits. The case was intended for use in an undergraduate taxation class focusing on business entities or an undergraduate accounting capstone or special topics course. The case and its attendant exercises were designed as applied vehicles for exploring the dimensions of the debt vs. equity classification and the nature of economic substance doctrine. The case and exercises require little knowledge of partnership taxation, but some research of the economic substance doctrine, the concept of what constitutes a partnership, and the arguments for debt vs. equity classification are required. The case may be used as a writing assignment or for class discussion. Estimated time for completion of the assignments, including research, is about four hours. Estimated time for class discussion of answers is less than one hour.

JEL: K34, H26

KEYWORDS: Tax Law, Tax Evasion

CASE INFORMATION

Janet Dolan, had just celebrated her sixth year as an attorney with the US Department of Justice Tax Division. During her time with the division she acquired substantial trial experience involving civil cases between the US government and taxpayers in the US Tax and District Courts. Her career had developed nicely and she enjoyed the progressive expertise and responsibility that came with her job, but she felt a bit apprehensive as she approached a new case assigned to her. This case involved a purported partnership tax shelter and the largest monetary stakes of her career, about 62 million dollars, were riding on the outcome.

The new case involved a partnership called Tolkin Holding set up by a large or US corporation with a couple of its subsidiaries as managing partners. The IRS disallowed the partnership arrangement as a sham transaction with no real business purpose other than tax avoidance and assessed back taxes, interest, and penalties in excess of 60 million dollars. The corporation paid the tax but sued in US District Court for a refund. Janet was anxious about handling the new case. Not only was the claim large but she had never prosecuted a tax shelter case of this size or nature before and she wasn't all that confident of her expertise in the issues involved.

The case had been assigned to her while she was on a two week vacation. She asked her assistant, Dan Fowler, to review the case and brief her on the important details when she returned from vacation. Today was her first day back and she heard a knock on her door at 10:00 AM. Dan was punctual as usual.

Janet: Hey, Dan. I enjoyed my time off, but I'm sure relieved you were here when this case arrived. Great to see you!

Dan: You, too! Hope you feel rejuvenated because we have some challenges with this one. Let me tell you a little about the new case. After reviewing this case, the words of two authors come to mind. One

described a tax shelter as an investment that is worth more after taxes than it was before taxes (Johnson, 1995). Another suggested that the partnership form of business was motivated more by tax avoidance than by business goals (Johnston, 2003). I won't go that far, but this arrangement sure seemed to be worth more to the organizers after considering the potential tax savings. This arrangement shifted many millions of dollars of taxes away from a major US corporation to foreign investors who were not subject to US tax.

Janet: Who were the partners involved in this partnership?

Dan: The majority partners were two wholly owned subsidiaries of ABL Corporation. They controlled about 82% of the beginning capital and their shares increased during the life of the partnership. The ABL partners ran the partnership operations with the assistance of other outside ABL subsidiaries that were paid for operational services on a contract basis. The minority partners were two foreign banks. They owned about 18% of the capital at formation of the partnership but those shares declined as their interest was liquidated through installment payments over six years.

Janet: So the banks were limited partners?

Dan: I guess you might call them that, but the IRS called them creditors using the criteria of IRS Notice 94-47. That's part of the reason we are here today.

Janet: What business did the partnership operate?

Dan: The Tolkin Holdings Partnership leased sixty-three older aircraft to various airlines. The primary operating activities involved collecting and monitoring lease payments, negotiating with airlines over lease issues and/or aircraft sales, locating new lessees or purchasers of aircraft after the expiration of lease terms, and maintenance and refitting of the older aircraft to bring them into compliance with noise regulations. As you may know, ABL Corporation was a very large finance company operating extensively in the airline leasing business for decades. The ABL subsidiary partners contributed sixty-three older airplanes and the attendant leases along with $240 million of cash to the partnership. These leases continued to operate throughout the six year life of the partnership. Some of the aircraft exited leases and some were sold or transferred to outside ABL entities during this time.

Janet: What did the foreign banks contribute for their partnership interest?

Dan: The foreign partners established their partnership accounts with an investment of approximately $117 million. Based on contributions to the initial capital accounts, the two ABL subsidiary partners owned slightly more than 82% of capital and the foreign banks each owned about 9%. Again, the capital ownership of the banks decreased with scheduled installment liquidations over the six year period.

Janet: How was this partnership arrangement initiated?

Dan: This partnership was a device masterminded by the investment banking firm of Lars & Mullen. Lars & Mullen was active in the airline investment and consulting industry and was identified by the IRS as the developer of a number of tax sheltering vehicles for multiple corporations. ABL Corporation retained Lars & Mullen in 1993 and this partnership arrangement was completed by the end of the year and operated for six years under its initial arrangement before winding up business and dissolving the partnership.

Janet: Yes, I remember the name Lars & Mullen. The Tax Division was acquainted with their work. You said that the partnership shifted millions of dollars of taxes away from the US corporate family and toward foreign exempt investors. How did the tax shifting arrangement operate?

Dan: Well, I had a hard time figuring it out at first but after analyzing the essential facts more completely, the arrangement was actually fairly simple. I drafted a simplified example showing how this arrangement operated (See Table 1). Essentially, what Tolkin Holdings did here wasn't much more complicated than my example. You just have to add a whole bunch of zeros to the numbers.

Table 1: Hypothetical Example of Partnership Tax Shifting

	Accounting Income	Taxable Income
Rental Revenues	$40,000	$40,000
Expenses w/o Depreciation	-$10,000	-$10,000
Depreciation	-$20,000	$0
Rental Income	$10,000	$30,000
Interest Revenue	$6,000	$6,000
Net Income	$16,000	$36,000
Allocations to Partners (50% to each)	Partner A	Partner B
Accounting Income	$8,000	$8,000
Taxable Income	$18,000	$18,000
Capital Accounts	Partner A	Partner B
Beginning Capital Accounts	$100,000	$100,000
Accounting Income Allocation	$8,000	$8,000
Ending Capital Accounts	$108,000	$108,000
Changes in Benefits from Partnership Arrangement	Partner A	Partner B
Increase (Decrease) in Accounting Return	-$2,000	$2,000
Decrease (Increase) in Tax Liability**	$3,600	-$3,600
Net Increase (Decrease) in Benefits	$1,600	-$1,600

Facts: Assume the AB Partnership forms with a building contributed by Partner A worth $100,000 and cash of $100,000 contributed by Partner B. For tax purposes, A's building is completely depreciated (and cannot be depreciated further) but the property will be depreciated at $20,000 per year for the next five years for partnership accounting purposes. A's property generates rental revenues of $40,000 per year and incurs expenses other than depreciation of $10,000. After deducting all expenses from rental revenues, A's property generates $10,000 of accounting income or a 10% return ($10,000/$100,000) on the beginning book value of the investment. B's cash generates a 6% return. Both accounting and taxable income are allocated 50% to each partner. Assume each partner has a 30% tax rate on income from the partnership. The results are summarized in the numerical example below.

*** If A did not enter into this partnership arrangement, A would be taxed on $30,000 of rental income instead of $18,000 of partnership taxable income. If B did not enter the partnership, B would be taxed on $6,000 of interest income instead of $18,000 of partnership taxable income. The changes in tax liabilities are determined from multiplying the differentials in taxable income by the assumed 30% tax rate.*

Explanation of Table 1: The numerical example provides a simplified illustration of how a partnership allowed one partner contributing heavily depreciated property to shift significant amounts of taxable income to another partner. A received a lower accounting return from this arrangement but that was more than compensated by higher tax savings due to taxable income shifting. B received a higher accounting return by this investment but the benefits were more than offset by the detriments of increased tax liability.

Janet: They managed to shift taxable income because of large differences between partnership accounting and taxable income due to fully depreciated property being contributed by one group of partners?

Dan: Yes.

Janet: I thought there were regulations requiring taxable income to be shifted back to the contributing partners under these circumstances.

Dan: Well, there are some rules requiring that now but this partnership was formed just before the effective date of those rules (*See* IRC § 1.704-3).

Janet: You don't suppose that was a coincidence, do you?

Dan: No. The large differences between accounting and taxable income were due mostly to the fact that the older aircraft contributed to the partnership by the ABL partners were fully depreciated for tax purposes using accelerated methods prior to their contribution but still had significant value and produced large depreciation deductions for partnership accounting purposes.

Janet: How big was the difference between the accounting and taxable income?

Dan: Well, look at Table 2. The banks' initial investments were increased by slightly less than 28 million of accounting income over the life of the partnership but the taxable income allocated to them was just over 310 million.

Table 2: Tolkin Holdings' Accounting and Taxable Operating Income and Respective Allocations to Foreign Bank Partners (1993-1998)

	Tolkin Holdings' Accounting Income	Allocation to Banks	Tolkin Holdings' Taxable income	Allocation to Banks
Year/Period				
10/6/1993-12/31/93	$339,000	$332,000	16,491,481	16,073,453
1994	$9,857,000	$9,660,000	76,593,747	75,061,872
1995	$6,682,000	$6,548,000	63,680,135	62,406,532
1996	$1,368,000	$1,340,000	50,892,829	49,874,972
1997	$2,304,000	$2,258,000	51,812,412	50,776,164
1998	$7,736,000	$7,560,000	57,244,395	55,945,807
Totals	$28,286,000	$27,698,000	$316,624,999	$310,138,800

Table 2 reports the accounting and taxable operating income of the Tolkin Holdings Partnership throughout its existence and the amount of that income that was allocated to the foreign partners. The reader can see that the overwhelming majority of this income was allocated to the foreign partners despite their minority capital position. The operating income does not include guaranteed payments to the controlling ABL partners for their management services.

Janet: Wow! Those differences were striking. The banks received most of the accounting income but the benefits of getting the lion's share of accounting income would have been more than offset by the additional tax burden from having such a large amount of taxable income shifted to them. Where the banks protected from the increased tax burden by tax treaty?

Dan: Correct. The treaty between the USA and their home country exempted this partnership income from US taxation under the geographical circumstances of the partnership. Had their partnership interest been classified as loans, the US government could have taxed the banks on the interest payments. More importantly, the interest payments would have provided the same deduction for both accounting and tax and the ABL partners would have been responsible for the remaining taxable income.

Janet: That treaty was convenient! The banks were truly tax indifferent. Lars & Mullen probably started with that condition as the centerpiece of their strategy.

Dan: Supposedly Lars & Mullen was paid somewhere in the neighborhood of nine million dollars for consulting and setting up this partnership.

Janet: Good help isn't cheap these days. We're in the wrong business, Dan! Tell me a little more about how income was determined and allocated under the partnership agreement.

Dan: The partnership was set up with the capital contributions I mentioned before. At any given time, the partners' investments in the partnership were calculated by the value assigned to their initial contributions, plus the accounting income allocated and added to their investments, minus any withdrawals by the partners. Because the investments of the foreign bank partners were liquidated by installment payments over six years, their shares of partnership capital declined continuously over time.

However, their shares of partnership accounting and taxable income stayed the same throughout their time in the partnership.

The partnership operating agreement did not allocate income according to ownership of capital. The agreement called for special allocations of accounting and taxable income. If positive, the operating income (both for accounting and tax purposes) was allocated 98% to the foreign banks (49% each) and 1% each to the ABL entity partners. The 98% accounting income allocation was structured, based on forecasts of income and liquidating balances of the foreign banks' investments, to allow the banks to receive a target return on their investment of approximately 9.036% during their membership in Tolkin Holdings. Under the partnership agreement, the banks were given a guaranteed minimum return of between 8% and 8.5% and a cap on any significant returns in excess of the target returns.

Janet: How did this target rate of return of somewhere around 9% for the banks' investment compare with the normal borrowing rate of ABL and subsidiaries?

Dan: According to ABL financial documents produced, the corporate family's normal borrowing rate on loans during the period ranged between 3% and 6%.

I should also mention that the partnership agreement called for different types of allocations for different types of income. The normal operating income was the type that was overwhelmingly allocated to the foreign banks. Other more volatile income was overwhelmingly allocated to the managing ABL partners.

The normal operating income from leases was simple and relatively stable. Revenues consisted of aircraft lease rental payments and interest on investments. Expenses consisted primarily of the administrative expenses (paid mostly to overseas ABL Corporation entities for technical and management services), interest expense on loans used to finance the aircraft, and deprecation on the leased aircraft. For both book and tax purposes, the ABL entity partners received guaranteed payments as managing partners and these reduced normal operating income.

The other type of income – gains and losses from disposals of leases and aircraft – was mostly allocated to the ABL partners. Some of the airplanes and leases were transferred to other ABL entities outside of the partnership. This type of income had the potential to be more volatile than the operating income and might have caused too much deviation from the target returns promised the banks if it had been allocated to them. The ABL managing partners could tweak the operating income by transferring planes and leases in and out of the partnership while also influencing operating income by controlling the amount paid to ABL entities outside the partnership for contract services.

Janet: Looks like the managing ABL partners had a great deal of control over the amount of accounting income allocated to the banks and the increases to their investment accounts. The ABL partners gave the minority bank partners a good accounting return on their investment but shifted a much larger amount of taxable income to them while being consistent with the 98% of operating income allocation.

OK, the partnership made a special allocation of partnership accounting and taxable income to the foreign partners. Although those partners never held more than 18% of the partnership capital they were allocated approximately 98% of the accounting and taxable operating income. That's usually acceptable for partnership tax purposes as long as those allocations are made for both partnership accounting and tax purposes. Technically, these income allocations to the foreign partners, although odd, didn't violate the letter of the law at the time. Challenging the income allocations may be problematic.

Dan: Yes, the other IRS claims for disallowing this arrangement: lack of economic substance apart from tax avoidance and re-characterizing the partnership as a debtor/creditor relationship may be more promising.

Janet: The economic substance doctrine was often how we attacked tax avoidance arrangements that may not have violated technical rules of the tax law but violated the spirit of the law. The doctrine required a taxpayer to demonstrate some non-tax business or investment purpose for setting up an investment arrangement. What business purpose did ABL Corporation claim motivated this transaction?

Dan: ABL claimed that this partnership was a proactive response to possible difficulties in selling or borrowing funds against its older aircraft portfolio which were the type contributed to this partnership. The company stated that this financing vehicle was just one of a number of alternatives considered for raising money from its older aircraft portfolio while keeping additional debt off its books. The company wished to raise funds for traditional cash and leverage purposes but did not wish to sell the aircraft because they were performing profitably under existing leases and their marketability was less favorable than newer aircraft that were more up-to-date in technology and compliance features.

ABL claimed that this partnership was a preferred financing vehicle over borrowing because of its existing leverage situation. The aircraft portfolio already was encumbered heavily by liabilities as many of its leases were leveraged leases where the lessor borrowed to finance the property and the loans were secured by the property. Also, much of ABL's unsecured debt contained negative pledges against incurring further secured debt on its aircraft portfolio. Finally, ABL Corporation claimed that it wished to maintain its AAA credit rating and had committed to keeping its debt to common equity ratio at or below 8 to 1. By 1993, the debt to common equity ratio stood at 7.96 to 1. Since ABL Corporation controlled the partnership, the corporation consolidated its assets and showed the interests of the foreign banks as minority interests in equity on its balance sheets.

Janet: They wanted to raise money by leveraging their older aircraft portfolio so their response was to contribute this aircraft and dump 240 million of their own money into a partnership for the purpose of obtaining 117 million from outside investors that was repaid over less than ten years with a cost of capital far exceeding their normal borrowing rate?

Dan: Apparently.

Janet: You described previously how this partnership operated existing leases contributed by the managing partners who ran the business assisted by other related corporate parties. Did this partnership have any employees of its own?

Dan: Tolkin Holdings had only one part-time employee who handled a small amount of administrative functions from an office in Bermuda. The ABL entities were the managing partners of the partnership and most other administrative functions were outsourced to outside entities controlled by ABL.

Janet: How much did the foreign banks participate in the management of Tolkin Holdings?

Dan: The banks did not participate in managing the partnership other than participating as non-voting partners in annual meetings and signing some consent documents. The ABL partners maintained that Federal Aviation Administration regulations limited the ability of foreign entities to have direct voting rights in Tolkin Holdings. For internal and government regulatory purposes of their home country, the foreign banks referred to their investments in Tolkin as loans.

Janet: The banks internal characterizations of their investments were interesting in that they indicated a preference for creditor classification. However, not participating in the management of a partnership isn't fatal to partner classification. Lack of management participation is typical of limited partners. Often a critical distinction between debt and equity concerns the possibilities of an upside return and a downside risk. What were the potentials of large gain or investment loss for the foreign banks?

Dan: The banks had negligible downside risk and the partnership arrangement contained a number of features to protect their investments. Their interests were intended to be liquidated by the end of the decade through a series of installment distributions. Other protection features were a guarantee by the partnership to hold liquid investments (which could include commercial paper of ABL) equal to 110% of the remaining value of the banks' investments, provisions enabling the banks to liquidate their investments in case of default (in which case there would be sufficient liquid assets to cover their remaining investments), and a separate guarantee of a minimum return by ABL Corporation. Finally, a tax indemnification agreement was given to the banks to compensate the banks for any U.S. tax liability in the event the IRS determined that the banks were subject to U.S. tax. As nonresident corporate partners, the banks were not subject to U.S. taxation under their tax treaty, but were subject to U.S. taxation on interest received if they were regarded as nonresident banks making commercial loans to U.S. companies (*See* IRC Sec. 881).

Janet: They were allocated 98% of the partnership operating income. What if the partnership operated at a loss? Potentially, that could have eroded part of their investment.

Dan: Under the partnership agreement, the foreign bank partners had some exposure to allocations of operating losses, but operating income was fairly predictable and operating losses never occurred. Even if losses had occurred, the agreement capped the banks' exposure to a maximum amount through the feasible range of operating results. Theoretically the bank partners could have received the benefits of higher than expected operating income, but the relatively predictable operating income could also be manipulated by guaranteed payments to the managing ABL partners and payments to related, outside entity contractors. The banks' shares of operating profit upside could be limited to a predictable stream. More unpredictable was non-operating income primarily from sales of aircraft to outsiders or transfers to outside ABL entities, but these types of gains or losses were mostly allocated to the ABL subsidiary partners.

Essentially the allocation formulas coupled with the installment distributions were designed to provide the foreign banks with a target return of approximately 9.036% on the average balance of their investments and those investors earned a return virtually identical to the target return over the period of their membership. The partnership maintained separate tracking investment accounts only for the bank investors. The overall increases to the bank investors' accounts were actually adjusted periodically in order to meet this target return.

Janet: Table 3 looks like a schedule of distributions to the banks.

Dan: Yes. The banks' minority interests were liquidated over a six year period with more than half of the value of their investment accounts returned within the first two and a half years. The agreement even provided for a premium in case of early redemption of the banks' partnership interests. Although the original agreement called for installment liquidations over eight years, the partnership was terminated effectively at the end of 1998 because of a change in the tax law for the treatment of partnerships under tax treaties that had the potential of making a material change in the taxability of the partnership arrangement.

Table 3: Investment Accounts of Foreign Bank Partners and Scheduled Distributions

	Adjustments at 9.036%	Scheduled Distributions	Account Balance
Opening Bal.			$117,286,000
1993	$3,494,000	$5,856,000	$114,924,000
1994	$10,374,000	$39,128,000	$86,170,000
1995	$7,776,000	$42,846,000	$51,100,000
1996	$4,518,000	$19,620,000	$36,098,000
1997	$3,260,000	$10,992,000	$28,366,000
1998	$2,654,000	$30,930,000	0

This table illustrates the investment accounts set up by the partnership for the foreign partners and the periodic adjustments made to them at the agreed upon target rate of return. The 1998 scheduled cash distribution represented the buyout of the banks interests. The 1998 payment was actually made in two installments during 1999 and 2000 and interest was added to those amounts. The final payments made in 1999 ($6,770,862) and 2000 ($26,032,067) brought the total of the cash payments to the banks to $151,246,151 which amounted to a return of their investment plus an effective rate of return approximating 9.036%.

Janet: Seems like the partnership was both created and dissolved for tax reasons. Well, thanks for the great overview of the case! You really did a lot of work here sorting this out.

Dan: What's your verdict so far?

Janet: Well, this arrangement contained many similarities to a limited partnerships but your description of the arrangement seems to fit the traditional debtor/creditor relationship, too. The installment payment schedule with a virtually fixed return doesn't seem substantially different from a car loan, albeit a very expensive one! If this was a debtor/creditor relationship, the foreign bank partners would have been subject to tax for the interest received on the loans and the interest deductions for the ABL partners would have been the same amount for both accounting and tax purposes. The differences in collective tax liabilities would have been huge.

Let's do a little preliminary research and application aimed at challenging this arrangement due to lack of economic substance. Let's also take a look at legal concepts of equity versus debt classification and the applied criteria of IRS Notice 94-47. Let's meet again a week from today, same time, to discuss our initial strategies after doing a little further research on these topics.

QUESTIONS

1) What is the tax doctrine of economic substance (sometimes called substantial business purpose or sham transaction doctrine) and what is its purpose? Briefly describe this doctrine and some of the normal concepts associated with it. Provide arguments that would both favor and refute the claim that this venture was formed with a business purpose other than tax avoidance.

2) After many years of discussion over codification and some failed attempts to accomplish that, a codification of the economic substance doctrine was added to the Internal Revenue Code in 2010 as part of that year's health care act. The codification was referred to as a clarification. Refer to IRC § 7701 (o) and review the language of the statute. What specific provisions of this amendment might have helped the government defeat this tax sheltering arrangement?

3) Were the foreign banks truly partners or were their interests more appropriately categorized as installment debt holders? What attributes of the arrangement made their investment seem like equity and what attributes pointed to a debt classification? In formulating your answer, apply the criteria of IRS Notice 94-47 to the facts of the case. You may also want to consult the Uniform Partnership Act.

A PARTNERSHIP, A SHAM, OR A LOAN?

TEACHING NOTES

Paul J. Brennan, Minnesota State University, Mankato

CASE DESCRIPTION

This case was an adapted version of a tax case heard in U.S. Federal District Court and the US Court of Appeals. The case involved a partnership set-up by a large US corporation with its own subsidiaries as managing partners and foreign partners as outside investors. The formation of the partnership resulted from a stated objective of finding an alternative to debt financing, but the arrangement provided far more significant tax benefits for controlling entity. The case was intended for use in an undergraduate taxation class focusing on business entities or an undergraduate accounting capstone or special topics course. The case and its attendant exercises were designed as applied vehicles for exploring the dimensions of the debt vs. equity classification and the nature of economic substance doctrine. The case and exercises require little knowledge of partnership taxation, but some research of the economic substance doctrine, the concept of what constitutes a partnership, and the arguments for debt vs. equity classification are required. The case may be used as a writing assignment or for class discussion. Estimated time for completion of the assignments, including research, is about four hours. Estimated time for class discussion of answers is less than one hour.

INSTRUCTOR'S OVERVIEW AND BACKGROUND INFORMATION

This case was an adapted version of a tax case heard in U.S. Federal District Court and the US Court of Appeals (TIFD III-E v. U.S., 2004/2006). The case was prepared from the published opinions and from trial materials submitted by counsels to the District Court. The essential facts are as represented in those documents but the names of the partnership and its partners have been disguised. The case uses a conversation between fictional attorneys representing the U.S. government as a device to transmit the facts and essential issues.

The case involved a partnership set-up by General Electric Capital Corporation (ABL Corporation of this case) with its own subsidiaries as managing partners and foreign banks as outside partner/investors. The formation of the partnership resulted from a stated objective of finding a financing vehicle to leverage a portion of the older aircraft used in its aircraft leasing operations while keeping debt off consolidated balance sheets. The resulting partnership, Castle Harbour (Tolkin Holdings of this case), accomplished the financial objective, but, more significantly, provided substantial tax shifting benefits.

A number of general partnership rules and specific financial and legal circumstances allowed this tax shelter to operate. The first was the general allowance of special allocations to partnerships. Special allocations have been defined by Congress as allocations of income, gain, loss, deduction, or credit (or items thereof) among partners in a manner that is disproportionate to the capital contributions of the partners (Staff of the Joint Committee, 1976). The foreign banks were allocated almost all of the accounting and taxable operating income despite having a decidedly minority portion of the partnership capital. Other forms of gain and loss that might have made the returns to the foreign banks deviate too much from the target returns were specially allocated to the majority controlling partners. The foreign investors were unaffected by the large allocations of taxable income to them because they were exempt from U.S. taxation by treaty provisions on income from this partnership. Had their investments been classified as loans, the interest payments would have been subject to U.S. taxation, and the tax savings to the domestic corporate partners would have been much smaller.

The tax savings to the ABL entity partners came at the expense of much smaller economic cost because the economic returns to the foreign bank partners were determined by allocations of partnership accounting income that were far smaller than the allocations of taxable income. Accounting income was much smaller than taxable income because the property contributed by the ABL partners was fully depreciated for tax purposes (and could not be depreciated further for that purpose) but still resulted in substantial depreciation deductions for partnership accounting purposes. Finally, regulations that would have required curative tax allocations (special allocations of deductions away from, or income toward, the ABL partners) to reduce or eliminate this accounting/tax discrepancy did not take effect until after the formation of this partnership.

Eventually the arrangement was challenged and disallowed by the Internal Revenue Service. The partnership paid the IRS assessment of 62 million dollars but challenged the IRS determination and sued for a refund in U.S. District Court. The U.S. attorneys advanced multiple arguments against the partnership arrangement including the claims that the arrangement lacked a bona fide business purpose other than tax avoidance and that the entity was not a true partnership in that its minority outside partners were virtually identical to debt holders. The District Court ruled for the partnership in finding a valid partnership arrangement and a sufficient business purpose other than tax avoidance. The government appealed and the District Court decision was reversed by the U.S. Court of Appeals for the Second Circuit.

The case was designed for use in an undergraduate business taxation class or an undergraduate accounting capstone or special topics course. The case does present some reasonably complex issues of partnership and international tax law but these are not emphasized here. The technical points of these issues were included in the litigation presentations of the partnership and the government but they are not particularly necessary or appropriate topics for discussion outside of an advanced (perhaps graduate level) class in taxation.

QUESTIONS

1) What is the tax doctrine of economic substance (sometimes called substantial business purpose or sham transaction doctrine) and what is its purpose? Briefly describe this doctrine and some of the normal concepts associated with it. Provide arguments that would both favor and refute the claim that this venture was formed with a business purpose other than tax avoidance.

Donald Korb (2005), Chief Counsel for the Internal Revenue Service, described the Economic Substance Doctrine as a tool for judicial interpretation of Congressional intent when transactions may not violate certain mechanics of the Code and Regulations but appear to violate the intent of the tax law. Harvard Law Professor Bernie Wolfman characterized the doctrine as a safeguard against excessively literal readings of narrow portions of the tax law that would fail to uphold the intent of the statutory scheme (Korb, 2005).

Tax sheltering devices often were designed to achieve desired tax benefits without violating the literal wording of the Internal Revenue Code and Regulations while violating the intention of the tax law. Provisions of the tax law may be employed (and often combined) for purposes not envisioned by the creators of the tax law in order to derive tax benefits. The government used to Economic Substance Doctrine to thwart these devices when it could not rely on the expressed wording of the Code or Regulations.

Economic Substance was a judicially developed doctrine that was used to set aside a transaction when it was considered to lack economic substance apart from the realization of tax benefits. If the taxpayer's treatment of a transaction was set-aside, the government could reclassify the transaction according to its

view of the transaction's substantive form. Judicial interpretations of common law doctrines usually were subject to considerable variation, and lack of uniformity was problematic in the historical application of the doctrine. Under a traditional two-factor test, a transaction had economic substance if 1) taken as a whole and viewed objectively, the transaction has economic substance and 2) the taxpayer had a subjective business purpose (other than tax avoidance) for the transaction. The degree to which courts demanded evidence to satisfy these factors was not uniform and neither was the weight given to each of these factors. Some decisions required proof of both while others required satisfaction of only one factor (Beavers, 2009).

The government argued that the Tolkin Holdings arrangement lacked economic substance because the arrangement did not make sense from a pre-tax economic perspective and was not a bona fide joint venture between partners to operate an enterprise. ABL did not need the foreign banks' funds and could have borrowed at a lower pre-tax rate than they gave the foreign partners; the liquid asset balance requirement froze funds in the partnership anyway; the banks provided nothing in term of expertise, management, or other needed services to the aircraft leasing operation; ABL essentially ran the business in the same way that it would have without the partnership; and significant transaction costs (for example, fees to the consultants designing and forming the venture) did not make sense from a non-tax economic perspective. If the partnership lacked economic purpose other than tax shifting, the partnership was a sham, should be disregarded for tax purposes, and the income allocated as if no partnership existed. Following this line of reasoning, the minority interests would have been classified as debt and ABL would have had a tax deduction only for the lower amount of actual payments (the target returns on investment distributed to the banks). The banks' interest income would have been subject to U.S. taxation.

The trial judge ruled that the partnership did have a valid business purpose and economic reality – not just in the fact that it operated a legitimate business – but also because a valid business reason existed for its formation. ABL sought financing solutions for its older leased aircraft without incurring additional debt and risking violating debt covenants. The partnership proposal met its need for off-balancing financing and this business objective probably could not have been accomplished without this type of entity. An interesting, although not particularly surprising, conclusion to be drawn from the trial judge's decision is that a form-over-substance transaction used for financial reporting purposes could provide legitimate business cover to avoid a sham characterization for tax purposes.

2) After many years of discussion over codification and some failed attempts to accomplish that, a codification of the economic substance doctrine was added to the Internal Revenue Code in 2010 as part of that year's health care act. The codification was referred to as a clarification. Refer to IRC § 7701 (o) and review the language of the statute. What specific provisions of this amendment might have helped the government defeat this tax sheltering arrangement?

The enacted provision has been included with this Teaching Note (See Appendix entitled Codification of the Economic Substance Doctrine) for the instructor's reference. An instructor assigning this question may choose to provide the appendix as a handout or to have the students look up the statute themselves.

The Codification of the Economic Substance Doctrine was one of the revenue raising provisions included in the administration's budget proposals. The provision was projected to raise approximately four and a half billion dollars but this was well below earlier estimates due to the government's success in battling tax shelters earlier in the century (Lipton, 2010). Attempts toward codification of the doctrine have come and gone over the last ten years. For example, a proposal enacted by Senator Levin of Michigan had been attached to a 2005 spending bill but pulled immediately before passage of the bill at year end. Supporters of codification argued that codification was necessary for guidance, uniform application, and enforcement. Critics of codification efforts (and they had been numerous) argued that legitimate planning

transactions may be penalized or, from a pro-government standpoint, that more specific codification of factors may hamper the flexibility of tax authorities and courts (Beaver, 2009).

The codification was called a "clarification" and primarily clarified that economic substance required satisfaction of both 1) a meaningful change in the taxpayer's economic position (apart from Federal income tax effects) and 2) substantial business purpose for the arrangement (apart from Federal income tax effects). Perhaps the most significant addition by the bill was an additional penalty for understatement of tax when a transaction was found to lack economic substance and the taxpayer failed to disclose the transaction. When this situation applied, the taxpayer could face a 40% penalty on the tax deficiency due to the tax sheltering arrangement.

The required two-pronged test provided by the codification probably wouldn't have changed the arguments made by the government in this controversy (*See* response to Question 1 above for a description of those). The inclusion of the adjectives "meaningful" and "substantial" may have enabled the government to insist that the taxpayer was required to present a stronger case to satisfy these conditions than the one accepted by the trial court judge.

§ 7701 (o)(2) required that when profit potential was considered in satisfying the two-pronged test, a taxpayer must show that any expected or potential pre-tax profit from a venture must be substantial in relation to the present value of expected net tax benefits and that transaction fees and foreign taxes must be considered to reduce any potential profits. State and local tax benefits were also to be considered as part of tax benefits. No quantitative guidance was provided for interpreting the meaning of "substantial."

The controlling corporate family of this partnership gave the foreign banks a significantly higher return on their funds than the corporation's normal borrowing rate and the pretax cash flow for the controlling corporation was smaller than it would have been if the leasing operations were not included in this partnership arrangement. In terms of partnership accounting income, the ABL partners kept little of this operating income for themselves after their guaranteed payments were subtracted. Conversely, the tax shifting benefits (See Table 2 of the case) were substantial. The economic benefits from the partnership clearly may have failed the substantiality test in comparison to the expected tax benefits. Under this language, the government could have argued that the meaningful change in ABL's economic position from this arrangement was negative without considering the tax benefits.

§ 7701 (o)(2)(B)(4) dismissed the presence of a financial accounting benefit as a substantial subjective business purpose if the origin of the benefit was a reduction of federal income tax. The shifting of income taxes to the foreign bank partners undoubtedly provided a tax savings financial accounting benefit in the form of reduced deferred tax liabilities, but Tolkin Holdings didn't tout this objective. Instead, the partnership advocated off-balance sheet financing as the primary financial accounting benefit of forming this partnership. The government may have been able to argue that both of these benefits had to be considered and the reduction of federal income taxes was the more significant financial accounting benefit. The fact that ABL deposited a considerable sum of its own money into this partnership (much larger than the amounts deposited by the outside bank investors) and the arrangement may have made very little difference in ABL's debt ratios may have refuted the argument that the off-balance sheet benefit was a substantial business purpose.

3) Were the foreign banks truly partners or were their interests more appropriately categorized as installment debt holders? What attributes of the arrangement made their investment seem like equity and what attributes pointed to a debt classification? In formulating your answer, apply the criteria of IRS Notice 94-47 to the facts of the case. You may also want to consult the Uniform Partnership Act of 1997.

Most state partnership laws have been based on the Uniform Partnership Act (current revision 1997). Section 202 (a) of the Act defines a partnership as an association of two or more persons to carry on as co-owners a business for profit. That general definition would seem broad enough for any unincorporated entity with two or more owners operating a commercial enterprise. However, Section 202(c)(3) of the Act provides that receipt of a share of partnership business profits is prima facie evidence that the person is a partner but that inference shall not be drawn if such profits were received in payment of debt in installments or otherwise or as interest on a loan though the amount of payment may vary with the profits of the business. Those provisions provided a standard to argue that the foreign banks' partnership interests should have been reclassified as debt.

Sections 7701(a)(2) of the Internal Revenue Code provides a general description of a partnership but that definition is very broad and almost any joint arrangement that isn't properly classified as another type of taxable entity (e.g., trust or estate or a corporation) would seem to qualify. Section 761(a) of the Code describes the taxability and reporting status of a partnership as being distinct from other named entities. These Code sections don't offer much guidance in making a distinction between a bona fide partner and a creditor.

A useful and simple framework for examining the debt vs. equity characteristic of the partnership arrangement is IRS Notice 94-47 (1994). The Notice provides a multi-factor test of considerations for distinguishing between debt and equity interests. The general considerations are listed in Table 4.

Table 4: Factors for Distinguishing Debt and Equity under IRS Notice 94-47

1	Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
2	whether owners of the interest have the right to enforce payment of principal and interest;
3	whether the rights of owners are subordinate to the rights of general creditors;
4	whether the owner/holders have rights to participate in management;
5	whether the issuer is thinly capitalized;
6	whether there is identity between the holders of the instrument in question and the stockholders of issue;
7	the label placed in the instruments by the parties; and
8	whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agencies, or financial accounting purposes.

The eight factors listed in Table 4 are the prescribed issues for distinguishing debt from equity interests under IRS Notice 94-47. No one factor is conclusive, there is no prescribed formula for weighting the factors, and no particular majority or supermajority of them is required for a definitive classification.

The U.S. attorneys argued strongly at trial that the minority foreign partners' interest should have been classified as debt. The trial judge's opinion discussed the factors of the Notice but dismissed the significance of the document for resolving the issue. The appellate court's reversal depended heavily on applying the factors of the document.

Factors five and six did not apply to the Tolkin Holdings situation. These factors would apply generally to a corporation where shareholders held both stock and debt of the corporation. If a corporation had mostly debt and relatively little stock in its capital structure, and most of the debt holders were also stockholders, there may be an appearance that the shareholders were attempting to avoid the double taxation of the corporate form by self-classifying much of their equity interest as debt so the corporation could deduct the interest payments to them. Tolkin Holdings was taxed under federal law as a partnership so the double taxation issue did not apply to them and none of the Tolkin partners held more than one type of interest in the partnership.

Counsels for ABL partners argued that repeated classification by ABL of Tolkin Holdings as an equity investment in its financial statements and in its filings with the FAA were clear evidence of the equity classification under Factors seven and eight. The minority partner banks were less committed to the

equity classification. Representatives from both banks testified that for internal book purposes and for home country tax purposes, the investments were treated as loans and one representative testified that his office made only loan investments. ABL's counsels argued that the banks' classifications were incomplete representations of how they viewed their interests and the trial court. The trial court judge apparently gave more weight to the ABL presentations, but the appellate judge found that the minority partner representation of the investments as debt should have been given greater weight than the self-serving representations of the ABL partners.

The government pointed to the trivial role of the banks in the management of Tolkin Holdings. They really had no role in the actual management of the enterprise. The ABL partners' counsels argued that the banks had to be kept out of management for FAA purposes and that the banks actually did participate in some annual meetings and did provide some consent forms. The trial court judge dismissed this factor as having little importance and said that many stockholders do not participate in management. The appellate judge differed by stating that the foreign banks were distinguishable from diffuse stockholders of a very large corporation, and while this factor was not conclusive in a debt or equity classification, the lack of management involvement by a significant investor weighed against viewing the investment as an equity interest.

The terms of the operating agreement carefully subordinated the rights of the foreign banks to general creditors. In addition, the banks did not have the traditional creditor rights to enforce repayment of interest and principal through judgment and collection or foreclosure proceedings. On the other hand, the banks specifically were entitled to require liquidation of Tolkin Holdings (and distribution of their capital accounts) if the scheduled payments were not made. The trial judge noted that the ability to force partnership liquidation was often given to partners and didn't infer a creditor interest. The appellate judge found that the banks' interest had even better collateral than most creditors because they could force liquidation where their investment was covered by the requirement that the partnership maintain liquid assets equal to 110% of the banks' remaining investment accounts and by ABL's separate guarantee of the payment schedule and the banks' returns.

The government argued that the minority partners' investments essentially were rights to receive a sum certain, with a relatively stable interest rate, and had a fixed maturity date indicated by the repayment schedule. The government stated that the agreement was "no more complicated than a car loan (TIFD-III, United States Trial Brief, 2004)." The last payment was scheduled for year 2000 either by a liquidating payment or the purchase of the banks' remaining interest by one of the ABL partners. The agreement also provided for a premium to be paid in case of early buyout much like a premium paid for early redemption of bonds or a penalty for prepayment provided for certain loan arrangements. The government also noted that the actual final return on investment was almost identical to the target return of the agreement and varied less than many consumer loans. The government argued that both the structure and return of the banks' investment gave them far less exposure to risk than would be experienced by a bona fide equity holder.

ABL's counsels likened the banks' investment to preferred stock with a potential upside, perhaps similar to the nature of participating preferred stock. The partnership attorneys' analogy of the foreign partners' interest to participating preferred stock contained some irony. Taking the characterization one step further, the partnership interest actually may have resembled mandatorily redeemable preferred stock which, since the enactment of Statement of Financial Accounting Standards 150 (FASB, 2003), should be treated as a liability.

The trial judge was persuaded by the upside potential and the plaintiff's characterization of the investment. The judge found that while the banks were more or less guaranteed a minimum return they were not guaranteed a maximum return so they could not have been characterized as an owner of a fixed

return. The trial judge argued that the potential upside, even if slight, makes the holder of such an interest concerned with the profitability instead of just solvency. The appellate court stated that the trial judge was too persuaded by the formalities of the partnership documents and erred by ignoring the operational realities of the venture where the managing partners could control any potential upside by tweaking the amount of partnership operating income and transferring leased assets to a controlled subsidiary of the partnership.

Although the trial court judge addressed the factors in IRS Notice 94-47, he gave them little weight in his decision. He felt that the factors were intended to reclassify purported stockholder debt as equity in cases where corporations were thinly capitalized and were not intended to reclassify the equity interest of a partner as debt. He noted that the government could not cite a single case where they were so used and apparently wasn't enthusiastic about breaking new ground. The appellate court found error in this asymmetrical interpretation and ruled that the factors were applicable across situations.

APPENDIX

Codification of Economic Substance Doctrine
§ 7701 (o) Clarification of economic substance doctrine (1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if— (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. (2) Special rule where taxpayer relies on profit potential. (A) In general. The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. (B) Treatment of fees and foreign taxes. Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. (3) State and local tax benefits. For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect. (4) Financial accounting benefits. For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax. (5) Definitions and special rules. For purposes of this subsection— (A) Economic substance doctrine. The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. (B) Exception for personal transactions of individuals. In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. (C) Determination of application of doctrine not affected. The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted. (D) Transaction. The term "transaction" includes a series of transactions.

REFERENCES

Beavers, J. (2009) "Codification of the Economic Substance Doctrine," *Tax Adviser* (March).

Financial Accounting Standards Board (FASB) (2003). *Statement of Financial Accounting Standards 150*, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" (May).

IRS Notice 94-47, 1994-1 *Cumulative Bulletin* 357

Johnson, C.H. (1995) "What's a Tax Shelter?" *68 Tax Notes 879 (1995)*.

Johnston, D.C. (2003) *Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich--And Cheat Everybody Else* (Portfolio Hardcover).

Korb, D.L. (2005) Speech delivered January 25 at the 2005 University of Southern California Tax Institute in Los Angeles, reported in Tax Analysts Electronic Citation # 2005 TNT 16-22.

Lipton, R.M. (2010) "Codification of the Economic Substance Doctrine – Much Ado About Nothing?" *Journal of Taxation* (June).

Staff of the Joint Committee on Internal Revenue Taxation, 94th Congress, 2nd Session, General Explanation of the Tax Reform Act of 1976 at 94, reprinted in 1976-3 *Cumulative Bulletin* (Vol. 2) 106.

TIFD III-E, the Tax Matters Partner of Castle Harbour-1 Limited Liability Company, v. United States of America, 342 F. Supp. 2d 94 (US Dist. Ct, CT), 2004. *Reversed* in TIFD III-E, INC. v. U.S., 459 F.3d 220 (2nd Cir), 2006.

TIFD-III. 2004. United States' Trial Brief (unpublished) at 41.

Uniform Partnership Act of 1997. Retrieved February 21, 2011 from http://www.law.upenn.edu/bll/archives/ulc/uparta/1997act_final.htm#TOC2_10

BIOGRAPHY

Paul J. Brennan is an Associate Professor of Accounting and Business Law at Minnesota State University, Mankato. He can be contacted at paul.brennan@mnsu.edu