ROBERTS & HOLLAND LLP

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Canal Corp. v. Commissioner: Tax Court Decision May Have Narrow Applicability

By:

One might expect that, when the Treasury enacts a Regulation whose explicit purpose is to provide that taxpayers do not recognize gain under specified conditions, a taxpayer that complies with the conditions would in fact not recognize gain. One might also expect that, at the very least, this taxpayer would not be subject to a penalty after receiving a tax opinion endorsing the tax-free nature of the transaction. However, the Tax Court's recent decision in *Canal Corporation v. Commissioner* seems to indicate that one might be wrong on both counts—at least on the facts in that case.

The taxpayer in *Canal Corporation* contributed property to a joint venture and received a cash distribution from the joint venture that appeared to satisfy the Regulations' criteria for a tax-free "debt-financed distribution." Yet, the Tax Court held that the taxpayer was not entitled to receive these funds tax-free and upheld the IRS's substantial understatement penalty, notwithstanding the fact that the taxpayer had relied on a tax opinion. What happened?

Background

A contribution of property to a partnership is generally tax-free, and a distribution of cash from a partnership to a partner is generally tax-free to the extent of the partner's basis in its partnership interest. However, Internal Revenue Code section 707 provides that a partner's contribution of property to a partnership and a related distribution of money or other consideration from the partnership to the partner will be treated as a sale of property by the partner to the partnership (commonly referred to as a disguised sale) under certain circumstances. Specifically, these reciprocal transfers will be treated as a sale if, when viewed together, they are "properly characterized as a sale or exchange of property." Transfers between a partner and a partnership within two years of each other are presumed to be a disguised sale.

The Treasury Regulations enumerate several circumstances in which reciprocal transfers between a partner and a partnership will not be treated as a disguised sale, including a transaction in which the partnership makes a "debt-financed distribution" to a contributing partner. Under this exception to the disguised sale rules, if (1) a partnership makes a distribution of cash to a partner that is traceable to a debt that the partnership incurred within 90 days of the distribution and (2) the debt is allocated to the distributee partner, then the distribution is not taken into account for purposes of determining whether there has been a disguised sale.

A partner's share of a recourse liability of a partnership is equal to the portion of the liability for which the partner bears the economic risk of loss. A partner is generally considered to bear the risk of loss for partnership liabilities to the extent that the partner would be obligated to repay liabilities of the partnership under a "constructive liquidation" scenario in which the partnership is considered to have disposed of all of its property in a taxable transaction for no consideration and then liquidated.

***Canal Corporation v. Commissioner*[1]**

Facts

Chesapeake Corporation (which later changed its name to Canal Corporation) was the common parent of an affiliated group that included Wisconsin Tissue Mills, Inc. (WISCO), a manufacturer of commercial tissue paper products. Chesapeake was interested in selling WISCO and found a willing buyer in Georgia Pacific (GP), but had a low basis and was unwilling to sell its WISCO stock in a taxable sale. Therefore, Chesapeake and GP (which also had a tissue paper business) entered into a transaction in which both WISCO and GP transferred their tissue paper businesses to a joint venture (the LLC). Then, the LLC borrowed $755 million and distributed all $755 million to WISCO in redemption of approximately 97% of WISCO's interests in the LLC in what was designed to qualify as

***Ezra Dyckman** is a partner in, and **Daniel W. Stahl** an associate of, the law firm of Roberts & Holland LLP.*

a tax-free debt-financed distribution. GP guaranteed the debt, but WISCO provided GP with an indemnity so that WISCO would be considered to bear the risk of loss for the debt and the debt would be allocated in its entirety to WISCO. (After the transaction, the assets retained by WISCO, which included only a $151 million intercompany note and a $6 million corporate jet, were worth 21% of the value of its $755 million exposure on the indemnity.) In addition, WISCO's potential indemnity obligation was limited in that (1) WISCO indemnified only GP's guarantee to pay the principal (but not the interest) and (2) GP would be required to proceed against the LLC's assets prior to demanding indemnification from WISCO.

Chesapeake received a tax opinion from PricewaterhouseCoopers (PwC) which concluded that its receipt of the $755 million distribution "should" be tax-free as a debt-financed distribution and not be treated as part of a sale. However, on audit, the IRS determined that the transaction constituted a sale and assessed a substantial understatement penalty.

Disguised Sale

Since Chesapeake and WISCO could cancel the intercompany note at any time, at which point WISCO would have virtually no assets, the Tax Court concluded that the note "served to create merely the appearance, rather than the reality" of WISCO having economic risk for a portion of the LLC's debt. The Tax Court then disregarded the indemnity agreement "because it created no more than a remote possibility that WISCO would actually be liable for payment." Absent the indemnity agreement, WISCO did not bear the risk of loss for any of the LLC's debt and, since GP had guaranteed the debt, all of the debt was allocated to GP and none of it was allocated to WISCO. Therefore, no portion of the $755 million distributed to WISCO qualified as a tax-free debt-financed distribution. Accordingly, the Tax Court held that WISCO had failed to rebut the presumption that its contribution of property to the LLC and its receipt of money from the LLC constituted a disguised sale.

IRS Penalty Assessment

The Tax Court next considered the IRS's assessment of a substantial understatement penalty. This accuracy-related penalty is not applicable if either (1) the taxpayer had "substantial authority" for its position or (2) the taxpayer shows that there was reasonable cause for, and that it acted in good faith with respect to, the understatement. Chesapeake had submitted its tax opinion from PwC as evidence of its reasonable cause and good faith. The Tax Court acknowledged that reasonable cause "has been found when a taxpayer selects a competent tax adviser, supplies the adviser with all relevant information and, in a manner consistent with ordinary business care and prudence, relies on the adviser's professional judgment as to the taxpayer's tax obligations."

However, the Tax Court held that Chesapeake acted neither with reasonable cause nor in good faith in its reliance upon PwC's opinion. First, the Tax Court faulted the opinion for various assumptions on which it relied, including (1) that the indemnity would result in the debt being allocated to WISCO and (2) that WISCO would hold assets sufficient to avoid an anti-abuse rule. The Tax Court considered PwC to have assumed away the very "crux" of the matter by virtue of these assumptions and found it "inherently unreasonable" to rely on the opinion as a result. The Tax Court also concluded that the opinion was "tainted by an inherent conflict of interest" and "looked more like a quid pro quo arrangement than a true tax advisory opinion" in that (1) Chesapeake paid an "exorbitant" $800,000 fixed fee for the opinion, (2) the fee was contingent upon closing and Chesapeake had informed PwC that it would not close without the opinion, and (3) the same tax lawyer both structured the transaction, with little input from PwC, and issued the opinion. Accordingly, the Tax Court held that Chesapeake did not act with reasonable cause or in good faith in relying on PwC's opinion and upheld the IRS's assessment of the penalty on Chesapeake.

Analysis

Canal Corporation poses some troubling questions. If it was insufficient for WISCO to retain property valued at 21% the amount of the LLC's debt, what percentage would be enough so that the debt would be allocated to WISCO? Would the result have been different if WISCO's retained assets consisted of T-bills instead of the intercompany note? Does the Tax Court really mean that the extent to which a partner is considered to be at risk for a partnership's debt depends upon the likelihood that, as a practical matter, the partner would be required to or would be able to repay the debt? The Regulations generally provide that the extent to which a partner is considered to bear the risk of loss with respect to partnership liabilities is determined based on a mechanical test that is unaffected by the likelihood of the partner repaying the debt.

However, *Canal Corporation*, at its core, may really be about the application of an anti-abuse rule and not about liability allocation rules. As the Tax Court notes, an anti-abuse rule provides that a partner's obligation to make a payment may be disregarded if (1) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to the obligation or (2) the facts and circumstances evidence a plan to circumvent or avoid the obligation. It is clear that the Tax Court was troubled by the fact that Chesapeake "crafted the indemnity agreement to limit any potential liability to WISCO's assets." On top of that, the Tax Court was *very* troubled by the fact that Chesapeake stripped out all of WISCO's assets other than its small interest in the LLC, an intercompany note that could be canceled at any time, and a corporate jet. Thus, it appears that the real underpinning behind the decision is the Tax Court's application of the anti-abuse rule as a result of its determination that Chesapeake had intentionally structured the transaction

so as to create a mere facade of WISCO bearing the economic risk of loss. A similar transaction without the suspect intentions very well might have led the Tax Court to come to an entirely different result.[2]

Conclusion

The IRS's litigation position in *Canal Corporation v. Commissioner* no doubt is disconcerting for tax attorneys and real estate professionals alike. In addition, some of the Tax Court's statements, if taken out of context, could be understood to have drastic consequences. However, it appears that the Tax Court concluded that the transaction was a taxable sale based on the application of a specific anti-abuse rule. Many commentators have taken the position that the Tax Court nonetheless was incorrect. Indeed, it may be poetic justice that Canal Corporation, after filing for bankruptcy, reached a preliminary settlement agreement with the IRS under which it would settle its $106.7 million obligation to the IRS for a paltry $2 million.

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[1] 135 T.C. No. 9 (2010).

[2] For an analysis of the Tax Court's upholding of the penalty, see David E. Kahen and Elliot Pisem, *Reliance on Tax Opinion May Not Prevent Penalties*, New York Law Journal, Dec. 16, 2010.

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