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Transaction "Integration": GSS Holdings (Liberty) Inc. v. United States

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Integration of multiple payments or events into a single transaction can favor a taxpayer or the fisc, depending on the circumstances. In *GSS Holdings (Liberty) Inc. v. United States*, 128 AFTR 2d 2021-5333, the Court of Federal Claims recently integrated multiple events into a single transaction and then disallowed the resulting loss, because it viewed the integrated transaction as a sale by a partnership to a related party. A corporate partner in that partnership that sought a better tax result through reporting the events in a different manner on an amended tax return of its own failed to persuade the court that a loss should be allowed. More helpfully, however, at least as precedent for other taxpayers, the court rejected the argument of the government that the doctrine of *Commissioner v. Danielson* (378 F.2d 771 (3rd Cir. 1967)) bound each partner to follow the characterization of the events reflected by the partnership on its original tax return.

Facts in *GSS Holdings*

The description in the opinion of the underlying facts is less than entirely clear, but it appears that Liberty Street Funding LLC (Liberty), an entity classified as a partnership for tax purposes, had been established as a "commercial paper conduit" that would borrow through the issuance of short-term notes and use the proceeds to acquire longer-term investments. The partners in Liberty included, at various times: the corporation which was the plaintiff before the Court of Federal Claims (GSS); a subsidiary of the Bank of Nova Scotia (BNS); and an otherwise unrelated third party, Reconnaissance Investors, LLC (Reconnaissance), which ultimately sold its positions relating to Liberty to the BNS subsidiary. BNS was the administrator of Liberty and the entity with the bulk of the potential benefits and risks with respect to Liberty.

To ensure liquidity with respect to an investment of Liberty in mortgage-backed securities known as "Aaardvark IV," Liberty entered into a Liquidity Asset Purchase Agreement (LAPA) in 2006 that provided Liberty with the right to sell its Aaardvark investment to BNS at a price equal to Liberty's basis. Subsequently, Reconnaissance funded a "First Loss Note" account in 2007; the funds in the account were lent to Liberty, but the funds were ultimately to be paid to BNS, as the party that would actually suffer a loss upon the exercise of the LAPA.

At least one of the objectives of the First Loan Note, which shifted at least some credit risk from BNS to Reconnaissance, was to permit BNS to deconsolidate Liberty from BNS for financial reporting purposes. Because of a subsequent change in applicable financial reporting standards in 2011, however, BNS again became required to consolidate Liberty onto its balance sheet, notwithstanding the First Loss Note. In light of this change, a subsidiary of BNS (Scotiabank) exercised a contractual right to purchase the First Loan Note from Reconnaissance.

The First Loan Note was acquired by Scotiabank on December 29, 2011. This acquisition also caused Scotiabank to become Reconnaissance's successor as a partner for tax purposes in Liberty. One day later, Liberty exercised its right to sell the Aaardvark investment to BNS for an amount equal to Liberty's basis. Because the Aardvark investment was then worth substantially less than basis, the remaining balance of the First Loan Note account of $24 million was paid simultaneously to BNS.

Liberty reflected the $24 million payment to BNS of the First Loan Note account on the Liberty partnership return by including that payment in its basis in the Aaardvark investment. It reported the sum of (i) the amount received from BNS under the LAPA (equal to basis) and (ii) $1.45 million of insurance proceeds paid to Liberty by reason of the payment in respect of the First Loan Note, as proceeds from the sale of the investment. This resulted in a net loss of approximately $22.55 million, which net loss was claimed on the Liberty partnership return and allocated thereon primarily to GSS.

Internal Revenue Code section 707(b)(1) precludes the deduction of a loss from the sale of property by a partnership to a person that owns directly or indirectly more than 50% of the capital interest or profits interests of the partnership. It was undisputed that BNS and Liberty were related parties within the scope of that provision, and Liberty's claiming of the loss in the manner described above seemed clearly to violate section 707(b)(1)'s prohibition. Through an amended corporate tax return, however, GSS characterized the loss realized by Liberty by reason of payment in respect of the First Loan Note as a transaction separate from the sale of Aaardvark and reported that payment (reduced by the receipt of $1.45 million from insurance) as an ordinary loss.

The IRS disallowed the claimed loss of $22.55 million and GSS proceeded to file a complaint in the Court of Federal Claims. The parties made cross-motions for summary judgement, with GSS claiming that the government was attempting to apply the step transaction doctrine improperly to collapse separate events into a single sale transaction. The government's position was that the sale and the payment had been correctly reported by Liberty in the first instance as part of a single transaction resulting in a loss not deductible under section 707(b)(1), and, further, that (apparently without regard to whether the partnership's reporting was correct) that the reporting of the events as a single transaction on the partnership return precluded its partners, under the *Danielson* rule, from disaggregating the payment from the sale transaction.

Discussion

The court addressed first the government argument that GSS was bound to the tax characterization of the sale and First Loan Payment in the Liberty partnership return. The opinion noted that the taxpayers in *Danielson* had attempted to allocate consideration for a transaction in a manner that was inconsistent with a contractual allocation previously agreed to by the parties, in a manner that would have reduced the taxpayers' ordinary income and increased capital gain. The Court of Appeals for the Third Circuit concluded in *Danielson* that, absent strong proof in the nature of undue influence or fraud that would cause the contract to be unenforceable, the government could hold the parties to the terms of their contract as to the proper allocation of purchase price for tax purposes, even if circumstances suggested that the allocation was incorrect.

In *GSS Holdings*, however, there was no contractual agreement to consolidate or to integrate the payment on the First Loan Note with the sale of the Aaardvark investment. That integration occurred only as a matter of tax reporting treatment on the partnership return of Liberty. The Court of Federal Claims declined to expand the *Danielson* rule so as to find that reporting treatment binding on the partners of Liberty, and rejected the government's argument on this point.

The Courts of Appeals have not always been in accord as to the scope of the *Danielson* rule. In any event, applying that rule, as the government sought, to require a taxpayer to report consistently on an amended return with a prior original tax return for the same tax period, whether its return or that of another taxpayer, would have been a clear, onerous, and novel expansion of a doctrine that has heretofore been applied, when applied at all, only to require consistency with contractual arrangements, and the decision of the Court of Federal Claims on this point is very welcome.

The court ultimately agreed with the government, however, that the sale of the investment and the First Loan Note payment "were, in substance, a single transaction," such that, under the tax concept of "substance over form," both events must be considered as a whole in determining whether the loss was allowable. The court noted that the application of this concept was not limited to situations involving transactions that were unnecessary or fictitious or that otherwise lacked any substance (none of which was being asserted by the government in *GSS Holdings*), and applied to the characterization of bona fide transactions that were linked and interdependent.

More specifically, the court found that the purpose of the First Loan Note was to compensate BNS for losses it might otherwise experience by reason of the exercise by Liberty of the LAPA at a time when the Aaardvark investment had declined in value; and that the payment on the First Loan Note was intended to be made in conjunction with the sale of the underlying investment. There was no dispute that the parties -- Liberty, and BNS through its subsidiary Scotiabank -- were related at the time of the sale and payment on the First Loan Note.

The court did not find the plaintiff's argument to the effect that the payment on the First Loan Note could not be consolidated with the sale because the First Loan Note agreement was not in place at the time of creation of the LAPA to be convincing, noting that the First Loan Note agreement was clearly entered into in contemplation of the eventual sale of the investment under the LAPA.

The court therefore concluded that the loss with respect to the First Loan Note was part of the sale of the Aaardvark investment, causing that loss to be a loss from the sale of the investment and therefore subject to disallowance under IRC section 707(b)(1). This was so, even though the loss with respect to the First Loan Note would apparently have been allowable if, at the time of payment, the First Loan Note had been held by an unrelated party (and Scotiabank was not a partner). The opinion observed: "It is plaintiff's misfortune that, at the time the particular sale was initiated, Scotiabank [which initiated the acquisition of the First Loan Note shortly before it was paid] had become a partner in Liberty."

Observations

The position of GSS in this litigation, to the effect that its loss on the payment of the First Loan Note was deductible as a separate, ordinary loss, was consistent with the tax treatment of similar payments made by

Liberty before Scotiabank became a partner, a treatment that had not been challenged by the IRS. One can only speculate as to whether, if the payment by Liberty at issue in this case had similarly been reported as a separate loss on Liberty's original partnership return, rather than as a part of the sale of the Aaardvark investment, the IRS would have taken issue with that treatment upon audit (setting aside the question of whether such reporting, without specific disclosure, would have been appropriate).

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