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CLIENT ALERT

Partnership that Lacked Economic Substance Liable for 40 Percent Gross Valuation Misstatement Penalty

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On March 14, 2017, the United States Court of Appeals for the Federal Circuit affirmed a Court of Federal Claims decision that sustained the IRS's disallowance of $50 million in partnership losses and the imposition of valuation penalties on Russian Recovery Fund Limited ("RRF"), which was acting through its tax matters partners Russian Recovery Advisers L.L.C. ("RRA") and Bracebridge Capital, L.L.C. ("Bracebridge").[1] Among other issues, the court determined that there was not a bona fide partnership and the relevant transaction lacked economic substance.

Background

Bracebridge, a management company, created RRF, a hedge fund, and managed FFIP, L.P. ("FFIP"), another fund. All three entities—Bracebridge, RRF, and FFIP—were partnerships. Nancy Zimmerman was a direct partner of FFIP, and FFIP became a direct partner of RRF as part of an attempt to attract investors.

Believing that she could profit from devalued Russian debt, Ms. Zimmerman entered into a series of transactions with two foreign partnerships of Tiger Management, LLC ("Tiger"), a large manger of hedge funds. The two foreign partnerships were looking to offload credit-linked notes ("CLN") tied to Russian sovereign debt—the CLNs had lost nearly all of their value when the Russian ruble collapsed in August 1998.

Deutsche Bank orchestrated the series of transactions beginning in May 1999. First, Tiger's two foreign partnerships transferred CLNs to RRF in exchange for an ownership interest in RRF. Then, on June 3, 1999 (*i.e.*, approximately two weeks after the first transaction between RRF and Tiger), Tiger sold its partnership shares in RRF to FFIP for a discounted amount. On June 22, 1999, RRF sold the majority of the Tiger CLNs to General Cigar Corporation ("General Cigar") for cash and shares. Finally, in 2000, RRF sold the remaining portion of the Tiger CLNs on the open market. RRF subsequently allocated a loss of over $49 million to FFIP on its 2000 tax return, and FFIP reported losses for 2000 and 2001 tax years, most of which were attributable to the losses claimed by RRF in 2000.

In 2005, the IRS issued a Notice of Final Partnership Administrative Adjustment to RRF disallowing approximately $50 million of losses that RRF had claimed for the 2000 fiscal year and imposing a 40 percent penalty on underpayment.

Tiger Was Not a Bona Fide Partner in RRF

The federal circuit court framed the question of whether the partnership between Tiger and RRF had bona fide intent by citing *Commissioner v. Culbertson*.[2] The court then rejected RRF's argument that the focus of the *Culbertson* test is "'not . . . objective'; it is the parties' 'true intent.'"[3] And "[t]he parties' 'true intent' is evaluated by 'considering all facts.'"[4] The court proceeded with its factual inquiry by affirming that the Court of Federal Claims did not err in its conclusion that Tiger did not intend to become a partner in RRF; rather, "both [Tiger and RRF] knew before the first transaction that Tiger would sell its CLNs for cash and that RRF would obtain CLNs with massive built-in losses."[5]

The court emphasized several facts in support of its conclusion. First, Deutsche Bank was a "common denominator" throughout the transaction: The bank helped Tiger acquire the Russian assets, it orchestrated and assisted with Tiger's transaction with RRF and FFIP, and it played an essential role in helping RRF sell the CLNs to General Cigar. In addition, Tiger held its partnership interest for only two weeks, and its employees were discussing selling the interest before the transaction with RRF had even occurred. Tiger also refused to sign the standard subscription agreement stating that "the Shares subscribed for hereby are being acquired . . . for *investment* purposes only . . . and *not with the view that any resale* or distribution thereof. . . ."[6] Furthermore, the court noted that independent of the tax consequences, the transaction "made no sense as investment"—the transaction neither diversified Tiger's investment portfolio nor provided Tiger with additional expertise.

The circuit court also rejected RRF's arguments that the Court of Federal Claims had "eschewed the time-tested and congressionally mandated standard for determining partnership formation in favor of its own test";[7] indeed, the court explained that the Court of Federal Claims properly focused upon the parties' "true intent" as required under *Culbertson*. RRF argued that Congress had preempted *Culbertson*, but the court rejected that RRF's citation to a "general statement"[8] and noted that *Culbertson* is valid precedent until it is overruled by either Congress or the Supreme Court. The court also dismissed RRF's argument that the Court of Federal Claims incorrectly focused upon Tiger's unilateral intent because *Culbertson* explicitly requires that "both parties must intend to form a partnership."[9] Finally, the court rejected RRF's argument that it had merely used the tax laws to its advantage; rather, the court concluded that the Court of Federal Claims had properly determined that RRF's and Tiger's "'sole intent' was manipulating the tax code."[10]

The Transaction Lacked Economic Substance

The court further concluded that even if a bona fide partnership had existed, RRF's transaction with Tiger lacked economic substance. The court explained that four of the five principles guiding its analysis of the economic substance doctrine were relevant. First, the law does not permit a taxpayer to receive tax benefits from transactions that lack economic reality, and the court emphasized that, according to the factual record, RRF's and Tiger's sole intent was to avoid treating the transaction as a sale. Second, when a taxpayer claims a deduction, he or she has the burden of proving that a transaction has economic substance. RRF claimed a deduction for the loss passed to FFIP and Ms. Zimmerman; however, according to the court, RRF failed to prove the transaction had economic substance. Third, the transaction must be viewed objectively rather than subjectively. The court determined that this principle supported the IRS's position and emphasized that Tiger sold its RRF shares to FFIP for far less than it had paid only two weeks earlier. Moreover, RRF arranged for all of the built-in losses to go to FFIP. Finally, fourth, the transaction analyzed is the transaction that gave rise to the alleged tax benefit. The court noted that, according to expert testimony, Tiger was "gaining nothing" from the transaction which gave rise to the tax benefit—RRF's exchange of shares for Tiger's CLNs.[11] Thus, the court concluded that the transaction lacked economic substance.

Gross Valuation Misstatement Penalty

The circuit court upheld the imposition of the 40 percent gross valuation misstatement penalty under Section 6662(h)(1). The court rejected the taxpayer's reasonable cause defense under Section 6664(c)(1), noting that the defense is a "narrow defense" and it is the "taxpayer [who] bears the burden of showing this exemption applies."[12] The Court of Federal Claims had found that the only evidence claimed by RRF of any professional advice was the tax return prepared by Ernst & Young. There were no supporting memos or other form of supporting documentation concerning the propriety of claiming the built-in losses. Accordingly, the circuit court upheld the penalty because tax returns are insufficient to demonstrate reliance on professional advice for the reasonable cause exception.[13]

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1 *See Russian Recovery Fund Ltd. v. United States*, 2017 WL 977033 (Fed. Cir. Mar. 14, 2017).

2 337 U.S. 733 (1949).

3 Id. at 742.

4 Id. at 743.

5 Slip Op. at 7.

6 Slip Op. at 8 (citing RRF II, 122 Fed. Cl. at 607).

7 Slip Op. at 9 (citing Appellant's Br. at 40).

8 *Horn v. Comm'r*, 968 F.2d 1229, 1231 (D.C. Cir. 1992).

9 Slip Op. at 10 (emphasis omitted) (citing *Culbertson*, 337 U.S. at 742).

10 Slip Op. at 10 (citing RRF II, 122 Fed. Cl. at 621).

11 Slip Op. at 11 (citing RRF II, 122 Fed. Cl. at 619).

12 Slip Op. at 11.

13 *See Richardson v. Comm'r*,125 F.3d 151 (7th Cir. 1997).

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