RUSSIAN RECOVERY FUND V. U.S.

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For many tax advisers, it is fashionable to complain about the O.E.C.D.'s B.E.P.S. project because it imposes an unrealistic standard of behavior on multinational groups. Then, along comes a case such as *Russian Recovery Fund, Ltd. v. U.S.*,[1] and one understands the problem of real base erosion. Here, hubris and greed in the financial services sector team up to make the O.E.C.D. look good.

BACKGROUND

The case involved a distressed asset/debt ("D.A.D.") transaction. This is a loss importation arrangement in which high basis, low value assets owned by a tax indifferent entity with regard to the U.S. – think of Cayman Islands funds with non-U.S. investors – are transferred to a foreign entity that is structured as a partnership for U.S. tax purposes. The goal is to allow U.S. investors the opportunity to harvest built-in losses while deriving cash-on-cash gains.

Russian Recovery Fund, Ltd. ("R.R.F.") was formed to capitalize on opportunities created by Russia's 1998 default on its sovereign debt. R.R.F. was a Cayman Islands L.L.C. created to invest in distressed Russian assets. When the government of the Russian Federation defaulted on all of its sovereign debt obligations in 1998, instruments issued by Russia and derivatives of such instruments lost virtually all of their value. The ruble also collapsed and was no longer freely traded due to currency exchange limitations imposed by the Russian Central Bank. Further complicating matters was the policy of the Russian government under which only a limited number of large international banks were recognized as intermediaries that could access the debt or trade in rubles. In the wreckage, R.R.F. saw an opportunity.

R.R.F.'s financial model involved the acquisition of devalued Russian debt at pennies on the dollar in anticipation of a recovery of the ruble and something approaching face value of debt instruments. Given the depressed nature of the debt – most were worth less than 10% of face value – even small increases would produce substantial gains because of high leverage. Because non-Russian hedge funds such as R.R.F. were not eligible to own ruble-denominated Russian Federation obligations directly, the investment was structured as a credit derivative swap transaction memorialized in credit-linked notes. The authorized bank retained legal title to the bonds but swapped all of the economic risk and benefit to a third party, such as a hedge fund, for cash or some other form of consideration.

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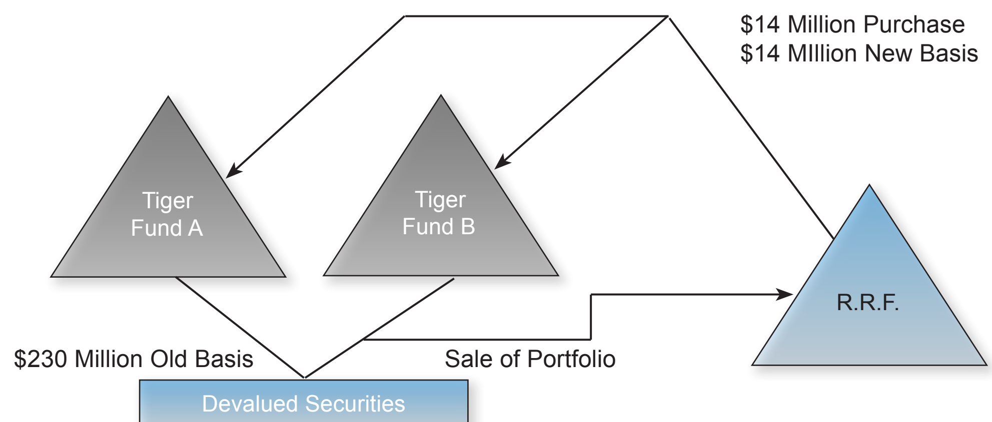
[1] 122 Fed. Cl. 600 (2015).

The offering memorandum R.R.F. used to solicit potential investors required participants to agree to stay in the fund for at least three years unless the fund appreciated by 100%, in which case a partial redemption was possible. Investors were warned that the fund was only suitable for those having no need for liquidity with respect to their investment. Investors were also warned that shares could not be transferred without approval by the Board of Directors, which could be withheld for any reason.

The serious marketing efforts lasted about six months, from the end of 1998 until June 1999. At that point, active marketing came to an end. If the scope of the investment story ended at this point, there would have been no tax controversy. Gains would have been computed based on the purchase price of the derivative instruments and all gains recognized at the level of R.R.F. would have been passed through to R.R.F.'s U.S. investor group as illustrated below:



However, the year was 1999, and Gordon Gekko of movie (*Wall Street*) fame remained an icon. This investment strategy was dismissed as simplistic.

At about this point in time, R.R.F. held discussions with two offshore funds (the "Tiger Funds") managed by Tiger Management, L.L.C. At the time, Tiger Management was one of the world's largest managers of hedge funds, with assets over $20 billion under management. The Tiger Funds held significant positions in derivative instruments that reflected floating rate, coupon-bearing bonds issued by the Russian government. These securities were acquired in transactions brokered by Deutsche Bank. The plan was relatively simple in its premise. A sale of the devalued derivative instruments would have triggered a loss to the Tiger Funds that might or might not generate a tax benefit, depending on the make-up of the investor group in the Tiger Funds. If the investors were non-U.S. persons or tax exempt U.S. entities, U.S. tax benefits would be frittered away. However, if the Tiger Funds contributed the same assets to a partnership having U.S. investors, the high basis in the low-value assets would be preserved, and at the time of sale of those assets by the partnership, the U.S. members of the investor group would be entitled to claim the losses realized by the partnership. (In a sense, the losses would have been "imported" to the partnership and realized by the partner group at the time.)

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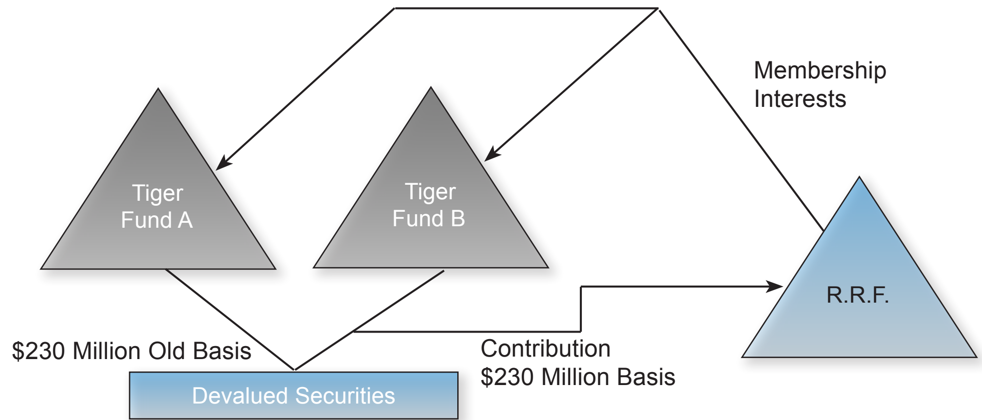
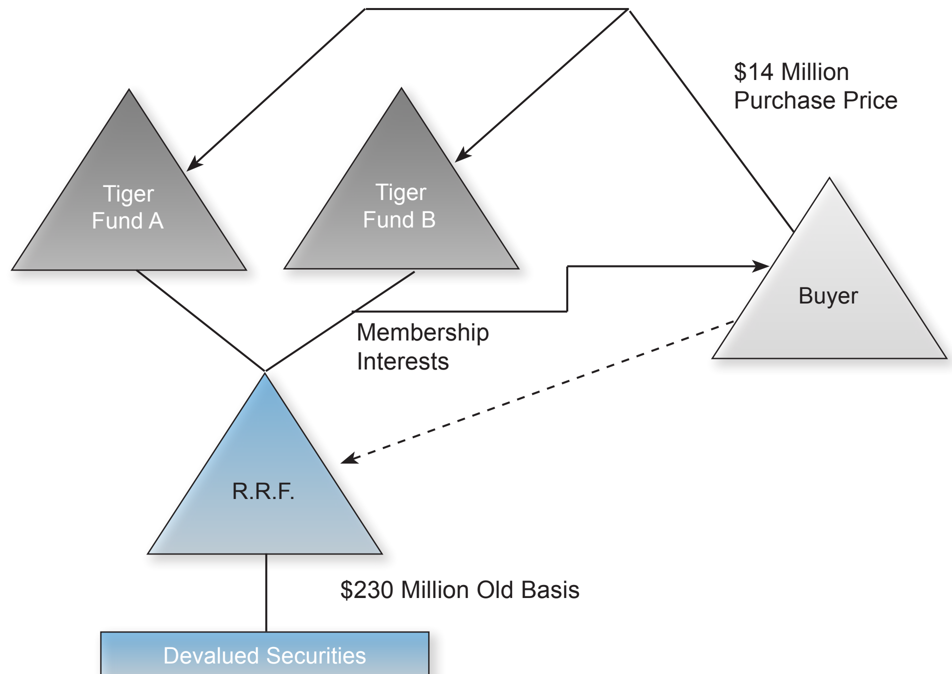
STEP 1



As the Tiger Funds were not interested in remaining partners, they could sell their interests in R.R.F. as soon as possible, thereby cashing out of a devalued investment.

STEP 2



In March 1999, Deutsche Bank prepared a tax shelter registration under its own name for an entity to be called “Preferred Stock Financing Transaction” (a generic placeholder name).

In 1999, General Cigar Corporation, a U.S. publicly-traded corporation, was interested in acquiring investments in depreciated Russian assets. Its board of directors made a decision to invest up to $25 million in deeply discounted, high-yield instruments and to advise the financial industry that the company was looking at strategies to generate tax benefits through these investments.

Meetings were held between Deutsche Bank and R.R.F. regarding the composition of R.R.F. investors. These meetings were intended to assure Deutsche Bank that individual investors held significant interests in the entity, which would protect the benefit of the built-in losses in the derivative instruments. The fear was that significant corporate investors in R.R.F. could preclude later resale of depreciated assets to tax-interested buyers.

Ultimately, the following three transactions occurred in 1999 in relatively close proximity to each other, approximating the facts in the second diagram above, labeled "Step 1."

- The Tiger Funds contributed a derivative instrument based on credit-linked notes to R.R.F. in return for shares of R.R.F. having a value of almost $15 million.
  - The basis in the derivative instrument contributed to R.R.F. was $230 million, which was intended to be carried over to R.R.F. under ordinary U.S. partnership tax rules.
  - The hedge funds negotiated a waiver of the three-year hold in the fund in the form of a right of redemption. The funds also negotiated a waiver of the mandatory representation that the transaction was being made for the purpose of investment.
- Within a period of weeks, the funds sold the shares of R.R.F. to a party related to R.R.F. for approximately $14 million.
  - During the period in which the transaction was negotiated, the value of Russian securities may have increased. However, the price at which the transaction closed was less than the value initially sought by the funds.
  - R.R.F. negotiated a provision with Deutsche Bank under which this transaction would not be registered with the I.R.S. as a tax shelter.
- General Cigar Corporation acquired approximately 77% of the derivative instruments held by R.R.F. for approximately $21 million, consisting of cash in the amount of approximately $17.95 million and preferred stock in General Cigar Corporation valued at approximately $3.23 million.
  - As a result of the acquisition, R.R.F. claimed a loss in the amount of $178 million that flowed through to its partners, principally consisting of the related party that acquired the partnership interest from the Tiger Funds.
  - The key to the loss generated at the level of R.R.F. was the status of the first transaction as a contribution of assets to a partnership in return for the issuance of a partnership interest by R.R.F.

- On a cash-on-cash basis, R.R.F. and its related parties generated a profit in excess of almost $7.2 million from the point in time when the Tiger Funds were bought out and a significant portion of the derivative instruments were sold to General Cigar Corporation.

In the year 2000, R.R.F. sold the balance of the derivative instruments for a cash profit of approximately $7.5 million but at a tax loss of approximately $49.8 million. The balance of the tax loss was realized in 2004.

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ISSUE PRESENTED

On examination, the I.R.S. disallowed both losses. The I.R.S. asserted that the Tiger Funds never became true partners in R.R.F. and always intended to flip the partnership interest in R.R.F. to the purchaser that was related to R.R.F. In other words, the contribution of high basis, low value shares to R.R.F. was a sham transaction. The true transaction was a purchase of the derivative instruments for approximately $14 million, which would cap the loss at that amount. The Court of Federal Claims affirmed the I.R.S.'s position.

RATIONALE

The thrust of the court's decision was that the set of structured transactions engineered for R.R.F. and the Tiger Funds never created a partnership and therefore basic partnership concepts – such as carryover basis from a partner to a partnership when an asset other than cash is contributed to the partnership in return for the issuance of a partnership interest – never came into play.

U.S. courts have developed analytical filters to test whether a taxpayer should really benefit from certain statutory provisions. Because these inquiries are judicially-created overlays to the Code, they are somewhat amorphous and in some respects overlap. One such provision is whether the parties intended to form a partnership within the meaning of U.S. tax jurisprudence. According to one court:

> A genuine partnership is a business jointly owned by two or more persons (or firms) and created for the purpose of earning money through business activities. If the only aim and effect are to beat taxes, the partnership is disregarded for tax purposes...'[T]he absence of a nontax business purpose is fatal.'[2]

This parallels a decision of the U.S. Supreme Court, holding:

> A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is a question of

[2] *ASA Investerings Partnership v. Commr.*, 201 F.3d 505, 512 (D.C. Cir. 2000).

> fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.' [*Citations omitted*.][3]

A transaction must also have economic substance in order to be recognized for income tax purposes. One court described the rationale behind the economic substance test as follows:

> The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute. * * * [A]lthough the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality.[4]

Transactions that are mere parts of an overall integrated transaction must be judged by the substance of the overall transaction. While the step transaction doctrine has been looked to in many decisions, the Supreme Court used the following language in one case:

> Under this doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus 'linking together all interdependent steps with legal or business significance, rather than taking them in isolation,' federal tax liability may be based 'on a realistic view of the entire transaction.' [Citations omitted.][5]

Applying these tests, the court concluded that the Tiger Funds wanted to sell the derivative instruments that had lost most of their value and were not interested in partnering with R.R.F. for a mid-term or long-term hold. They negotiated the right to sell or to have their interests completely redeemed and refused to certify that an investment intent existed for the contribution. These actions did not create a partnership in the circumstances presented. The conclusion that no partnership existed is consistent with a provision of the Income Tax Regulations addressing sham partnerships:

> The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K * * *. Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter

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3 *Commr. v. Tower*, 327 U.S. 280, 287 (1946).

4 *Coltec Industries, Inc. v. U.S.*, 454 F.3d 1340, 1353–57 (D.C. Cir. 2006).

5 *Commr. v. Clark*, 489 U.S. 726 (1989).

> K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—
>
> (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
>
> (2) One or more of the purported partners of the partnership should not be treated as a partner; * * *
>
> (5) The claimed tax treatment should otherwise be adjusted or modified.[6]

Finally, R.R.F. was liable for a 40% accuracy-related penalty due to misstating its income. R.R.F. attempted to argue that it relied on the advice of its tax preparer, EY, and therefore, it had reasonable cause to believe the transaction was tax compliant. EY did not provide tax advice to R.R.F. because it did not independently investigate the transaction. Rather, it merely followed R.R.F.'s instructions.

CONCLUSION

In a bygone era of financial products and big law opinions in support of anticipated outcomes, one U.S. tax adviser was quoted as saying that capital gains tax for corporations was optional, not mandatory. Recognized gains could be offset by engineered losses such as those claimed by R.R.F. Now, we are in the global era of B.E.P.S., and in light of holdings such as the one in Russian Recovery Fund, it appears that the hubris expressed in the earlier statement may have given rise to the strict tax regime of the latter.

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[6] Treas. Regs. §1.704(b).