A COMPARATIVE VIEW OF THE PRINCIPAL PURPOSE TEST – U.S. TAX COURT V. B.E.P.S.

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INTRODUCTION

In the procedural maze that leads to a trial in the U.S. Tax Court, motion practice is an important part of tailoring issues presented to the court. In particular, motions to grant summary judgment are often filed by the I.R.S. to preclude a full trial. According to Rule 121(a) of the U.S. Tax Court Rules of Practice and Procedure, either the taxpayer or the I.R.S. may submit a motion for summary judgment in its favor regarding all or any part of the legal issues in controversy. The motion is granted and an order is issued if the party requesting summary judgment shows that no genuine dispute exists as to any material fact and the moving party is entitled to a favorable decision based solely on the law and the undisputed facts. While the reasoning of the court in granting the motion is not binding, it is informative of the state of the law.

In *Peking Investment Fund et al v. Commr.*, the I.R.S. submitted a motion for summary judgment in a case involving losses claimed in a distressed asset fund. The court denied the motion in an order dated February 12, 2018.[1] The court determined that material facts were in dispute – the I.R.S. failed to demonstrate that the partnership was a sham or that the principal purpose was to generate a loss. The taxpayer was entitled to its day in court.

The I.R.S. argument in support of its motion was similar to the principal purpose test ("P.P.T.") under the B.E.P.S. initiative and the P.P.T. described in the Anti-Tax Avoidance Directive ("A.T.A.D.").[2] To that extent, the court's ruling may be of interest to European and Canadian tax advisers who face application of a P.P.T. standard under domestic law or a tax treaty.

P.P.T. IN PRACTICE IN THE U.S. TAX COURT

Facts

China Cinda Asset Management Corporation ("Cinda") held a portfolio of nonperforming loans originated by China Construction Bank (the "C.C.B. N.P.L. Portfolio"). From the development of the case and the deduction ultimately claimed by the taxpayer, the aggregated face amount of the loans in the portfolio appears to have been $245.45 million.

During late 2001, Chenery Associates Incorporated ("Chenery") promoted an investment program to invest in the Asian distressed security market, which is similar

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[1] Peking Investment Fund L.L.C., Peking Investment Holdings L.L.C., Tax Matters Partner v. Commr., (Docket No. 12772-09).

[2] Council Directive (EU) 2016/1164 of 12 July 2016.

to "Distressed Asset/Debt" or "D.A.D." transactions. These were transactions in assets with low value and high basis that were transferred to a U.S. partnership by a tax-indifferent party, typically an entity formed outside the U.S. Other partners were U.S. taxpayers. Ultimately, the partnership recognized huge losses when the high basis assets were sold or otherwise disposed of in a transaction that was recognized for U.S. tax purposes. Those losses were allocated to U.S. partners.[3]

On December 10, 2001, Cinda contributed to Peking Investment Fund LLC ("P.I.F.") an 11.06836% interest in the CCB NPL portfolio in exchange for a 99% interest in P.I.F. As a result of its contribution, Cinda received a capital account credit of $774,999. Under U.S. partnership rules, the capital account credit reflected fair market value at the time of contribution.[4] At that time, Chenery Management Incorporated ("C.M.I.") owned the remaining 1% interest in P.I.F.

On December 24, 2001, Cinda contributed to Peking Investment Holdings LLC ("P.I.H."), another Delaware L.L.C., a 98% interest in P.I.F. in exchange for a 99% interest in P.I.H. On that same date, Cinda sold its entire interest in P.I.H. to four individuals (collectively referred to as "the U.S. investors"), who paid Cinda an aggregate purchase price of $767,170 ($774,999 × 98 ÷ 99).

P.I.F. filed Form 1065, *U.S. Return of Partnership Income*, for the taxable year beginning on December 25, 2001, and ending on December 31, 2001. The partnership reported a loss of $26,903,619. The claimed loss represented the excess of a claimed basis of $27,678,617 in P.I.F.'s interest in the CCB NPL portfolio over an amount realized of $774,998.[5] These losses were allocated to the U.S. individuals.

As the loss was recognized at the partnership level, the I.R.S. examination focused on the partnership tax return. The I.R.S. disallowed the losses, and the partnership filed a petition for redetermination in the U.S. Tax Court disputing the disallowance of the deduction by the I.R.S.

Pre-Trial Motions

The case has not yet been tried. However, in pre-trial motions, the I.R.S. requested summary judgment. As mentioned above, for the motion to be granted, the I.R.S. must show that there is no genuine dispute as to any material fact and that a decision may be rendered as a matter of law.

In support of its position that no material question of fact existed in the case, the I.R.S. argued that the partnership was a "sham partnership." According to a Supreme Court case that addressed whether a partnership should be recognized for

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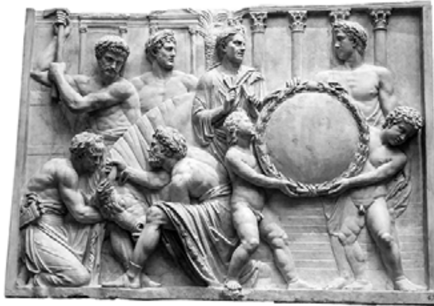
[3] Similar D.A.D. transactions were addressed in *Superior Trading, LLC v. Commr.,* 137 T.C. 70, 71 (2011), affd, 728 F.3d 676 (7th Cir. 2013), and *Russian Recovery Fund Ltd. v. U.S.*, 122 Fed. Cl. 600, 601 (2015), affd, 851 F.3d 1253 (Fed. Cir. 2017).

[4] Code §704(c); Treas. Regs. § 1.704-3(a).

[5] The American Jobs Creation Act of 2004 ("AJCA"), Pub. L. 108-357, sec. 833, 118 Stat. 1589, amended Code §§ 704, 734, and 743 effective for transactions entered into after October 22, 2004. The statutory changes were intended to prevent shifting a built-in loss from a tax indifferent foreign entity to a U.S. taxpayer through the use of a partnership.

U.S. income tax purposes, *Commissioner v. Culbertson*,[6] the purported partners must act in good faith and, with a business purpose, intend to join together in the present conduct of the enterprise. The I.R.S. argued that no good faith intent to carry on a partnership existed under facts asserted in the pleadings and not disputed. In support of its position that P.I.F. and P.I.H. were sham partnerships, the I.R.S. submitted the following three legal arguments:



- **The Generation of Losses to Reduce Tax Without Risk Was the Principal Purpose of Forming the Partnership.** P.I.F. and P.I.H. were formed to implement a "tax scheme" intended to allow the U.S. investors to claim tax losses without being exposed to an economic risk of loss. Correspondence from Chenery's managing director to prospective investors highlighted the fact that Chenery would allow fund members the opportunity to request the sale of specific investments through December 31, 2001.
- **Cinda Had No Intent to Be a Partner.** Cinda did not intend to become a partner in P.I.F. or P.I.H. or to conduct the business of collecting non-performing loans for P.I.F. and had only a nominal interest in P.I.F., with no real participation in the profits or activities of P.I.F. In support of that claim, the I.R.S. pointed to Cinda's contribution of a 98% interest in P.I.F. to P.I.H. and its prompt sale of P.I.H. to the U.S. investors. Cinda took no action to collect on the non-performing loans and had only a fleeting, nominal interest in P.I.F.
- **The Intent of the Partners Was Limited to the Enhancement of Outside Basis.** Neither P.I.F. nor the P.I.H. partners intended to conduct the business of collecting non-performing loans. The partnerships were formed for the purpose of allowing the P.I.H. investors to increase their outside bases in P.I.H. solely to claim the benefit of tax losses.

Alternatively, the I.R.S. claimed that Code §482 provided the authority to reduce Cinda's basis in the CCB portfolio of non-performing loans, so that P.I.F. acquired its interest in the portfolio with a basis of $774,999. According to the I.R.S., both entities were government-owned in China and for that reason were under common control.

In response, P.I.F. argued that *Culbertson* was applied incorrectly because the U.S. investors' interest in tax losses does not rebut P.I.F.'s over-arching profit-making business purpose. It also contended that Cinda retained an ongoing 1% interest in P.I.F. Finally, P.I.F. argued that, notwithstanding one report submitted by the I.R.S. that no steps were ever taken to collect outstanding claims, other reports show that loan proceeds were collected.

Denial of Motion for Summary Judgment

The court denied the motion for summary judgment. The burden of proof to demonstrate that no dispute exists as to material facts was on the I.R.S., as it proffered the motion. The I.R.S. failed to meet its burden.

- **Generation of Losses.** The court applied the reasoning of *Culberson* in determining whether P.I.F. could be viewed as a partnership for U.S. income tax purposes. According to the court, even if the main purpose of forming P.I.F. was to generate a tax loss, the partnership may have had a secondary

[6] *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

purpose to conduct business. To prevail under the *Culbertson* test, the factual record must establish that the partners had no real interest in collecting non-performing loans. If the facts show an objective of profiting from collection, even though that objective may be outweighed by the investors' objective of realizing the benefit of substantial tax losses, the partnership should not be disregarded as a sham under *Culbertson* as a matter of law.

Carrying on a business necessarily involves economic risk. The I.R.S. failed to demonstrate that the U.S. investors intended to be protected against the risk of all loss in carrying on the business. Whatever documentation showed that the investors could minimize the risk of loss did not mean that all risk was eliminated.

- **Intent of Cinda to Be a Partner.** If Cinda is disregarded as a partner of P.I.F., it would have no partnership interest to transfer to P.I.H., causing P.I.F. to be disregarded altogether. A partnership must have more than one partner in order to exist. However, the record contained no evidence to support the I.R.S.'s claim that Cinda's partnership interest should be disregarded. Cinda retained a 1% interest in P.I.F. after it contributed most of its P.I.F. interest to P.I.H. and then sold its interest in P.I.H. to the U.S. investors. Cinda's prompt disposition of most of its interest in P.I.F. may have affected how much of Cinda's interest in P.I.F. should be recognized for tax purposes, but it does not support disregarding Cinda as a partner in P.I.F. altogether.

- **Enhancement of Basis.** Accepting that the U.S. investors were interested in tax losses does not establish that they had no other intent in joining P.I.H. If P.I.F. and P.I.H.'s partners were also motivated to an appreciable extent by the prospect of benefitting from the collection of the assets in P.I.F.'s portfolio of non-performing loans, *Culbertson* would not require disregarding P.I.F. as a sham. To the extent that the formal appraisal of the portfolio at the request of Chenery took into account concerns regarding enforceability, those concerns cannot be viewed as evidence that P.I.F., P.I.H., and their partners were indifferent to the prospects of collection on those loans.

- **Code §482 Issues.** The alternative I.R.S. argument is based on the arm's length transfer pricing rules of Code §482. The court determined that common ownership of both parties by the Chinese government was amorphous, at best, and did not meet the Code §482 standard. The "'bright line' between state ownership and enterprise management" allowed each entity to treat its property and assets as its own, and for that reason, it could not be assumed that a sufficient degree of direct or indirect ownership or control existed to justify application of Code §482.[7]

Path Forward

The denial of the motion for summary judgment does not mean that the deduction claimed for losses in the non-performing loan portfolio will be allowed. Indeed, quite the opposite. Case law cited above and in notes 3 and 7 suggest that the partners of P.I.F. face an enormous hurdle that must be overcome before the I.R.S. adjustment will be reversed by the U.S. Tax Court. However, P.I.F. will be entitled to its

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[7] *Southgate Master Fund v. U.S.,* 651 F. Supp.2d at 596, 647 (N.D. Tex. 2009), affd. on other issues, 659 F.3d 466 (5th Cir. 2011).

day in court and has a reasonable chance of success to settle or win on penalties that have been asserted by the I.R.S.

P.P.T. IN THE FRAMEWORK OF THE A.T.A.D. AND B.E.P.S.

The A.T.A.D. contains five legally-binding anti-abuse measures that identify common forms of aggressive tax planning. All E.U. Member States must transpose the directive into domestic law. Member States are required to apply these measures beginning on January 1, 2019. The A.T.A.D. is intended to create a minimum level of protection against corporate tax avoidance throughout the E.U., while ensuring a fairer and more stable environment for businesses.

"Tax avoidance is in the mind of the administrators."

One of the measures is the general anti-abuse rules ("G.A.A.R."), which contain a P.P.T. G.A.A.R. is designed to counteract aggressive tax planning when other rules don't apply, thereby preventing companies from utilizing loopholes to bypass the tax laws.

G.A.A.R. is contained in Article 6 of A.T.A.D. and reads as follows:

1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for *the main purpose* or *one of the main purposes of obtaining a tax advantage* that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.[8]

As is readily apparent, G.A.A.R. is a one-way street in favor of authorities, as no standard is provided by which a genuine arrangement is distinguished from a non-genuine arrangement nor a valid commercial reason reflecting economic reality is distinguished from an invalid commercial reason. Taxpayers are cautioned that economic substance in a U.S. tax context may bear little resemblance to a valid commercial reason and economic reality. U.S. law allows for new and innovative commercial transactions that may take into account tax reasons and business reasons. The E.U. approach seems to be one that looks back to the time of a business that operates in a single location with no affiliates elsewhere. Any deviation is likely to be viewed as devoid of both valid commercial reasons and economic reality.

The A.T.A.D. language used for G.A.A.R. is similar to the language used by the O.E.C.D. in B.E.P.S. Action 6, except that G.A.A.R. under A.T.A.D. has a much broader scope than G.A.A.R. under B.E.P.S. In B.E.P.S. Action 6, G.A.A.R. is applied to treaty abuse, and in particular treaty shopping. A treaty benefit should not be granted, if one of the principal purposes of the transaction or arrangement is to obtain treaty benefits (a subjective test), unless it is established that granting these

[8] *Id.*

benefits would be in accordance with the object and purpose of the provisions of the treaty (an objective test).[9] In this manner, Action 6 provides a two-step analysis for the application of G.A.A.R. in connection with a treaty. First, the principal purpose of the transaction must be to obtain a treaty benefit under a subjective test. If that test is met, the taxpayer is allowed to demonstrate that allowing a treaty benefit is consistent with the purpose of the treaty provision in.

CONCLUSION

Under the *Culbertson* test, a transaction can be respected even if it is tax motivated as long as economic substance is present – meaning a taxpayer can enter a transaction that provides tax benefits but also is a real transaction. In the E.U., the language is so broad as to be meaningless. Tax avoidance is in the mind of the administrators, who likely never ran an operating business. Under Action 6, the tax benefit is at risk if only one of the main purposes is to obtain a tax advantage.

9 O.E.C.D./G-20 B.E.P.S. Project, 2015.

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