VI. TAX OPINION LETTERS

RELATING TO

PROJECT TOMAS

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November 23, 1998

Enron Corp.
1400 Smith Street
P.O. Box 1188
Houston, Texas 77251

Ladies and Gentlemen:

You have requested our opinion as to certain federal income tax consequences of the transaction summarized in this paragraph (the ***"Transaction"***) in which (i) certain subsidiaries of Bankers Trust Corporation, a New York corporation (***"BT Corp."***), namely BT Leasing Corp., a New York corporation (***"BT Leasing"***), and EN-BT Delaware, Inc., a Delaware corporation (***"EN-BT Delaware,"*** and, together with BT Leasing, the ***"BT Partners"***), and (ii) Portland General Holdings, Inc., an Oregon corporation (***"PGH"***), a wholly owned subsidiary of Enron Corp., a Delaware corporation (***"Enron"***), contributed certain assets to Seneca Leasing Partners, L.P. (the ***"Partnership"***), a newly formed Delaware limited partnership that will elect to be classified as a partnership for federal income tax purposes, in exchange for all of the partnership interests of the Partnership. Our opinion represents our best judgment as to the likely outcome of the issues discussed if presented to a court of law. Our opinion is not binding on the Internal Revenue Service (the ***"Service"***) or a court. Thus, no assurance can be given that a court would agree with our opinion.

In preparing our opinion, we have examined such documents related to the Transaction as we deemed necessary and have assumed they represent the true, accurate and entire agreement of the parties with respect to the matters described therein; that they have been and will be respected by the parties as such; and that the parties will act in accordance with the form of such documents. Further, we have relied upon your representation that you have reviewed the factual matters and assumptions set forth herein and that such factual matters and assumptions are correct for purposes of rendering this opinion. In the event that the factual matters and assumptions so relied upon are incorrect, our opinion could change.

Except as explicitly set forth herein, we express no opinion as to the tax consequences whether federal, state, local or foreign of the Transaction to any party.

I. FACTS

A. BACKGROUND

(1) Prior to the Transaction, PGH was the owner of 100% of two Oregon corporations, Columbia Willamette Leasing, Inc. ("*CWL*"), and Oneida Leasing, Inc. ("*Oneida*"), formerly known as PLC Kalamazoo, Inc.

(2) Prior to the Transaction, CWL owned certain items of personal property leased to third parties unrelated to Enron and its affiliates[1] as well as 100% of the stock of another Oregon corporation, Rail Leasing, Inc. ("***Rail Leasing***"). The assets of Rail Leasing consisted of a number of railcars under lease to GE Capital Railcar Associates, Inc. as more specifically described in the Subscription and Contribution Agreement dated September 15, 1998 (the "***Contribution Agreement***") by and between PGH and the Partnership. In the aggregate, the 17 leased assets held directly or indirectly by CWL had a gross fair market value of $279,678,051. Each of the assets was subject to non-recourse debt (the "***Nonrecourse Debt***"), totaling $169,555,556. The tax basis of the assets totaled approximately $8,000,000.

(3) Prior to the Transaction, Oneida held only a few assets. Oneida had been formed by PGH in 1990 to engage in a joint venture in the oil and gas industry. While the business never materialized, PGH was able to deduct the losses from the joint venture. As required pursuant to a tax sharing agreement between PGH and Oneida, PGH was indebted to Oneida with respect to the use of such losses. Such indebtedness was continuously reflected on the balance sheets of Oneida and PGH such that Oneida's balance sheet showed an account receivable from PGH worth $600,000. Oneida also held other nominal assets. Other than as described in this paragraph, Oneida has not engaged in any business transactions for four years. On September 14, 1998, all of the assets of Oneida other than the Enron Note (as defined below), were distributed from Oneida to PGH.[2]

B. THE TRANSACTION

The Transaction involves the formation of the Partnership by BT Leasing, EN-BT Delaware and PGH. It is anticipated that the Partnership will engage directly and indirectly in the business of owning and operating a portfolio of leased equipment and investing in other permitted investments.

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[1] The assets generally consisted of airplanes, railcars, a Mack Truck facility, ships and certain other equipment, and are more specifically described in the Contribution Agreement (hereinafter defined).

[2] On September 14, 1998, Oneida adopted a resolution to pay a dividend to PGH, thereby clearing from its accounts any cash contributed by PGH in satisfaction of its indebtedness as well as any other Oneida assets.

(1) *Borrowing of Funds and Capitalization of Oneida*

All of the following occurred on July 17, 1998:

(a) PGH borrowed $250 million from Toronto Dominion (Texas), Inc. ("***Toronto Dominion***") on a recourse basis (the "***Recourse Debt***"). The terms of the Recourse Debt require PGH to repay the principal and interest accrued thereon, on or before October 30, 1998. The interest rate on the Recourse Debt was set at LIBOR (as defined in the terms of the Recourse Debt) plus 35 basis points (.35) on a per annum basis. The Recourse Debt was not secured.

(b) Pursuant to a Guarantee issued by Enron on July 17, 1998 (the "***Enron Guarantee***"), Enron guaranteed the Recourse Debt.

(c) Pursuant to a Contribution and Subscription Agreement dated July 17, 1998, between PGH and Oneida, PGH contributed $250 million cash to Oneida.

(d) Oneida loaned $250 million to Enron in exchange for a demand promissory note dated July 17, 1998 (the "***Enron Note***"), in which Enron agreed to pay the principal amount upon the earlier of demand or July 31, 2003, with an annual interest rate equal to LIBOR (as defined in the terms of the Enron Note) plus thirty-five basis points (.35).

(2) *Merger of PGH and its Subsidiaries*

(a) On September 4, 1998, CWL merged with and into its parent corporation, PGH, pursuant to a plan of merger adopted on September 3, 1998. Immediately after such merger, PGH held all of CWL's leased assets as well as 100% of the stock of Rail Leasing.

(b) On September 10, 1998, Rail Leasing merged with and into PGH pursuant to a plan of merger adopted on September 9, 1998. As a result of such merger, PGH held Rail Leasing's only leased asset plus the 16 leased assets formerly held by CWL.

(3) *The Formation and Funding of the Partnership*

(a) On September 9, 1998, PGH, BT Leasing, and EN-BT Delaware (referred to collectively herein as "***the Partners***") formed the Partnership as a Delaware limited partnership, by filing a Certificate of Limited Partnership with the Secretary of State of the State of Delaware and entering into a partnership agreement. Pursuant thereto, BT Leasing and EN-BT were admitted to the

Partnership as general partners, with 4% and 1% general partnership interests, respectively, and PGH was admitted to the Partnership as a limited partner with a 95% limited partnership interest.

(b) On September 15, 1998, PGH, BT Leasing and EN-BT Delaware entered into the First Amended and Restated Limited Partnership Agreement (the "***Partnership Agreement***"). On the same date, pursuant to the Contribution Agreement, PGH transferred 16 of its 17 leased assets and obligated itself to contribute the Mack Truck Facility or an amount of cash equal to the net fair market value of the Mack Truck Facility (collectively, the "***Contributed Equipment***") to the Partnership, as well as 100% of the stock of Oneida. The gross fair market value of the Contributed Equipment at the time of the transfer was $279,678,051, and each item of the Contributed Equipment was transferred to the Partnership subject to the Nonrecourse Debt totaling $169,555,556. The aggregate fair market value of the Contributed Equipment above includes PGH's obligation to contribute the Mack Truck Facility or cash equal to the net fair market value of such asset. The fair market value of the Oneida stock at the time of the transfer was $252,521,946.

(c) On September 15, 1998, the Partnership assumed the Recourse Debt pursuant to, and as contemplated by, the Contribution Agreement. The Partnership, and in turn, BT Leasing and EN-BT Delaware, as general partners in the Partnership, became primarily liable on the Recourse Debt, although Enron remained liable as a guarantor until such debt was repaid two days later on September 17, 1998, as described below. However, in the event that Enron would have been required to make payments on the Recourse Debt as a guarantor, Enron would have had the right to collect from the Partnership such amounts paid under the Enron Guarantee.

(d) In exchange for its contribution of the Contributed Equipment and the Oneida stock to the Partnership, PGH received a 95% limited partnership interest with a fair market value of $110,122,495, a floating preferred return (the "***Preferred Return***") on $68,013,558 of its partnership interest, and the Retirement Right (as defined below).

(e) In exchange for its contribution of $8,972,646 cash, BT Leasing received a 4% general partnership interest, and in exchange for its contribution of $2,243,161 cash, EN-BT Delaware received a 1% general partnership interest.

(f) On September 30, 1998, PGH transferred the Mack Truck Facility to the Partnership in satisfaction of its obligation under the Contribution Agreement and the Partnership Agreement to contribute either the Mack Truck Facility or cash in an equivalent amount.

(4) *Operations, Allocations and Distributions of the Partnership*

(a) It is anticipated that the Partnership will invest the cash capital contributions from BT Leasing and EN-BT Delaware in certain permitted investments described in the Partnership Agreement.[3]

(b) Under the Partnership Agreement, Profits and Losses (as such terms are defined in the Partnership Agreement) are allocated in accordance with the Partners' relative percentage ownership interests (the "***Percentage Interests***"). However, if PGH's capital account is reduced to $68,013,558, then the Profit and Loss allocations change such that BT Leasing and EN-BT Delaware will be allocated 99% of the Partnership Profits and Losses (allocated between them in accordance with their proportionate interests) and PGH will be allocated 1% of the Partnership Profits and Losses.

(c) The Partnership Agreement provides that distributions shall be made to the extent of cumulative retained earnings of the Partnership, (i) first, to the extent of Net Cash Flow (as such term is defined in the Partnership Agreement), to the extent of the excess of the Preferred Return over the sum of certain prior distributions and (ii) second, to the partners in proportion to their Percentage Interests.

(d) Section 5.4 of the Partnership Agreement provides that BT Leasing and EN-BT Delaware (hereinafter sometimes referred to as the "***General Partners***") are to pay all ordinary and customary expenses of the Partnership incurred in the ordinary course of business in exchange for a management fee of $300,000 per year. However, for the year ending December 31, 1998, the General Partners will receive a prorated management fee of $87,500.

(e) Pursuant to a Service Agreement dated September 15, 1998, between BT Leasing and Oneida, Oneida will pay BT Leasing $300,000 per annum to act as its agent to engage in the business of owning and operating a portfolio of leased equipment.

[3] The permitted investments are described in section 5.6 of the Partnership Agreement.

(5) *The Guaranty and Indemnification Agreements*

(a) BT Corp. entered into a Guaranty and Indemnification Agreement (the "***BT Guaranty and Indemnification Agreement***") on September 15, 1998, in favor of PGH, guaranteeing the due and punctual performance by each General Partner of its respective material obligations and covenants as general partner under the Partnership Agreement, and indemnifying PGH for any damages arising from any misstatements or omissions by a General Partner of any material fact under the Partnership Agreement or any of the contribution agreements between a General Partner and the Partnership.

(b) Enron entered into a Guaranty and Indemnification Agreement on September 15, 1998, in favor of BT Leasing and EN-BT Delaware, guaranteeing the due and punctual performance by PGH of all of its material obligations and covenants under the Contribution Agreement between PGH and the Partnership, and indemnifying BT Leasing and EN-BT Delaware against any damages arising from any misstatements or omissions by PGH of any material fact under the Contribution Agreement or the Partnership Agreement between PGH and the Partnership.

(6) *The Formation of and Contribution to PGH Leasing, LLC*

(a) On September 14, 1998, PGH formed PGH Leasing, LLC ("***PGH LLC***"), by filing a Certificate of Formation with the Secretary of State of the State of Delaware, and by entering into a limited liability company agreement on that date. Pursuant to certain representations to be made by PGH, PGH LLC will elect to be treated as an entity which is disregarded for federal income tax purposes.

(b) On September 16, 1998, PGH contributed its limited partnership interest in the Partnership to PGH LLC, pursuant to the Contribution Agreement (the "***PGH LLC Contribution Agreement***") on that same date. BT Leasing and EN-BT Delaware acknowledged and agreed to accept PGH LLC as a substituted limited partner of the Partnership by signing the PGH LLC Contribution Agreement.[4]

[4] Under section 10.6(f) of the Partnership Agreement, the partners consent to the transfer of PGH's limited partnership interest in the Partnership to PGH LLC and to its admission to the Partnership as a substituted limited partner.

(7) *Refinancing of the Recourse Debt*

(a) On September 15, 1998, and prior to the contribution of the Oneida stock to the Partnership, Enron transferred cash in the amount of $252,521,946 to Oneida in satisfaction of the Enron Note.

(b) On the same date, Oneida lent to BT Corp. $252,521,946 on a recourse basis in exchange for a demand promissory note from BT Corp. (the "***Oneida Demand Note***"). Under the terms of the Oneida Demand Note, Oneida could demand payment of all or any part of the principal amount due at any time and from time to time. Interest on such note will accrue at a per annum rate equal to LIBOR (as defined under the terms of the Oneida Demand Note) plus 35 basis points (.35).

(c) On the same date, BT Corp. lent $252,521,946 cash to the Partnership on a recourse basis in exchange for a note of the Partnership (the "***BT Note***"). The terms of the BT Note require the Partnership to repay the principal, including accrued interest on such BT Note on December 31, 2003 or earlier, by acceleration or otherwise. The interest rate on the BT Note was set at LIBOR (as defined under the terms of the BT Note) plus 35 basis points (.35) on a per annum basis.

(d) On September 17, 1998, the Partnership paid $252,606,236.46 cash to Toronto Dominion in full satisfaction of the Recourse Debt.

C. Purposes of the Transaction

PGH has undertaken the transaction for a variety of business reasons, certain of which are set forth below. First, PGH has gained the expertise of BT Corp. in managing and expanding its leased asset portfolio. PGH has incentivized BT Corp. to achieve the best results from the management of the portfolio by causing the BT Partners to acquire a 5% economic interest in the Partnership and by including allocations in the Partnership Agreement that allocate to the BT Partners 99% of the losses after a decline in asset value below a particular level. In addition, the Partnership Agreement provides PGH with wide flexibility with respect to the continuation of the Partnership. PGH expects to receive a reasonable commercial return on the value of its investment in the Partnership, noting that the return is, in significant part, a function of the changing values of the assets included in the Partnership. Finally, PGH expects certain financial accounting benefits to be recognized on the consolidated GAAP financial statements in which it is included. For example, under GAAP, notwithstanding the tax treatment of the transaction, Enron may report gain for GAAP purposes

arising from the Transaction because it has shifted a material amount of the risk of decline in the value of the Contributed Equipment to the BT Partners as a result of the allocations in the Partnership Agreement.

The BT Partners also expect a reasonable commercial return on their investment in the Partnership, although, again, it should be noted that the level of return is, in significant part, a function of the changing values of the assets of the Partnership.

D. Potential Future Events

At any time after two years from September 30, 1998,[5] PGH LLC, as the transferee of PGH's Limited Partnership interest, may exercise its right to compel the Partnership to liquidate its Partnership interest in exchange for assets of the Partnership (the "***Retirement Right***").[6] Upon exercise of its Retirement Right, under Section 10.8 of the Partnership Agreement, the Gross Asset Values (as defined in the Partnership Agreement) of the Partnership assets will be increased or decreased, to their fair market values, which adjustments will be reflected in the partners' capital accounts. PGH LLC will receive distributions in an amount equal to the positive balance in its capital account, plus the amount of Nonrecourse Debt or the BT Note assumed by it. Absent agreement to the contrary, the value of each leased asset will be based on the bids received in an open bidding process which will occur prior to the liquidation.[7] The composition of such assets as well as the amount of debt to be assumed by PGH will be solely at the discretion of PGH.

Additionally, in the future, the Partnership may decide to change the state of incorporation of Oneida from Oregon to Delaware through a redomestication process.

No contracts, agreements, understandings or arrangements exist with respect to such future events apart from the provisions of the Partnership Agreement relating to the Retirement Rights and the redomestication of Oneida.

II. TAX REPRESENTATIONS RELIED UPON

A. BT CORP. REPRESENTATIONS

BT Corp. has made the following representations to Akin, Gump, Strauss, Hauer & Feld, L.L.P. in connection with the Transaction for the purpose of providing a basis for the Firm's

[5] Such date reflects the date on which the Mack Truck Facility was contributed to the Partnership by PGH.

[6] The Retirement Right is described under section 10.8 of the Partnership Agreement. In addition to its right to retire after September 30, 2000, PGH LLC also has the option to exercise its Retirement Right under certain limited circumstances set forth in section 10.8 of the Partnership Agreement.

[7] The bidding process is more fully described in section 10.8(c) and Exhibit A of the Partnership Agreement.

rendering of tax advice to its respective clients, with respect to Transaction including the formation, capitalization and operations of the Partnership by PGH and BT Partners.

(1) BT Corp. has caused the BT Partners to enter into the Transaction for substantial business purposes, including, an opportunity to collect management fees, an opportunity to expand its relationship with a customer, and to benefit financially from the potential profits resulting from leasing equipment.

(2) The Transaction documents were negotiated between the BT Partners and PGH at arm's length including the valuation of the assets contributed to the Partnership. All future transactions affecting the relative rights of the BT Partners and PGH will likewise be undertaken at arm's length.

(3) The BT Partners will file returns, reports and other statements consistent with and act in accordance with the terms of the Transaction documents.

(4) Each BT Partner expects a reasonable commercial positive pre-tax economic return from its investment in an interest in the Partnership after consideration of fees and expenses incurred by such BT Partner (and its affiliates) in connection with the Transaction.

(5) The Partnership will file tax returns consistent with its status as a partnership.

(6) The BT Partners believe that the value of the assets of the Partnership may vary over time and the composition of the assets held indirectly by the Partnership is likely to significantly change. In particular, it is the intent of the BT Partners to cause Oneida to acquire a substantial portfolio of leased equipment that will further diversify the Partnership's portfolio of equipment.

(7) Neither of the BT Partners nor any person who is a related person (within the meaning of Treas. Reg. § 1.752-4(b)(1)) with respect to the BT Partners or the Partnership was the lender with respect to, or has an interest in, any of the Nonrecourse Debt.

(8) For the two-year period following the Effective Date (as such term is defined in the Partnership Agreement), PGH will receive no distributions from the Partnership other than distributions of "operating cash flow" or "reasonable preferred returns" (within the meaning of Treas. Reg. §§ 1.707-4(b)(2) and 1.707-4(a), respectively).

(9) The Partnership will make a timely election, in the manner prescribed in Section 754, to adjust the basis of its property, that would be effective should PGH exercise its retirement right.

(10) BT Corp. expects the Partnership to continue in business for a prolonged period of time, holding the Contributed Equipment, any newly leased assets, and any other Permitted Investments.

(11) Prior to the retirement of PGH's interest in the Partnership, the Partnership will make no contributions to the capital of Oneida.

B. PGH TAX REPRESENTATIONS

The following representations have been made by PGH in connection with the Transaction for the purpose of providing a basis for the Firm's rendering of tax advice to its respective clients, with respect to the Transaction including the formation, capitalization and operations of the Partnership by PGH and BT Partners.

(1) PGH has entered into the Transaction for substantial business purposes. PGH's purposes include (i) gaining the expertise of BT Corp. in managing and expanding its leasing portfolio, while (ii) placing with BT Corp. an economic interest in the portfolio, including a disproportionate share of the downside, and (iii) preserving the opportunity to reevaluate BT Corp.'s performance.

(2) The Transaction documents were negotiated between the BT Partners and PGH at arm's length including the valuation of the assets contributed to the Partnership. All future transactions affecting the relative rights of the Partners will likewise be undertaken at arm's length.

(3) PGH will file returns, reports and other statements consistent with and act in accordance with the terms of the Transaction documents.

(4) PGH expects a reasonable commercial positive pre-tax economic return from its investment in the Partnership after consideration of fees and expenses incurred in connection with the Transactions.

(5) The Partnership will file tax returns consistent with its status as a partnership.

(6) PGH believes that the value of the assets of the Partnership may vary over time and the composition of the assets held indirectly by the Partnership is likely to significantly change. In particular, it is the intent of PGH that Oneida acquire a substantial portfolio of leased equipment that will further diversify the Partnership's portfolio of equipment. Oneida intends to acquire such assets using proceeds of calls upon the Oneida Demand Note.

(7) On July 17, 1998, the $250,000,000 of proceeds of the Recourse Debt were advanced by Toronto Dominion directly to Oneida at the request of PGH.

(8) Each component of the Nonrecourse Debt was originally incurred by CWL or Rail Leasing, as the case may be, solely for the purpose of financing the acquisition of the Contributed Equipment secured thereby, and all of the proceeds of such debt were used to pay the purchase price of such Contributed Equipment.

(9) Each component of the Nonrecourse Debt has encumbered the related Contributed Equipment for more than two years prior to the date of the Transactions.

(10) The Recourse Debt is not secured by any property.

(11) Oneida was formed by PGH for valid non-tax business reasons more than two years prior to the beginning of discussions of the Transaction. PGH has held 100% of the stock of Oneida for the two years prior to the date of the Transaction. Oneida's existence for state law and federal income tax purposes has been continued and has been respected during that time.

(12) PGH LLC will be wholly-owned by PGH and will elect to be treated as an entity disregarded for federal income tax purposes.

(13) The leases to which the Contributed Equipment contributed by PGH to the Partnership are subject are considered "true leases" for federal income tax purposes.

(14) Neither of the BT Partners, nor any person who is a related person (within the meaning of Treas. Reg. § 1.752-4(b)(1)) with respect to the BT Partners or the Partnership was the lender with respect to, or has an interest in, any of the Nonrecourse Debt.

(15) The Nonrecourse Debt assumed by the Partnership in connection with PGH's contribution to the Partnership of the Contributed Equipment represents nonrecourse liabilities within the meaning of Treasury Regulation Section 1.752-1(a)(2).

(16) PGH expects the Partnership to continue in business for a prolonged period of time, holding the Contributed Equipment, any newly leased assets, and any other Permitted Investments.

III. OPINION

Based upon the facts set forth above, the representations given to Akin Gump by BT Corp. and PGH and the existing law:

(1) We believe that the merger of CWL with and into PGH and the merger of Rail Leasing with and into PGH should each constitute a liquidation of CWL and Rail Leasing, respectively, within the meaning of Section 332 of the Code.

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(2) We believe that the Partnership should be treated as a "partnership" and not as an association taxable as a corporation for federal income tax purposes.

(3) We believe that the transfers of (i) the Contributed Equipment (subject to the Nonrecourse Debt) and (ii) the stock of Oneida to the Partnership should constitute transfers governed by Section 721(a) of the Code.

(4) We believe that neither the Partnership's receipt of the Contributed Equipment subject to the Nonrecourse Debt transferred by PGH, nor the Partnership's assumption of the Recourse Debt should be treated as consideration received by PGH subject to Section 707 of the Code (relating to "disguised sales").

(5) We believe that at the time of its contribution of Contributed Equipment subject to the Nonrecourse Debt to the Partnership, PGH should be allocated the Nonrecourse Debt of the Partnership as follows: (i) first, to the extent of PGH's share of Partnership minimum gain, if any, (ii) second, to the extent of the amount of any taxable gain that would be allocated to PGH pursuant to Section 704(c) of the Code with respect to the Contributed Equipment if the Partnership disposed of such Contributed Equipment in a taxable transaction in full satisfaction of the Nonrecourse Debt and for no other consideration and (iii) third, the balance of any remaining Nonrecourse Debt, to PGH in accordance with its share of Partnership profits (95%).

(6) We believe that PGH LLC will be treated as an entity that is disregarded for federal income tax purposes and that the contribution from PGH of its interest in the Partnership to PGH LLC will be treated as a non-event for federal income tax purposes.

(7) In the event that PGH LLC exercises the Retirement Right and receives distributions consisting solely of cash, Contributed Equipment and stock of Oneida, we believe that, except to the extent of cash distributed or deemed distributed to PGH LLC in excess of PGH LLC's basis in its interest in the Partnership, no gain should be recognized upon the exercise of and distribution pursuant to the Retirement Right of PGH LLC. In particular, we believe that if such a distribution to PGH LLC consists of stock of Oneida and/or all or a portion of the Contributed Equipment, the exceptions in sections 737(d)(1), 751(b)(2)(A) and 731(c)(3)(A)(i) should be applicable to such distribution.

(8) We believe that the opinions expressed in Paragraphs 1 through 8 above should not be subject to change under the business purpose doctrine, section 269 of the Code, the substance-over-form doctrine, or the partnership anti-abuse regulations promulgated under section 701 of the Code.

Our opinion is based on the Code as in effect on the date hereof, and applicable Treasury regulations, case law, administrative rulings and pronouncements, and other authoritative sources. In the event of any change in the body of law upon which our opinion is based, our opinion on the matters expressed herein may change. We disclaim any undertaking to advise

you of any subsequent changes in applicable law. In particular, note that opinion number 8 above relates to possible future transactions analyzed under existing law. Relevant intervening changes in the Code, Treasury regulations or interpretations thereof could change our opinion on such issues.

Our opinion represents our best legal judgment as to the ultimate outcome if the issues addressed herein were presented to a court of law. Our opinion is not binding on the Service or the courts, however, and there can be no assurance that the Service or the courts would agree with our opinions on the issues discussed herein if those issues were presented to them.

IV. ANALYSIS

A. LIQUIDATION OF CWL AND RAIL LEASING

Generally, when a wholly owned subsidiary merges with and into its parent corporation, such merger is treated as a subsidiary liquidation under Code section 332. Under Treasury Regulation section 1.332-2(d), "[i]f a transaction constitutes a distribution in complete liquidation within the meaning of the Internal Revenue Code of 1954 and satisfies the requirements of section 332, it is not material that it is otherwise described under the local law." Further, section 332(b)(2) explicitly provides that a shareholder's resolution authorizing the distribution of all the corporation's assets in complete cancellation or redemption of all the stock "shall be considered an adoption of a plan of liquidation."

Section 332(a) provides that "[n]o gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation."

Section 332(b) provides that section 332(a) shall be applicable where the recipient of the distribution is a corporation holding at least 80% by vote and value of the stock of the liquidating corporation at all times on and after the date of the adoption of the plan of liquidation.[8]

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[8] The complete text of section 332 is as follows:

(a) General rule.

No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) Liquidations to which section applies.

For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if—

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of section 1504(a)(2); and either

In Rev. Rul. 75-521, 1975-2 C.B. 120, the Service held that the 80% control requirement of section 332(b) was met where a corporate shareholder that owned 50% of the stock of a corporation purchased all the remaining stock from individual shareholders and immediately thereafter adopted a plan of complete liquidation of the corporation. There appears to be no reason this result would be changed as a consequence of a corporation acquiring 100% of the stock of the corporation rather than 50% immediately before a liquidation is adopted. As described immediately below, the treatment of liquidations as good liquidations under 332 immediately following a qualified stock purchase (as that term is used in section 338) reinforces this conclusion.

Section 338 was added to the Code in 1982. Pursuant to the applicable legislative history, section 338 is "intended to replace any nonstatutory treatment of a stock purchase [followed by a liquidation] as an asset purchase under the *Kimbell Diamond* doctrine." *See* House-Senate Conference Committee Report, S. Rept. No. 97-530, 97th Cong., 2nd Sess. At 536 (Aug. 17, 1982) 1982-2 C.B. 600, 632. Rev. Rul. 90-95, 1990-2 C.B. 67, affirms that a "qualified stock purchase" of target stock by a corporation followed by a liquidation of the target into the acquirer will not be subject to the application of the step-transaction doctrine. The ruling states:

> [t]he step-transaction doctrine does not apply . . . Asset purchase treatment turns on whether a section 338 election is made (or is deemed made) following a qualified stock purchase. A qualified stock purchase of the target stock has independent significance from a subsequent liquidation of the target into the acquirer regardless of whether section 338 election is made or deemed made.

1990-2 C.B. at 68-69. *See also*, Treasury Regulation section 1.338-2(c)(1).

The Service has ruled privately that successive liquidations of pre-existing corporate subsidiaries satisfy the requirements of section 332(b) of the Code. In Private Letter Ruling 9029030 (April 20, 1990), Parent was a mutual life insurance company which owned 100% of

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(2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(3) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under paragraph (1) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

the stock of Sub 1, a holding company, which in turn owned 100% of the stock of Sub 2. Sub 2 owned stock in several subsidiaries, including 100% of the stock of certain subsidiaries (*"Sub 3"*). In order to streamline Parent's corporate structure and achieve operating efficiencies, and pursuant to successive plans of liquidation to be adopted by Parent and Sub 1, then Parent and Sub 2, and then Parent and Sub 3, each of Sub 1, Sub 2, and Sub 3 would be liquidated. With respect to each liquidation, a representation was made that Parent, on the date of the adoption of the plan of liquidation, and at all times until receipt of the property of the liquidating subsidiary, would be the owner of 100% of the total combined voting power of all classes of stock of such subsidiary entitled to vote. The Service concluded that each liquidation would be treated as a complete liquidation under section 332(a) of the Code.

Similarly, in Private Letter Ruling 9103028 (October 23, 1990), P was the parent corporation and owned 100% of the stock of S1, which in turn owned 100% of the stock of FC1, a foreign corporation. FC1 owned 100% of the stock of FC2, which, in turn owned 100% of S2. In order to achieve an integration of business operations, and pursuant to plans of dissolution, FC2 would be liquidated and, thereafter, pursuant to a separate plan of liquidation, FC1 would be liquidated. As a result of such steps, S1 would become the sole shareholder of S2, formerly held by FC2. Each of FC1 and S1 represented that on the date of the respective plans of liquidation and at all times thereafter until the receipt of property, FC1 and S1, respectively, owned 100% of the voting power and value of the stock of FC2 and FC1, respectively. Again, the Service concluded that each of the proposed liquidations would be treated as a complete liquidation within the meaning of section 332 of the Code.

The steps of the liquidations of CWL and Rail Leasing were consistent with the requirements of section 332(b). In particular the plan of merger of CWL with and into PGH was adopted on September 3, 1998, with the merger becoming effective on September 4, 1998. The plan of merger of Rail Leasing with and into PGH was adopted on September 9, five days after PGH had acquired 100% of the stock of Rail Leasing. Each plan of merger was agreed to by the shareholder of the liquidating corporation and the liquidating corporation itself. In addition, each plan of merger sets forth that it is intended to be a merger for state law purposes and a liquidation within the meaning of Code section 332 for federal income tax purposes. Thus, the mechanics set forth under Code section 332(b) appear to be satisfied both with respect to the merger of CWL with and into PGH and the subsequent merger of Rail Leasing with and into PGH.

Based on the foregoing, we believe that the merger of CWL with and into PGH and the merger of Rail Leasing with and into PGH should each constitute a liquidation of CWL and Rail Leasing, respectively, within the meaning of section 332 of the Code.

B. PARTNERSHIP STATUS OF SENECA LEASING PARTNERS, L.P.

The discussion in this section analyzes whether the Partnership should be treated as a partnership rather than as an association taxable as a corporation for federal income tax purposes. A partnership, for federal income tax purposes, is a business entity that has elected, or defaulted

to, partnership classification under the entity classification regulations. *See* Treas. Reg. sections 301.7701-1 through 3 (hereinafter referred to as the "***Check-The-Box Regulations***"). To be eligible to elect classification as a partnership for tax purposes, a particular arrangement must:

(1) qualify as a "separate entity" for federal tax purposes;
(2) be a "business entity" as opposed to a trust;
(3) be an "eligible entity" as opposed to a corporation *per se;*
(4) be composed of two or more members; and
(5) not have elected to be treated as an association taxable as a corporation.

Accordingly, under the Check-The-Box Regulations, a business entity is eligible to elect classification as a partnership for federal income tax purposes if it has two or more members and if it is not mandatory that it be classified as a corporation.

1. SEPARATE ENTITY STATUS

The Check-The-Box Regulations only apply to those organizations which are determined to be separate entities for federal income tax purposes.[9] The determination as to whether an organization is a separate entity for federal tax purposes is a matter of federal tax law, and "does not depend on whether the organization is recognized as an entity under local law." Treas. Regs. section 301.7701-1(a). For this purpose, Treasury Regulation section 301.7701-1(a)(2) defines a separate entity as a joint venture or other contractual arrangement that is entered into, where "the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity for tax purposes exists where co-owners of an apartment building lease space and provide services to the occupants either directly or through an agent." However, where two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes, rather, they have engaged in a joint undertaking merely to share expenses.[10] Treas. Reg. section 301.7701-1(a)(2).

Courts interpreting whether associations or other contractual arrangements constitute separate entities for tax purposes focus on the intentions of the parties involved and the purpose or purposes for the affiliation or other arrangement. For example, a partnership will generally be considered an entity separate from its partners for tax purposes if the partners, in good faith and

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[9] In certain situations, organizations which constitute separate entities for tax purposes are not eligible to make a classification election, such as those that require special treatment under the Code and those taxed as trusts under subchapter J. *See* Treas. Reg. section 301.7701-1(b).

[10] Several types of entities are not recognized as separate entities for federal income tax purposes, including: (1) certain qualified cost sharing arrangements described in Treas. Reg. section 1.482-7; (2) certain local law entities, such as organizations wholly owned by a State if they are an integral part of the State; and (3) certain incorporated tribes. *See* Treas. Reg. section 301.7701-1(a)(3). In addition, organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners. *See* Treas. Reg. sections 301.7701-3.

acting with a business purpose, intend to join together in the present conduct of an enterprise.[11] *See Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949); *ASA Investerings Partnership, AlliedSignal Inc., Tax Matters Partner v. Commissioner*, 76 T.C.M. (CCH) 325 (Aug. 20, 1998); *Cusick v. Commissioner*, 76 T.C.M. (CCH) 241 (Aug. 5, 1998). The standard used to determine whether such an intent exists was articulated by the United States Supreme Court in *Culbertson*, 337 U.S. at 742. The court concluded in that case that a partnership exists for federal income tax purposes only when

> considering all the facts – the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. *Culbertson*, 337 U.S. at 742.

An association between two corporations was held not to be a valid partnership when considering all of the facts, the parties did not intend to join together in the present conduct of an enterprise. *See ASA Investerings Partnership*, 76 T.C.M. (CCH) 325. In 1991, AlliedSignal expected to realize a $446.7 million capital gain by selling a subsidiary. A member of AlliedSignal's board suggested a tax proposal developed by Merrill Lynch to create an offsetting capital loss to shelter the anticipated gain. The plan involved forming a partnership, ASA Investerings Partnership ("***ASA***"), with a foreign partner, capitalized largely by the foreign partner. The partnership would purchase high-grade, floating-rate private placement notes ("***PPNs***"), and sell them for cash and LIBOR-indexed installment notes. The partnership would report the sale of the PPNs using the installment method, with the foreign majority partner recognizing most of the gain. AlliedSignal would then buy a portion of the foreign partner's interest, with AlliedSignal becoming the majority partner, and the partnership would distribute the LIBOR notes to AlliedSignal. AlliedSignal could then sell the LIBOR notes for a loss which could be used to offset its capital gain.

The court concluded that the parties to the partnership agreement did not join together for the common purpose of investing in interest-bearing instruments and sharing profits and losses. This conclusion was based on the findings that AlliedSignal and its purported partner, Algemene Bank Netherlands, N.V. ("***ABN***")[12], had different business goals, with AlliedSignal entering into the venture to generate capital losses and ABN desiring a specified return with no intention to share profits and losses. The court also found that the partners did not follow partnership formalities; for example, the agreement called for a sharing of losses, but ABN did not want, and did not share in, ASA's losses. The court further found that ABN bore minimal risk of loss on

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[11] A corporation may be disregarded as a separate entity for federal income tax purposes if it holds no assets and it lacks a business purpose or any business activity. *See Moline Properties, Inc. v. CIR*, 319 U.S. 436, 438-439 (1943).
[12] Although several other corporations had formed the partnership with AlliedSignal, the court found that the relevant parties were AlliedSignal and ABN. *See ASA Investerings Partnership*, 76 T.C.M. (CCH) 325.

the PPNs and LIBOR notes, and that AlliedSignal approved the plan before it even knew the identity of the foreign partner. AlliedSignal was obligated to pay all expenses, and it made all critical management decisions. Thus, the court concluded that, rather than creating a partnership, AlliedSignal and ABN had created a debtor-creditor relationship, with AlliedSignal as the borrower and ABN as the creditor. Accordingly, ASA was not treated as an entity separate from AlliedSignal and ABN for federal income tax purposes.

In another case, an association between two parties constituted a valid partnership, and therefore, a separate taxable entity, even though no formal partnership agreement was entered into, because, considering all the facts, the parties intended to join together in the present conduct of an enterprise. *See Cusick*, 76 T.C.M. (CCH) 241. Between 1987 and 1991, two parties, an individual and a married couple, purchased property as tenants in common. Each party contributed half of the capital, and they agreed to share profits and losses equally. In addition, they each handled management at various times, by maintaining books and records, collecting rent, and repairing various maintenance tasks. When they sold one property on an installment basis, they split the proceeds equally. Based on these facts, the court concluded that the arrangement between the two parties constituted a joint venture carrying on a "business, financial operation, or venture" and therefore that it fell within the statutory definition of a partnership. As such, the partnership was treated as a separate entity for federal tax purposes.

When forming the Partnership, PGH, BT Leasing, and EN-BT Delaware entered into the Partnership Agreement and each contributed assets or cash proportionate to their respective interests. Furthermore, they agreed to divide Profits and Losses in accordance with the Partners' relative percentage ownership interests, unless PGH's capital account should drop below $68,013,558, in which case the Partners' interests in the allocation of Profits and Losses would flip.[13] Moreover, under section 5 of the Partnership Agreement, the Partners agreed that the General Partners will manage and control the business of the Partnership and the Limited Partner will compensate them for their expenses and services by means of a management fee. The Partners have represented that the Transaction documents were negotiated at arm's length including the valuation of the assets contributed to the Partnership, and that all future transactions affecting the relative rights of the Partners will be undertaken at arm's length. The Partners have further represented that they expect a reasonable commercial positive economic return from their investment in the Partnership after consideration of fees and expenses in connection with the Transaction. All allocations and distributions are based on the fair market value of the Partnership's assets, which are, for the most part, expected to be leased assets and leased personal property, which values will fluctuate and should be distinguished from financial assets such as those in *ASA Investerings*, which were less likely to fluctuate. Thus, unlike in *ASA Investerings*, this relationship reflects the sharing of profits and losses. The Partners' business intentions and expectations regarding the formation of the Partnership are discussed further in the Business Purpose section.

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[13] Under the terms of the Partnership Agreement, if PGH's capital account drops below $68,013,558, PGH will be allocated 1% of the Profits and Losses, and the General Partners will be allocated 99% of the Profits and Losses.

Based on the foregoing discussion, we believe that the Partnership should be treated as an entity separate from its partners for federal tax purposes.

2. "BUSINESS ENTITY" STATUS

Only "business entities" are eligible to elect treatment as partnerships. *See* Treas. Reg. section 301.7701-2. A "business entity" is an entity that is not a trust, as such term is defined by Treas. Reg. section 301.7701-4.

The Partnership does not fall into the definition of a trust under Treasury Regulations section 301.7701-4. The Partners formed the Partnership to actively participate in a number of business activities identified in Section 1.3 of the Partnership Agreement, including leasing activities related to the Contributed Equipment and newly acquired leased assets. The Partnership was not created by will or by an inter vivos declaration, nor was the Partnership formed for the purpose of "the protection and conservation of property for beneficiaries." Thus, the Partnership should qualify as a "business entity."

3. "ELIGIBLE ENTITY" STATUS

Business entities are divided into two categories: (i) those that are treated as corporations *per se*, and (ii) "eligible entities." *See* Treas. Reg. 301.7701-3(a). An "eligible entity" is a business entity that is not classified as a corporation *per se*. Corporations *per se* include business entities "organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic" and any business entity "organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association." Treas. Reg. sections 301.7701-2(b)(1) and (3). In addition, the *per se* category of corporations includes certain business entities conducting banking activities, entities taxable as insurance companies, entities wholly owned by a State or any political subdivision thereof, those entities that are taxable as corporations under a provision of the Code other than section 7701(a)(3), and certain foreign entities listed in the Treasury Regulations. Treas. Reg. sections 301.7701-2(b)(4)-(8).

The Partnership does not fall into any of the categories defining a *per se* corporation and, therefore, should be considered an "eligible entity."

4. TWO OR MORE MEMBERS

A domestic eligible entity established after December 31, 1996, with two or more members will be treated, by default, as a partnership for federal income tax purposes. *See* Treas. Reg. section 301.7701-3(b)(1)(i).

Single owner entities may not elect to be classified as a partnership for federal income tax purposes. In fact, absent an election, an eligible entity with a single owner will not be treated as an entity separate from its owner. However, such entities can elect to be classified as an association taxable as a corporation. *See* Treas. Reg. sections 301.7701-1(a)(4), -3(a), -3(b)(ii).

The Partnership is composed of three partners, and was established after December 31, 1996. Thus, the Partnership should be considered a partnership for federal income tax purposes by default.

5. ELECTION TO BE TREATED AS AN ASSOCIATION TAXABLE AS A CORPORATION

The default classification may be overridden by an affirmative election. Thus, eligible entities that are not satisfied with their default classification may elect the other classification. *See* Treas. Reg. section 301.7701-3(c)(1)(i).[14] No such election has been made for the Partnership.

For the foregoing reasons, we believe that the Partnership should be treated as a partnership for federal income tax purposes.

C. TAX-FREE CONTRIBUTION OF PROPERTY UNDER CODE SECTION 721

Section 721(a) provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." Thus, as the Contributed Equipment and Oneida stock are clearly "property," no gain or loss should be recognized by PGH on its contribution of the Contributed Equipment and Oneida stock to the Partnership except to the extent that an exception applies.[15]

Section 721(b) provides that "[s]ubsection (a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated." Section 351(e) and the Treasury regulations thereunder provide that a corporation is an "investment company" at any particular time if more than 80% of its assets consist of certain defined categories of investment assets at such time (taking into account plans in existence at that time). Treas. Reg. sections 1.351-1(c)(1) and (2). Because at the time of PGH's contributions to the Partnership, the Contributed Equipment constituted more than 20% of the assets of the Partnership and the

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[14] An entity may not elect to change its classification more than once every five years without permission from the Internal Revenue Service. *See* Treas. Reg. section 301.7701-3(c)(1)(iv). However, this rule does not apply to eligible entities that existed on the day the Check-The-Box Regulations were finalized. *See* Treas. Reg. section 301.7701-3(b)(3).

[15] Such exceptions and their applicability to the Transaction are discussed in sections ______ herein.

Contributed Equipment does not fall into any of the categories of investment assets listed in section 351(e)(1) (taking into account plans in existence at that time), the Partnership should not be an "investment company" and section 721(b) should be inapplicable.

Based on the foregoing analysis, we believe that the transfers of (i) the Contributed Equipment (subject to the Nonrecourse Debt) and (ii) the stock of Oneida to the Partnership should constitute transfers governed by section 721(a) of the Code.

D. ANALYSIS OF DISGUISED SALES

Section 707, relating to "disguised sales," can also apply (as an exception to nonrecognition under section 721(a)) to certain transactions that, in form, are contributions of property to a partnership that otherwise are governed by section 721.[16] Generally, under section 707, if the partnership that receives a contribution of property from a partner also tenders consideration other than a partnership interest ("*other property*") to the partner in return for such contribution, the part of the property contributed to the partnership by the partner for the other property will be treated as sold by the partner to the partnership in a taxable transaction. Treas. Reg. section 1.707-3(a)(1).[17]

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[16] section 707 (a) provides as follows: Partner not acting in capacity as partner.

(1) In general. -- If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) Treatment of payments to partners for property or services. -- Under regulations prescribed by the Secretary --

(A) Treatment of certain services and transfers of property. If --

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1).

(B) Treatment of certain property transfers. If --

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

[17] Treas. Reg. section 1.707-3(a) provides as follows:

In particular, with respect to PGH's contributions to the Partnership pursuant to the Transaction, the Partnership's assumption of the Recourse Debt or the Partnership's taking subject to Nonrecourse Debt may be considered to be, in whole or part, other property received by PGH unless the Nonrecourse Debt and Recourse Debt are "qualified liabilities" within the meaning of Treasury Regulation section 1.707-5. Treasury Regulation section 1.707-5(a)(1) provides the general rule regarding the assumption of the liabilities of a partner in connection with a capital contribution of property to a partnership:

> [I]f a partnership assumes or takes property subject to a qualified liability of a partner, the partnership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability [referred to hereinafter as a "nonqualified excess liability or "NEL"], as provided in paragraphs (a)(2), (3) and (4)...

Because no portion of the Recourse Debt assumed by the Partnership should be allocable to PGH, if the Recourse Debt is not a qualified liability, 100% of the amount of the Recourse Debt could be treated as paid to PGH in a disguised sale from some part of the Leased Equipment or the Oneida stock.

With respect to nonrecourse liabilities that are not qualified liabilities, paragraph (a)(2)(ii) provides:

> *Nonrecourse liability.* A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the

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(1) *In general.* Except as otherwise provided in this section, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1) of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership.

(2) *Definition and timing of sale.* For purposes of §§1.707-3 through 1.707-5, the use of the term sale (or any variation of that word) to refer to a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner means a sale or exchange of that property, in whole or in part, to the partnership by the partner acting in a capacity other than as a member of the partnership, rather than a contribution and distribution to which sections 721 and 731, respectively, apply. A transfer that is treated as a sale under paragraph (a)(1) of this section is treated as a sale for all purposes of the Code (e.g., sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

> partner's share of the excess nonrecourse liability under §1.752-3(a)(3) [i.e., the residual profit sharing percentages]. A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under §1.752-1(a)(2)[18] or would be a nonrecourse liability of the partnership under §1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

Applying these rules, and subject to the limitations addressed below, if the Nonrecourse Debt were not a qualified liability, approximately 5% of the Nonrecourse Debt (i.e., $8.5 million) would be an NEL treated as consideration paid for a portion of the Equipment in a taxable transaction.

In the event that the Nonrecourse Debt is not a qualified liability, the Treasury Regulations potentially provide that an even greater percentage of the Nonrecourse Debt would be treated as part of the disguised sale transaction. Treasury Regulation section 1.707-5(a)(3) provides:

> For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if --
>
> (i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and
>
> (ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under § 1.707-3.

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[18] The Nonrecourse Debt will be a "nonrecourse liability" under Treasury Regulation section 1.752-1(a)(2) "to the extent that no partner or related person bears the economic risk of loss for that liability under §1.752-2." Under Treasury Regulation section 1.752-2(b), "a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner." Thus, in short, the Nonrecourse Debt will be a "nonrecourse liability" only to the extent that no partner or a related person bears any risk of loss with respect to the Nonrecourse Debt. PGH has represented that the Nonrecourse Debt is a "nonrecourse liability" within the meaning of Treasury Regulation section 1.752-1(a)(2). PGH has also represented that none of BT Leasing, EN-BT Delaware, PGH or their affiliates is liable for such debt (other than through the loss of the Contributed Equipment pursuant to a foreclosure), and that none of such persons is the lender with respect to any portion or all of the Nonrecourse Debt. Finally, there is no explicit restoration obligation by a Partner or the Partnership with respect to the Nonrecourse Debt in the Partnership Agreement.

Thus, under section 707, the ability of PGH to pick and choose which assets to take upon exercise of its Retirement Right could be treated as a provision that results in the anticipated reduction of the allocation of the Nonrecourse Debt to PGH. In this event, if the Nonrecourse Debt were not a qualified liability, then $169 million of the contributed property (i.e., the Contributed Equipment, and perhaps the Oneida stock) might be treated as sold pursuant to a disguised sale upon contribution (generating significant taxable gain to PGH). This test is subjective and will be applied in hindsight. Consequently, the Nonrecourse Debt and the Recourse Debt must be qualified liabilities in order to avoid gain recognition under the disguised sale rules.[19]

Qualified Liabilities. Treasury Regulation section 1.707-5(a)(6) defines the term "qualified liability" for purposes of the contribution of property by a partner to a partnership as follows:

> (6) *Qualified liability of a partner defined.* A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is a qualified liability of the partner only to the extent –
>
> (i) The liability is –
>
> (A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;
>
> (B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

[19] The 5% (i.e., $8.5 million) portion of the Nonrecourse Debt represents the difference between the amount of the Nonrecourse Debt and PGH's share of the Partnership nonrecourse liabilities. As noted above, PGH's share of the Partnership Profits and Losses is 95%, unless and until its capital account drops below approximately $68 million. At such time, PGH's share of the Partnership Profits and Losses is reduced to 1%. Under Treasury Regulation section 1.752-3(a)(3), a "partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners." Thus, if the Nonrecourse Debt is not a qualified liability under Treas. Reg. section 1.707-5, PGH's percentage share of the excess nonrecourse liabilities may actually be less than 95%, thereby decreasing its share of the Nonrecourse Debt and increasing the amount of gain recognized by PGH.

(C) A liability that is allocable under the rules of §1.163-8T to capital expenditures with respect to the property; or

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i)(C) or (D) of this section) at the time of the transfer.

Application to Nonrecourse Debt. Each of (i)(A) – (D) is analyzed below to determine if the Nonrecourse Debt meets the definition of a "qualified liability." Neither (A) nor (B) would literally apply to the Nonrecourse Debt because the Contributed Equipment was transferred subject to the Nonrecourse Debt from Rail Leasing and CWL in section 332 liquidations prior to the Transaction. In particular, "(A)" is not literally applicable because PGH did not itself incur the Nonrecourse Debt more than two years prior to its contribution of the Contributed Equipment to the Partnership, but rather took the Contributed Equipment subject to such Nonrecourse Debt pursuant to the merger of CWL into PGH and the merger of Rail Leasing into PGH. The provisions under "(B)" also may not be literally applicable under the argument that PGH incurred the Nonrecourse Debt in anticipation of its contribution of the Contributed Equipment subject to the Nonrecourse Debt to the Partnership.[26] It is also not clear that "(D)" would be applicable and further factual information would be needed to make such determination. However, if the Nonrecourse Debt would be a "qualified liability" in the hands of either Rail Leasing or CWL were either of them to participate in the Transaction directly, then paragraph (C), which invokes the tracing rules of Treasury Regulation section 1.163-8T, should be applicable. PGH has represented that CWL and Rail Leasing originally incurred the Nonrecourse Debt on their respective items of Contributed Equipment and that all of the proceeds of the Nonrecourse Debt were used to pay the purchase price on their respective items of Contributed Equipment. Furthermore, PGH has represented that each component of the Nonrecourse Debt has encumbered the related Contributed Equipment for more than two years prior to the date of the Transaction.

Treas. Reg. section 1.163-8T(c)(1) provides the general rule for the allocation of debt proceeds to various expenditures:

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[26] In the case of either "(A)" or "(B)", however, a court may well find the acquisition of the Contribution Equipment in transactions governed by section 381 to include the history of the predecessors.

> *Allocation in accordance with use of proceeds.* Debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in paragraph (m) of this section, interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in paragraph (m) of this section, debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest.

Also relevant is Treas. Reg. section 1.163-8T(c)(3)(ii):

> (ii) *Debt assumptions not involving cash disbursements.* If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.

Thus, under the debt proceeds tracing rules, since PGH acquired the Contributed Equipment from CWL or Rail Leasing subject to the Nonrecourse Debt (and the Nonrecourse Debt is otherwise a qualified liability with respect to CWL or Rail Leasing, whichever is applicable), then the Nonrecourse Debt should be treated as a qualified liability for purposes of the Transaction. Moreover, under section 8.3(a) of the Partnership Agreement, PGH LLC (as successor to PGH) has the right to direct the Partnership to allocate liabilities of the Partnership for purposes of Treasury Regulations section 1.163-8T. Thus, the Nonrecourse Debt should remain a qualified liability.

Application to Recourse Debt. The analysis of the treatment of the Recourse Debt as a qualified liability is similar to the analysis of the status of the Nonrecourse Debt as a qualified liability. The proceeds of the Recourse Debt, which was originally incurred by PGH, were directly paid by Toronto Dominion into Oneida at the direction of PGH. Thus, the proceeds should be treated as directly traceable as a capital expenditure with respect to the stock of Oneida under the rules of Treasury Regulation section 1.163-8T.

Based on the foregoing analysis, we believe that neither the Partnership's receipt of the Contributed Equipment subject to the Nonrecourse Debt transferred by PGH, nor the Partnership's assumption of the Recourse Debt should be treated as consideration received by PGH subject to the disguised sale rules of section 707 of the Code.

The balance of this Opinion assumes that the Recourse Debt and the Nonrecourse Debt are qualified liabilities for purposes of the contributions to the Partnership by PGH in the Transaction.[21]

E. ALLOCATION OF LIABILITIES UNDER SECTION 752

1. ALLOCATION OF NONRECOURSE DEBT

With respect to the Nonrecourse Debt, under section 752(b) and (c), upon contribution of the Contributed Equipment subject to the Nonrecourse Debt, the Partnership is treated as making a cash distribution to PGH equal to the $170 million amount of the Nonrecourse Debt to which the Contributed Equipment is subject (so long as the amount of the Nonrecourse Debt does not exceed the value of the Contributed Equipment). Under section 752(a), any increase in PGH's allocable share of Partnership liabilities attributable to the Partnership taking the Contributed Equipment subject to the $170 million of Nonrecourse Debt will be treated as a contribution of cash by PGH to the Partnership. In the context of a single transaction, the increases and decreases to basis under section 752 are netted. Treas. Reg. section 1.752-1(f). Thus, to determine whether there has been a net cash distribution to PGH pursuant to the Transaction, as a result of the Partnership's assumption of the Nonrecourse Debt, the amount of the Nonrecourse Debt allocable to PGH under section 752(a) must be determined.

Assuming the Nonrecourse Debt is a "nonrecourse liability" within the meaning of the Treasury Regulations under section 752[22], the $170 million of Nonrecourse Debt will be allocated among the three Partners of the Partnership pursuant to Treasury Regulation section 1.752-3(a) in the following order:

> In general. A partner's share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows --
>
> (1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder ("Tier (1)");
>
> (2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities

[21] Disclosure of the assumption of a liability by a partnership is required in certain circumstances under Treasury Regulations section 1.707-5(a)(7)(ii) if the liability is not subject to tracing under Treasury Regulation section 1.163-8T. It would be expected that the assumption of the Recourse Debt and the Nonrecourse Debt by the Partnership would not be subject to this requirement as the proceeds will be directly traceable to the stock of Oneida and the Contributed Equipment.

[22] PGH has represented that the Nonrecourse Debt constitutes a "nonrecourse liability" under Code section 752.

of the partnership in full satisfaction of the liabilities and for no other consideration ("Tier (2)"); and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits ("Tier (3)")

With respect to Tier (1), partnership minimum gain is the excess, if any, of the amount of the nonrecourse indebtedness that is secured by partnership property over the section 704(b) book value ("book value") of the property. Initially, the Partnership will have zero partnership minimum gain because the initial book value of the Contributed Equipment will be $280 million, which is in excess of the $170 million of Nonrecourse Debt. Thus, none of the Nonrecourse Debt should initially be allocated pursuant to Tier (1).

With respect to Tier (2), the amount of potential section 704(c) gain to PGH is approximately $272 million (i.e., the excess of the $280 million book value of the Contributed Equipment over its tax basis of approximately $8 million). The minimum section 704(c) gain described in Tier (2) is $162 million (or $170 million of Nonrecourse Debt less the tax basis of approximately $8 million). Thus, under Tier (2), approximately $162 million of the $170 million of Nonrecourse Debt would be allocated to PGH at the time of its contributions to the Partnership.

The remaining $8 million of basis would be allocated in proportion to the Tier (3) residual sharing ratios, which is agreed in section 3 of the Partnership Agreement to be 95%.

Under the netting rule, the net impact of the contribution of the Nonrecourse Debt by PGH pursuant to the Transaction is certainly less than $8 million, and thus no deemed distribution or contribution in excess of basis results from the operation of section 752.

Based on the foregoing, we believe that at the time of its contribution of Contributed Equipment subject to the Nonrecourse Debt to the Partnership, PGH should be allocated the Nonrecourse Debt of the Partnership as follows: (i) first, to the extent of PGH's share of Partnership minimum gain, if any, (ii) second, to the extent of the amount of any taxable gain that would be allocated to PGH pursuant to section 704(c) of the Code with respect to the Contributed Equipment if the Partnership disposed of such Contributed Equipment in a taxable transaction in full satisfaction of the Nonrecourse Debt and for no other consideration, and (iii) third, the balance of any remaining Nonrecourse Debt, to PGH in accordance with its share of Partnership profits (95%).

2. ALLOCATION OF RECOURSE DEBT

With respect to the Recourse Debt which will be assumed by the Partnership, because PGH is a limited partner in the Partnership, the BT Partners (in the aggregate) will be allocated the entire amount of the Recourse Debt. Underlying this conclusion is the assumption that the Recourse Debt is "assumed" for purposes of the Code. Under section 752(a) an increase in a partner's individual liabilities by reason of the assumption of partnership liabilities by the partner is treated as a contribution of money by the assuming partner. Treasury Regulation section 1.752-1(d) states that a person is considered to have assumed a liability only if--

(1) The assuming person is personally obligated to pay the liability; and

(2) If a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability immediately after the assumption.

Prior to the adoption of these Regulations, the Service's position was that a partner did not "assume" a debt for purposes of section 752 unless there was a "novation" with respect to the original obligor. *See* Priv. Ltr. Rul. 8404012 (where the IRS ruled that a partner had not "assumed" partnership debt, for purposes of section 752 and section 465, as long as the partnership remained liable on such debt under state law irrespective of the partnership's right to proceed against the assuming partner for the payment of the liability). The Tax Court, however, has consistently ruled that an "assumption" under section 752 does not require a "novation" with respect to the original obligor so long as the assuming partner has "*ultimate liability*" with respect to the liability assumed, whether by contract or otherwise. *See, Smith v. Commissioner*, 84 T.C. 889, Tax Ct. Rep. (CCH) 42,096 (1985), affirmed 805 F.2d 1073 (1986); *Abramson v. Commissioner*, 86 T.C. 360, Tax Ct. Rep. (CCCH) 42,919 (1986) and *Gefen v. Commissioner*, 87 T.C. 1471, Tax Ct. Rep. (CCH) 43,600 (1986). *See also, Peters v. Commissioner*, 89 T.C. 423, Tax Ct. rep. (CCH) 44,173 (1987) (holding that a limited partner had not "assumed" a debt for purposes of section 465 where he was not "ultimately liable" for the repayment of the debt under state law).

By analogy to these specific requirements for a partner's assumption of a liability, the Partnership's assumption of the Recourse Debt has been structured so that the Partnership is ultimately liable for the amount assumed even though there is no "novation" with respect to PGH. In the Transaction, pursuant to the Contribution Agreement, the Partnership assumed the Recourse Debt. Until the Recourse Debt was satisfied, Enron remained a guarantor on such Recourse Debt. However, in the event that Enron would have been required to make a payment under the guaranty, upon full satisfaction of the Recourse Debt, Enron would have had the right to claim reimbursement from the Partnership.

The assumption by the Partnership of the Recourse Debt pursuant to the Transaction with no allocation of such liability to PGH will result in a deemed distribution to PGH of the amount of the Recourse Debt. Such deemed distribution will reduced PGH's basis in its Partnership interest by $250 million.

An assertion that the Partnership does not have sufficient assets to satisfy any obligation to reimburse Enron should be disregarded, because pursuant to section 12.3 of the Partnership Agreement, the BT Partners are obligated to restore any negative capital account balances which may result from reimbursing Enron. Furthermore, if for some reason the BT Partners are unable to fulfill this obligation, BT Corp. is obligated to restore any negative capital account balances pursuant to the BT Guaranty and Indemnification Agreement. Pursuant to Treasury Regulation section 1.752-2(b)(6), "[f]or purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation." In the present situation, the facts and circumstances indicate that the Partnership did not intend to circumvent or avoid any of its obligations. On the contrary, not only did the Partnership contain valuable leased assets, as well as other Permitted Investments which it could have sold to fulfill its obligations, there are also the obligations of the General Partners and the guaranty of BT Corp. to perform if the Partnership is unable to do so. These facts demonstrate an intent not to circumvent or avoid satisfying any such obligations. Therefore, it should be presumed that the Partnership will be able to fulfill any obligation it has to reimburse Enron.

Based on the foregoing analysis, at the time of the assumption of the Recourse Debt by the Partnership, the BT Partners should be allocated the Recourse Debt.

F. TAX TREATMENT OF PGH LLC

Immediately after the Transaction, PGH's interest in the Partnership was transferred to PGH LLC, a wholly owned limited liability company.

Treasury Regulation section 1.7701-3 provides as follows:

(c) Other business entities. For federal tax purposes—

(1) The term partnership means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) Wholly owned entities. (i) In general. A business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

PGH has represented that it wholly owns PGH LLC and that it has opted to treat PGH LLC as an entity that is disregarded for federal income tax purposes. Thus, for federal income tax purposes, PGH LLC will be disregarded as an entity separate from PGH. Accordingly, the tax analysis is the same as if PGH had continued to hold the limited partnership interest in the Partnership.

Based on the foregoing analysis, we believe that PGH LLC will be treated as an entity that is disregarded for federal income tax purposes and that the contribution from PGH of its interest in the Partnership to PGH LLC will be treated as a non-event for federal income tax purposes.

G. TAX CONSEQUENCES OF A DISTRIBUTION OF PARTNERSHIP ASSETS

1. GENERAL RULES

In the event that PGH exercises the Retirement Right, it would be treated as receiving a distribution from the Partnership in liquidation of its interest in an amount equal to its allocable share of the Partnership liabilities (under section 752) from which it is relieved, *net of* any liabilities assumed by PGH in connection with the liquidation of its interest.[23] Second, PGH would be treated as receiving a distribution of any Partnership assets actually distributed.[24] Under section 731(a)(1) of the Code, "gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution." Thus, PGH would recognize gain under section 731(a)(1) only to the extent that the net reduction in PGH's share of liabilities that result from the liquidation of its interest through exercise of its Retirement Right (which net reduction amount is treated as a distribution of money) exceeds the tax basis of PGH in its interest in the Partnership immediately before the liquidation of its interest in the Partnership. Since PGH's tax basis would have been increased under section 752 by the prior allocation to it of precisely the liabilities from which it would be relieved under section 752 by virtue of the exercise of its Retirement Right, PGH should not be treated as having been relieved of liabilities in excess of its tax basis (which excess, if any, would constitute recognized gain under section 731). The one case in which gain could arise under section 731 will be if PGH has been allocated losses from the Partnership.

PGH's initial tax basis in the Partnership after the Transaction should be approximately equal to its aggregate tax basis in the contributed property (the Oneida Stock and Leased Equipment), except that such aggregate tax basis must be (i) decreased by the amount of the Recourse Debt, (ii) decreased by the amount of the Nonrecourse Debt, and (iii) increased by the

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[23] Under the netting rule of Treasury Regulation section 1.752-1(f), the decrease in PGH's allocable liabilities under section 752 and the assumption by PGH of any Partnership liabilities are netted to determine a net deemed distribution (or contribution).

[24] Section 10.8 of the Partnership Agreement gives PGH the right to select which assets should be distributed to it upon exercise of its Retirement Right.

portion of the Nonrecourse Debt allocated to PGH under section 752. Inasmuch as adjustment (i) should roughly offset PGH's tax basis in Oneida stock and adjustment (ii) should roughly offset adjustment (iii), the initial basis of PGH in its Partnership interest will be approximately equal to its pre-contribution tax basis in the Leased Equipment. If, as a result of the exercise of its Retirement Right, PGH receives no property subject to Nonrecouse Debt and assumes none of the Recourse Debt, then the decrease in its share of the $169 million Nonrecourse Debt would result in a deemed cash distribution to PGH, which in turn would result in taxable gain to PGH if such deemed cash distribution exceeded PGH's basis in its Partnership interest. If PGH either received Leased Equipment subject to Nonrecourse Debt or assumed a portion of the Recourse Debt, then under the netting rule of Reg. section 1.752-1(f) then any such taxable gain would be reduced or eliminated.

Also as a result of the exercise of its Retirement Right, under section 732(b)[25], PGH would take a basis in the assets distributed to it equal to its basis in its interest in the Partnership immediately before the liquidation of its interest decreased (but not below zero) by the net liability reduction resulting from the transaction, or increased by the net liability increase.

Several technical rules (including exceptions to these general rules) are analyzed below to determine whether they change the result described above.

2. SECTION 737

The general rule of section 737 provides:

> (a) General rule.--In the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of --
>
> > (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or
> >
> > (2) the net precontribution gain of the partner.
>
> Gain recognized under the preceding sentence shall be in addition to any gain recognized under section 731. The character of such gain shall be

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[25] Section 732(b) reads:

(b) *Distributions in liquidation.* The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

> determined by reference to the proportionate character of the net precontribution gain.

Section 737(a)(1) is generally applicable to protect the flip side of section 704(c) (*i.e.*, while section 704(c) triggers gain to a partner that contributed appreciated property to a partnership on the distribution of such contributed property to a noncontributing partner, section 737 triggers gain on the distribution of non-contributed property to such contributing partner). Thus, subject to certain limitations discussed below, section 737(a)(1) causes gain to be recognized to a contributing partner who has contributed appreciated property to a partnership if other property (other than money) is distributed to the contributing partner within seven years of the contribution of the appreciated property to the partnership.

Section 737(d)(1) provides as follows:

> If any portion of the property distributed consists of property which had been contributed by a distributee partner to the partnership, such property shall not be taken into account under subsection (a)(1) and shall not be taken into account in determining the amount of the net precontribution gain. If the property distributed consists of an interest in an entity, the preceding sentence shall not apply to the extent that the value of such interest is attributable to property contributed to such entity after such interest had been contributed to the partnership.

Accordingly, pursuant to the literal terms of section 737(d)(1), any distribution of contributed property back to the contributing partner is exempt from the application of section 737(a)(1).[26]

The legislative history to section 737 expressly affirms the exception provided in section 737(d)(1) and contains an example of previously contributed property in the form of stock in a corporation. The example assumes that A and B form a partnership to which A contributes appreciated property X and B contributes appreciated property Y. In addition, A contributes the stock of C, a corporation with no substantial assets. Subsequent to the contributions, the partnership contributes property Y to C and then distributes the stock of C back to A. Technically, the distribution of the C stock is a distribution of property contributed by the distributee partner. Under the second sentence of section 737(d)(1), however, the exception in section 737(d) will not apply to the extent that the value of the C stock is attributable to property contributed to C after the interest in C was contributed to the partnership. The example provides that upon the distribution of the stock of C to A, A must include in income its gain with respect to property X to the extent that the value of the C stock (taking into account

[26] For this reason, it is important that the contributions made by PGH qualify as a contribution and not (even in part) as a disguised sale. Contribution status also is important for purposes of the exceptions to section 751(b) and section 731(c) as discussed *infra*.

the value of property Y) exceeds A's basis in its partnership interest. The example clearly contemplates that the distributed C stock triggers section 737(a)(1) only to the extent of the value of the C stock that is attributable to the Y property. Clearly missing from this example is any indication that the distribution of the C stock triggers gain under section 737(a)(1) in the absence of the prior contribution of the Y property to C. By negative inference, this example therefore confirms the plain language of the statute.

The Treasury Regulations promulgated under section 737 provide an even more specific example of the exception under section 737(d)(1). Example 2 of Treasury Regulation section 1.737-2(e) provides that A, B, and C form a partnership to which (i) A contributes property A with a value of $10,000 and a tax basis of $5,000, along with all the stock of corporation X with a value and tax basis of $500; (ii) B contributes $500 cash and property B with a value and tax basis of $10,000, and (iii) C contributes $10,500 cash. After formation, the partnership contributes property B to corporation X in a nonrecognition transaction under section 351. Subsequently, all the stock of X is distributed to A in complete liquidation of A's interest in the partnership.

The example concludes that the stock of X is treated as previously contributed property with respect to A only to the extent of the $500 fair market value of the X stock (*i.e.*, as determined without regard to the contribution to X of property Y). Since the actual value of the X stock distributed equals $10,500 ($500 original value plus $10,000 from the property B contribution), $10,000 of the value of the X stock distributed is taken into account for purposes of section 737(a)(1), resulting in A's recognition of its entire $5,000 gain on property A.

This example clearly contemplates that the portion of the X stock value that does not relate to the partnership's contribution of assets to X is not taken into account for purposes of section 737(a)(1). *See also*, Treas. Reg. section 1.737-2(d)(2) (making clear that the adverse rule for contributions by the partnership to X does not apply if the contributed asset previously had been contributed to the partnership by A, the distributee partner).

Therefore, the distribution of assets to PGH in an amount equal to the value of PGH's capital account should not trigger gain to PGH under section 737(a)(1) to the extent that the distributed assets are assets previously contributed to the Partnership by PGH. Pursuant to the plain language of section 737(d), to the extent the distributed assets consist of stock of Oneida, an entity previously contributed by PGH, the distribution would not trigger gain under section 737(a)(1) if the value of the interest in Oneida is not attributable to assets contributed to Oneida after PGH's contribution of the stock of Oneida to the Partnership. Pursuant to section 6.4 of the Partnership Agreement, the Partnership may not make any contributions to Oneida without the express consent of PGH. Thus, upon exercise of its Retirement Right, distributions to PGH should come within the provisions of section 737(d)(1).

Treasury Regulation section 1.737-4 is a broadly worded anti-abuse Regulation granting the Commissioner authority to "recast the transaction" where "a principal purpose of a

transaction is to achieve a tax result that is inconsistent with the purpose of section 737." Each of the examples deals with distributions to a partner of property other than property that was contributed by that partner. The Treasury Regulations contain no inference that they are intended to override the express prohibition on the application of section 737(a)(1) that is found in section 737(d).

3. SECTION 751

Section 751(b)(1)[27] is intended to impose tax in the case of a distribution that results in an effective exchange by a partner of a portion of its interest in "hot assets" (i.e., substantially appreciated inventory or unrealized receivables, which, of particular significance with respect to the Contributed Equipment or any future purchased leased assets (hereinafter together referred to as ***"Leased Assets"***), includes potential section 1245 recapture amounts). If the property selected by PGH to be distributed to it pursuant to its Retirement Right is the stock of Oneida, such distribution would result in the receipt by PGH of two properties from the Partnership – the stock of Oneida and a deemed distribution of money under section 752(b) as a result of an elimination of the allocation to PGH of its share of the debts of the Partnership. In addition, exercise of the Retirement Right could result in the elimination of the interest of PGH in the Leased Assets if it does not select such assets. Thus, unless section 751(b)(1) is not otherwise inapplicable to such a distribution upon exercise of the Retirement Right, PGH may be treated as realizing ordinary income equal to part or all of the potential depreciation recapture in the Leased Assets as a result of its disposition of its interest in the Leased Assets upon its withdrawal from the Partnership.

Section 751(b)(2)(A) provides an exception to the income recognition mandated by section 751(b)(1) as follows:

> (2) Exceptions.
>
> Paragraph (1) shall not apply to (A) a distribution of property which the distributee contributed to the partnership...

---

[27] (1) General rule.

To the extent a partner receives in a distribution --

(A) partnership property which is --

(i) unrealized receivables, or

(ii) inventory items which have appreciated substantially in value, in exchange for all or a part of his interest in other partnership property (including money), or

(B) **partnership property (including money)** other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii), such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

This exception is on its face applicable to the distribution of the stock of Oneida and the Contributed Equipment to PGH because PGH contributed such assets to the Partnership in a transaction governed by section 721. This exception would also appear to be equally applicable to the deemed distribution of money to PGH under section 752(b) because the money deemed distributed upon reallocation of the Nonrecourse Debt to the BT Partners upon a distribution pursuant to the exercise of PGH's Retirement Right reasonably is treated as the same money deemed contributed by PGH to the Partnership under section 752(a) upon the initial allocation of the Nonrecourse Debt to PGH at the time of the Transaction. Section 752(a) and (b) read as follows:

> (a) Increase in partner's liabilities.
> **Any increase in a partner's share of the liabilities of a partnership**, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, **shall be considered as a contribution of money by such partner to the partnership.**
>
> (b) Decrease in partner's liabilities.
> **Any decrease in a partner's share of the liabilities of a partnership**, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, **shall be considered as a distribution of money to the partner by the partnership.**

(Emphasis added). If the exception of section 751(b)(2)(A) is applicable to all of the properties distributed or deemed distributed by the Partnership to PGH, then ordinary income will not be recognized by PGH upon its receipt of distributions and its withdrawal pursuant to the exercise of its Retirement Right.

A Revenue Ruling issued in 1984, however, indicates that the Service may not consider the deemed cash distribution pursuant to PGH's exercise of its Retirement Right to be subject to the exception under section 751(b)(2)(A). If such an argument were successful, it would result in part or all of the potential depreciation recapture with respect to the Leased Assets being recognized by PGH as a result of the exercise of its Retirement Right.

In Revenue Ruling 84-102, 1984-2 C.B. 119, a three person cash basis professional partnership admitted a fourth equal partner. The partnership had $100 of liabilities and the admission of the fourth partner caused a decrease in each original partner's share of the liabilities of $8.33 (from $33.33 to $25). In addition, the partnership also had $40 of unrealized receivables, and the interest therein of each of the original three partners was decreased as a result of the admission of the fourth partner by $3.33 (from $13.33 to $10). The ruling holds that the original three partners are subject to taxation under section 751(b) as a result of the combination of (i) the deemed distribution of $8.33 in cash and (ii) the $3.33 decrease in the interest of each such partner in the unrealized receivables of the partnership.

Revenue Ruling 84-102 does not appear to have been applied by any court or the Service. Applying the logic of Revenue Ruling 84-102 to the distributions pursuant to PGH's exercise of its Retirement Right, the deemed distribution of cash to PGH under section 752(b) would result in recognition of part or all of the unrealized receivable represented by depreciation recapture. However, Revenue Ruling 84-102 has been criticized by commentators due to its failure to apply the deemed contribution fiction of section 752(a) *in tandem with* the deemed distribution fiction of section 752(b). *See, Partner Can Avoid Recognition of Phantom Gain when Partnership Liabilities are Reduced*, 15 Tax'n for Lawyers 112 (1986); Carman, *Revenue Ruling 84-102--An Erroneous Conclusion?*, 15 J. Partnership Tax'n 1371, 372-73 (1986). In particular, the commentators point out that for purposes of applying the section 751(b)(2)(A) exception to section 751(b)(1), section 752(a) should be afforded no less respect than section 752(b).

In the case of the Partnership, for example, the deemed contribution of cash upon the allocation of the Nonrecourse Debt to PGH under section 752(a) should be taken into account in applying the exception of section 751(b)(2)(A), i.e., the deemed distribution should be viewed as a return of the same hypothetical cash that was contributed as a result of the allocation of the Nonrecourse Debt. Upon exercise of its Retirement Right, PGH will be required to take the position that the rationale of Revenue Ruling 84-102 does not cause PGH to recognize gain under section 751(b)(1) by reason of the deemed cash distribution.

As stated above, the cornerstone of the position that Revenue Ruling 84-102 and section 751(b) do not apply to the deemed cash distribution that could result pursuant to PGH's exercise of its Retirement Right is that PGH should be treated as having contributed cash to the Partnership by reference to the same liabilities it is relieved of pursuant to its Retirement Right. Treasury Regulation section 1.752-1(f) raises a question, however, as to whether PGH should indeed be treated as contributing cash in the amount of its share of such debt, despite the plain language of section 752 to such effect. Treasury Regulation section 1.752-1(f) provides as follows:

> (f) Netting of increases and decreases in liabilities resulting from same transaction. If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and **only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to** or distribution from **a partnership of property subject to a liability** or the termination of the partnership under section 708(b) **will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution** or received a distribution as a result of the transaction. (Emphasis added).

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The netting rule was added to the originally proposed (and temporary) Treasury Regulations under section 752 by amendment in late 1989. The preamble to the amendment stated:

> This document amends the temporary section 752 regulations **to clarify** that an increase in a partner's share of partnership liabilities (or the partner's individual liabilities) and a decrease in a partner's share of partnership liabilities (or the partner's individual liabilities) that result from the same transaction **may be offset against each other prior to** determining the amount of any constructive contribution or distribution or money under section 752 and the regulations thereunder.

T.D. 8274, 1989-2 C.B. 101, 103. (Emphasis added). The language proposed in 1989 was subsequently modified to its current state although with no substantive difference.

The netting rule represents the adoption of a position of the Service under section 752 previously announced in Revenue Ruling 79-205, 1979-2 C.B. 255. That Ruling involved the distribution of property by a Partnership that was subject to debt, part of which had been previously allocable under section 752 to the distributee partner. The Analysis and Holding of the Service in that Ruling was as follows:

> ANALYSIS & HOLDING
> In general, partnership distributions are taxable under section 731(a)(1) of the Code only to the extent that the amount of money distributed exceeds the distributee partner's basis for the partner's partnership interest. This rule reflects the Congressional intent to limit narrowly the area in which gain or loss is recognized upon a distribution so as to remove deterrents to property being moved in and out of partnerships as business reasons dictate. *See* S. Rep. No. 1622, 83rd Cong., 2nd Sess., page 96 (1954). Here, since partner liabilities are both increasing and decreasing in the same transaction offsetting the increases and decreases tends to limit recognition of gain, thereby giving effect to the Congressional intent. Consequently, in a distribution of encumbered property, **the resulting liability adjustments will be treated as occurring simultaneously, rather than occurring in a particular order.** Therefore, on a distribution of encumbered property, the amount of money considered distributed to a partner for purposes of section 731(a) (1) is the amount (if any) by which the decrease in the partner's share of the liabilities of the partnership under section 752(b) exceeds the increase in the partner's individual liabilities under section 752(a). The amount of money considered contributed by a partner for purposes of section 722 is the amount (if any) by which the increase in the partner's individual liabilities under section 752(a) exceeds the decrease in the partner's share of the liabilities of the partnership under section 752(b). The increase in the partner's individual liabilities occurs by reason of the assumption by the partner of

partnership liabilities, or by reason of a distribution of property subject to a liability, to the extent of the fair market value of such property.

Because the distribution was part of a single transaction, the two properties are treated as having been distributed simultaneously to A and B. Therefore, all resulting liability adjustments relating to the distribution of the two properties will be **treated as occurring simultaneously, rather than occurring in a particular order.**

TREATMENT OF PARTNER A
A will be deemed to have received a **net** distribution of 600x dollars in money, that is, **the amount by which the amount of money considered distributed to A** (2,200x dollars) **exceeds the amount of money considered contributed by A** (1,600x dollars). Since 600x dollars does not exceed A's basis for A's interest in M immediately before the distribution (1,000x dollars), no gain is recognized to A.

Thus, to the extent the netting rule of Treasury Regulation section 1.752-1(f) is interpreted consistently with the netting principle of Revenue Ruling 79-205, PGH would be treated at the time of its contributions to the Partnership as having received a distribution from the Partnership under section 752(b) of the amount of the Nonrecourse Debt and as having made a contribution of its allocable share of the Nonrecourse Debt. This interpretation of the netting approach is consistent with giving effect to the plain language of section 752(a) and section 752(b).

In a subsequent Ruling, Rev. Rul. 87-120, 1987-2 C.B. 161, the Service again interpreted the provisions of section 752(a) and section 752(b) as being simultaneously applied, stating:

Rev. Rul. 79-205, 1979-2 C.B. 255, considers increases and decreases in partners' individual liabilities resulting from a transaction involving nonliquidating distributions of encumbered partnership properties. That ruling holds that these increases and decreases are treated as occurring simultaneously for purposes of determining the amount of money considered distributed or contributed. The ruling also holds that, for purposes of applying sections 732(a) and 733 to a distributee of encumbered property, the basis adjustments triggered by the distribution are treated as occurring first, and the distribution itself as occurring second...

In the present situation, each partner's individual liability is increased by $9x as a result of that partner's assumption of the mortgage that encumbered the property that was distributed to that partner in liquidation of the partnership interest. Under section 752(a) of the Code, this increase in liabilities is considered a contribution of money by the partner to the partnership. In addition, each partner's share of partnership liabilities is decreased by $9x, representing each

> partner's $3x share of the mortgage that encumbered each of the distributed parcels. Under section 752(b), this reduction in liabilities is considered a distribution of money to the partner by the partnership. Because the nonrecognition provision of section 731(a)(1) is limited to the amount of the distributee partner's adjusted basis, **the tax consequences** for X, Y, and Z **depend on the order in which the money is deemed distributed to, or contributed by,** each of them.
>
> In a liquidating distribution of encumbered property, the liability adjustments--and thus **the resulting deemed distributions and contributions under sections 752(a) and (b)--are all treated as occurring simultaneously.** *See* Rev. Rul. 79-205. Since the amount of the increase in each partner's individual liabilities equals the decrease in each partner's share of the partnership liabilities, **the deemed contribution of money under section 752(a) and the deemed distribution of money under section 752(b) for each partner are exactly offsetting amounts.** Therefore, no gain or loss to X, Y, or Z results from the section 752 liability adjustments. Moreover, after taking into account such liability adjustments, each partner's interest has a remaining basis of $6x ($6x + $9x - $3x - $3x - $3x). The determination of a partner's basis in the distributed property is made after the partner's basis in his partnership interest is adjusted to reflect any net increase or decrease in liabilities. *See* Rev. Rul. 79-205. (Emphasis added)

Thus, the position of the Service prior to the netting rule of Treasury Regulation section 1.752-1(f) was clearly that both section 752(a) and section 752(b) were to be given full effect on a simultaneous basis when a single transaction resulted in decreases and increases in a partner's share of partnership liabilities. The Preamble to the netting rule stated only that the netting rule was to "clarify" that the amount of any increases or decreases in a single transaction may be offset against each other and did not indicate the intention to provide a rule inconsistent with sections 752(a) and 752(b), or to change by Treasury Regulations the meaning of those sections as they had been interpreted in Revenue Ruling 79-205 and Revenue Ruling 87-120.

Additionally, the adverse interpretation of the netting rule would be at odds with the fundamental workings of section 752. Under the plain language of that section, every incurrence and reduction of a liability by a partnership results in a change of a partner's share in the partnership liabilities and is either a deemed distribution or contribution under section 752. It is the assumption of the Nonrecourse Debt and the resulting deemed distribution to PGH that is the currency used by the Partnership to acquire the Contributed Equipment from PGH. Thus, the application of the netting rule in a fashion that would ignore the component adjustments under section 752(a) and section 752(b) is contrary to the plain language of the statute, inconsistent with the framework of handling liabilities under the statute, and a departure from (rather than a "clarification" of) the established interpretations of section 752(a) and section 752(b).

Finally, with respect to Revenue Ruling 84-102, an interpretation of the Code making section 751(b) applicable to PGH's exercise of its Retirement Right is inconsistent with section 707(a)(2)(B) of the Code, which provides:

> Under regulations prescribed by the Secretary -- If --
> (i) **there is a** direct or indirect **transfer of money** or other property **by a partner to a partnership,**
> (ii) **there is a related** direct or indirect **transfer of money** or other property **by the partnership to** such partner (or **another partner**), and
> (iii) **the transfers** described in clauses (i) and (ii), **when viewed together, are properly characterized as a sale or exchange of property,**
> **such transfers shall be treated** either as a transaction described in paragraph (1) or **as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.** (Emphasis added).

Section 707(a)(2)(B) gives the Service the authority to treat PGH's exercise of its Retirement Right as a disguised sale of an interest in the Partnership from PGH to the BT Partners, because the BT Partners will be deemed to have contributed cash to the Partnership and PGH will be deemed to have received a cash distribution from the Partnership. If a disguised sale were to occur, then section 751(a), and not section 751(b) would be potentially applicable to PGH's withdrawal. In light of the clear Congressional sanction to this treatment of PGH's exercise of its Retirement Right pursuant to section 707 and section 751(a), a less clear treatment under section 752(b) seems inappropriate, i.e., one transaction should not be deemed taxable under both section 751(a) and section 751(b). The Service has currently only reserved with respect to the issuance of Treasury Regulations implementing the disguised sale provisions as they relate to transactions among partners.

4. SECTION 731(c)

Section 731(c) provides that distributions of marketable securities shall be treated as the equivalent of cash distributions for purposes of determining whether gain is recognized by a partner under section 731(a) as the result of a distribution to the partner of cash in excess of the partner's basis in its interest in the partnership. If any of the property distributed by the Partnership to PGH pursuant to PGH's exercise of its Retirement Right consists of marketable securities, the resulting deemed cash received by PGH is likely to result in gain being recognized by PGH.

Generally, the Leased Assets will not fall within the definition of a marketable security. Therefore, generally, the Leased Assets could be distributed to PGH pursuant to the exercise of its Retirement Right without implicating section 731(c). However, section 731(c)(2)(B) includes as a marketable security "(ii) any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities..."

Thus, Leased Assets that are subject to contracts to sell, may be marketable securities and should not be distributed to PGH.

With respect to the possible distribution to PGH of the stock of Oneida, section 731(c)(2)(B) includes as a marketable security "(v) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both..." Thus, under this rule the stock of Oneida could be treated as a marketable security depending upon the composition of its assets.

The Treasury Regulations contain more guidance, providing that if the underlying assets of an entity are (i) 90% or more marketable securities, all the interests in the entity shall be treated as a marketable security, (ii) between 20% and up to 90% marketable securities, a proportionate part of the interests in the entity shall be treated as marketable securities, and (iii) less than 20% marketable securities, none of the interests of the entity shall be treated as marketable securities. Treas. Reg. section 1.731-2(c)(3). However, section 731(c)(3)(A)(i) provides that the rule treating marketable securities as money for purposes of section 731 (and section 737) "shall not apply to the distribution from a partnership of a marketable security to a partner if . . . the security was contributed to the partnership by such partner, except to the extent that the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) to the entity to which the distributed security relates . . ." Thus, because the stock of Oneida was "contributed" to the Partnership by PGH, it should not be viewed as a marketable security vis a vis PGH regardless of the composition of its assets, so long as no additional contributions of assets are made to Oneida by the Partnership. Any such contributions must be explicitly approved by PGH under section 6.4 of the Partnership Agreement.

Treasury Regulation section 1.731-2(h) does contain an anti-abuse rule. However, this rule is focused on situations involving the disguised distribution of marketable securities to a partner. The rule does not purport to override the clear exception to the application of section 731(c) for the return of previously contributed property.

5. SECTION 707 Application

An assumption to the application of the foregoing exceptions to sections 731, 737 and 751 is that the stock of Oneida is treated as having been "contributed" to the Partnership by PGH. The stock of Oneida was transferred to the Partnership along with the Leased Equipment pursuant to the Contribution Agreement. The Partnership also assumed the Recourse Debt and took the Leased Equipment subject to the Nonrecourse Debt. The Recourse Debt, while traceable to the stock of Oneida pursuant to Treasury Regulation section 1.163-8T, was not secured by the stock of Oneida nor the Leased Equipment. Inasmuch as the stock of Oneida is beneficially owned by the Partnership and, as such, the partners of the Partnership will share in the appreciation and depreciation of the value of such stock consistently with their normal

sharing ratios, the stock of Oneida should be treated as having been transferred to the Partnership on the Effective Date. Further, there is no authority under section 721 that would suggest that, apart from section 707 where applicable, a single integrated contribution transaction should be viewed as in part a sale and in part a contribution. In fact, in the analogous context of contributions under section 351, the Service has ruled to the contrary. *See* G.C.M. 38873 (July 7, 1982), cited favorably by G.C.M. 39413 (September 25, 1985). *See also*, Rev. Rul. 95-74, 1995-2 C.B. 36 (contribution not bifurcated in section 351 transfer, even though transferor benefited from the assumption of certain contingent liabilities by transferee); Rev. Rul. 94-45, 1994-2 C.B. 39 (same); Tech. Adv. Mem. 9716001 (June 17, 1996). Thus, the form of the transaction and the analogous authorities applying section 351 to the form of similar transactions, support treating the stock of Oneida as having been "contributed" to the Partnership by PGH.

6. Conclusion

Based on the foregoing, we believe that if PGH LLC exercises the Retirement Right and receives distributions consisting solely of cash, Contributed Equipment and stock of Oneida, we believe that, except to the extent of cash distributed or deemed distributed to PGH LLC in excess of PGH LLC's basis in its interest in the Partnership, no gain should be recognized upon the exercise of and distribution pursuant to the Retirement Right of PGH LLC. In particular, we believe that if such a distribution to PGH LLC consists of stock of Oneida and/or all or a portion of the Contributed Equipment, the exceptions in sections 737(d)(1), 751(b)(2)(A) and 731(c)(3)(A)(i) should be applicable to such distribution.

H. SECTION 701 ANTI-ABUSE REGULATIONS AND BUSINESS PURPOSE DOCTRINE

1. SECTION 701 ANTI-ABUSE REGULATIONS

Assuming compliance with the technical provisions of the Code, application of the intended results to the Transaction will revolve around the less technical issues of Treasury Regulation section 1.701-2, the partnership anti-abuse regulation, and the business purpose doctrine generally. The partnership anti-abuse rule has not been applied in any case. Thus, the approach to its application by the courts is uncertain.

Treasury Regulation section 1.701-2 might fail to apply to the Transaction either because it is inapplicable under its terms or because it is invalid as applied to the Transaction. Given the lack of judicial interpretation, we cannot advise as to whether the regulation is invalid by its terms. The following discussion analyzes whether the regulation should be treated as inapplicable by its terms. Under the literal terms of Treas. Reg. section 1.701-2(a), it will be inapplicable by its terms if the following requirements are satisfied:

> (1) The partnership must be bona fide and each partnership transaction . . must be entered into for a substantial business purpose.

> (2) The form of each partnership transaction must be respected under substance over form principles.
>
> (3) . . . [T]he tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, *proper reflection of income*). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision . . . .[28]

Treas. Reg. section 1.701-2(a).

Thus, at its core, if the requirements of paragraphs (a)(1) and (2) are satisfied, the issue under Treasury Regulation section 1.701-2 will be whether Congress clearly contemplated tax-free combinations of property in partnerships when it enacted the nonrecognition regime of section 721 and whether Congress clearly contemplated tax-free distributions when it enacted the nonrecognition regime of section 731. In particular, and assuming that the stock of Oneida or the Contributed Equipment is ultimately being distributed to PGH, the transaction relies on, (i) the

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[28] Accepted on its face, and as interpreted primarily through the illustrative fact patterns set forth in the regulatory examples, the partnership anti-abuse rule purports to establish three basic rules as are well summarized in the McKee treatise:

> 1. Using a partnership to avoid restrictions contained in non-Subchapter K Code provisions is generally permissible;
>
> 2. Allocations which have some potential economic corollary and are valid under the § 704(b) Regulations are not subject to the abuse-of-Subchapter-K rule; and
>
> 3. Transactions that are "tax planned" from the outset are vulnerable to attack, especially if the tax plan minimizes the economic risks and rewards to one or more partners. In contrast, transactions involving historic partnerships, partners, and partnership assets will generally be respected even if the transaction in question is highly tax charged. Although large tax benefits are not fatal per se, they weigh against a transaction and can be determinative in close cases.

McKee, Nelson, & Whitmore, *Federal Taxation of Partnerships and Partners* at section 1.05[1][a]. As applied to the instant case, the Transaction may be viewed as "tax planned" from the outset. Thus, it is important to ensure that the Transaction does not minimize the economic risks and rewards to PGH or the BT Partners.

applicability of section 721 and the inapplicability of section 707 for the tax-free capital contributions by PGH of the Contributed Equipment and the stock of Oneida, and (ii) the applicability of section 731(a)(1) and the applicability of the exceptions in sections 731(c)(3)(A)(i), 737(d), and 751(b)(2)(A) to the distribution of Oneida stock back to PGH. We will examine the validity of these assumptions below.

Paragraphs (a)(1) and (2) require that the partnership be "bona fide," that *each* partnership transaction have a "substantial business purpose," and that "each partnership transaction must be respected under substance over from principles." The preamble to Treasury Regulation section 1.701-2 states that "the final regulations confirm certain fundamental principles that must, in all cases, be satisfied in applying the provisions of subchapter K to partnership transactions." T.D. 8588, 1995-1 C.B. 109, 112. Thus, the partnership anti-abuse regulation should be applied based on traditional notions of "bona fide," "business purpose," and "substance over form." Examples 7, 8 and 11 of Treasury Regulation section 1.701-2 provide the best guidance as to when the Service believes these requirements are met.

Example 7. In Example 7, a new partnership is formed to effect a rent strip transaction, in which X (a foreign corporation) joins as a partner, is allocated substantially all the income generated from a sale of the rental income stream from the partnerships assets "shortly thereafter," and "thereafter" X receives a cash distribution in liquidation of its interest. The Example states that "[o]n these facts, [the partnership] is not bona fide . . . . and the transaction is not respected under applicable substance over form principles . . . , and does not properly reflect the income of" the domestic corporate partner that received the benefit of the high tax basis in the leased equipment.

Under the facts of Example 7, X became a partner and in short order was allocated the income from the rent strip and was removed as a partner. Thus, although the Example does not describe the appropriate adjustment under Treasury Regulation section 1.701-2, presumably X's admittance as a partner under state law would be deemed not to be bona fide for tax purposes, not to be respected under substance over form, and (for good measure) not to have a substantial business purpose. Based on the short time frame and apparent indifference of X as to the ultimate changes in value of the assets of the partnership, the Service may be able to justify this result under traditional notions of bona fide, business purpose, and substance over form. The Transaction is distinguishable from Example 7 because PGH and the BT Partners will be sharing profits and losses with respect to a significant number of assets over a substantial period of time. As a consequence, the BT Partners and PGH should be bona fide members of the Partnership.

Example 8. Example 8 involves the creation of a partnership that allows the duplication of tax basis. A owned land with a $100 basis and a $60 value that A wanted to sell to B. A formed a partnership with persons other than B and contributed the land to the partnership. The other partners contributed cash. The land was leased to B for three years, with B having an option to purchase after three years at fair market value at that time. In year 3, "at a time when the values of the partnership's assets have not materially changed," the interest of A was

liquidated. As a consequence, A was able to recognize his $40 loss. Thereafter, the partnership sold the property to B and the remaining partners were allocated the partnership's $40 loss. The Example concludes that--

> any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes. Accordingly, the transaction lacks a substantial business purpose. In addition, the partnership was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with subchapter K. On these facts, the partnership is not bona fide and the transaction is not respected under applicable substance over form principles.

In this Example, presumably the other partners are not viewed as actual participants in the economics of the ownership of the land because of the arrangement with B to purchase the land and the fact that the "values of the partnership's assets had not materially changed." The Service may have had a basis for this conclusion under traditional notions of bona fide partnership and substance over form, although given the possibility of changes in the value of the partnership's assets it is difficult to see how the members of the partnership were not actually participating in a joint profit sharing venture. Once again, the Partnership is distinguishable from the Example because a key fact in the Example was the static value of the single asset, which had a built-in buyer at the formation of the partnership. The Partnership has been structured such that a change in the composition of the assets over time, in the Partnership and in Oneida, is both possible and intended. A functioning business with repositioning of the risks and rewards of multiple assets in the Partnership and Oneida should establish a bona fide intent to share profits and losses from the joint ownership of a changing portfolio of assets.

Example 11. In Example 11, a pre-existing partnership admitted a partner, X, who desired to acquire certain undeveloped land held by the partnership with a basis of $5 and a value of $95. X contributed $100 for its interest in the partnership. "Subsequently (at a time when the value of the partnership's assets [had] not materially changed), the partnership distribute[d] to X in liquidation of its interest in the partnership the land and another asset with a value and basis to the partnership of $5." The distribution of the additional asset allowed X to allocate $50 of basis to the other asset and thereafter sell the asset for a $45 loss, which in the view of the Example allowed X to "recover a substantial portion of the purchase price of the land almost immediately." The Example held that the proper reflection of income standard was not satisfied because "the ultimate tax consequences [to X] that would thereby result, were not clearly contemplated by that provision [section 732] of subchapter K." Interestingly, the Example does not hold that the partnership is not bona fide, that the transactions would fail to meet the substance over form test, or that the transactions lacked a substantial business purpose.

The Service gives no indication of how this transaction should be recharacterized and, apart from treatment under section 707 as a disguised sale which would impact both the

partnership and X, the Service would apparently intend to merely ignore the plain meaning of section 732 and revert to pre-1954 basis allocation rules.

Again, the Partnership should be distinguishable from Example 11. In the facts of the Example, apparently the timing of the entrance and exit of X to and from the partnership was such that the value of the assets of the partnership had not materially changed. Like Examples 7 and 8, the facts in each case presuppose less than an active trade or business in the partnership. Accordingly, the Transaction is factually distinguishable from the partnership in Example 11 assuming BT Leasing will actively manage the affairs of the Partnership in Oneida by disposing of properties and by acquiring new properties.

With respect to the disposition of the land by the partnership for the cash contributed by X, Example 11 directly leaves open the possibility of the application of the section 707 disguised sale rules. Application of the disguised sale rules would impact both X, who would have a fair market value cost basis in each asset distributed to it in the disguised sale, and the original partners of the partnership. It is interesting (and helpful) that Example 11 does not appear to expand the reach of Treasury Regulation section 1.701-2 directly to broaden the override of section 721 nonrecognition by section 707.

If a transaction is found to have results that are inconsistent with the intent of the partnership anti-abuse regulations, the "Commissioner can recast the transaction for federal tax purposes." Treas. Reg. section 1.701-2(b). Presumably, although the examples in the Regulation are remarkably silent, the plain language of subchapter K will then be applied to the recast transaction. This approach would be consistent, although a substantial expansion, of the substance-over-form doctrine, which applies the language of the Code to transactions the forms of which have been recharacterized to reflect their substance. In the case of the Transaction, the Service will presumably assert that the Transaction should be recharacterized under one of two approaches. First, the Service might attempt to recast the contribution of the Contributed Equipment as a disguised sale under section 707-like principles (thus triggering gain on the Contributed Equipment as of the date contribution thereof).

Second, the Service might assert that the stock of Oneida was never an asset of the Partnership. Under that approach, the contribution of the stock of Oneida would not have increased the basis of PGH in its interest in the Partnership and the release of PGH from its allocation of the Nonrecourse Debt at the time of its exercise of the Retirement Right would result in additional gain at such time under section 731.

Active operations of Oneida and the Partnership and the ownership of assets that may significantly change in value make it difficult for the Service to successfully assert that either such recast of the Transaction is appropriate. With respect to the disguised sale rules, the regulations under section 707 find a sale where "a subsequent transfer [to a partner who contributed appreciated property] is not dependent upon the entrepreneurial risks of partnership operations." Treas. Reg. section 1.707-2(b)(1)(ii). Because PGH will retain a very substantial

(95%) share in the profit and loss on the portfolio of Contributed Equipment, the Service will be hard pressed to argue that the form of the transaction violates the spirit and purpose of the disguised sale Regulations.

With respect to the assertion that the stock of Oneida was never contributed to the Partnership, the active participation of Oneida in a leasing business in which the BT Partners share 5% of profits and up to 95% of losses is contrary to such an assertion. If the Service is unable to divorce Oneida from the Partnership, it will be difficult for the Service to argue that section 737(a) should result in gain to PGH at the time of its exercise of the Retirement Right in the face of the plain language of section 737(d).[29]

Finally, a good case can be made that the intended tax results under subchapter K are achieved in the Transaction. PGH's basis in the stock of Oneida, if that is the property distributed, would be zero (or thereabouts). Thus, PGH has not had an accession to an amount of basis that is inconsistent with the application of subchapter K. The Service may complain that the inside basis of the assets of Oneida is effectively available to PGH because of the application of section 332 of the Code, but (i) inherent in the subchapter C regime is a maintenance of unequal inside and outside basis absent a section 338 election, (ii) subchapter K is not concerned with the inside basis of a corporation in its assets (such that the inside asset basis results of a particular transaction should not be considered inconsistent with the intent of subchapter K), (iii) section 269 is devoted to such issues, and (iv) Congress has considered legislation designed to coordinate the operation of section 332 and subchapter K but has chosen not to revise the Code in such a fashion.[30]

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[29] We would be remiss, however, if we did not note that the Service may discern no limits to its authority under the partnership anti-abuse rules, having included the following language in Treasury Regulation section 1.701-2(b):

> 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 . . . [t]he claimed tax treatment should otherwise be adjusted or modified.

The Service may view this language as allowing it to override the provisions of the Code even if a transaction cannot be "recast . . . 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." Treas. Reg. section 1.701-2(b).

[30] On April 8, 1997, the Joint Committee on Taxation (the "*JCT*") released a report that analyzed a variety of issues relating to the taxation of partnerships under subchapter K of the Code. The report stated:

> The proposal would provide that if stock of a corporation is distributed by a partnership to a corporate partner, and the corporate partner owns 80 percent or more (by vote and value), directly or indirectly, of the stock as a result of the partnership's distribution (whether solely as a result of the distribution, or as a result of the distribution combined with acquisitions of stock within one year before or after the distribution), then the corporation (whose stock was distributed) must reduce the basis of its assets. The amount of the reduction to asset basis would the amount by which the stock basis is reduced as a result of the distribution.

97 TNT 68-8 (footnotes omitted).

2. BUSINESS PURPOSE DOCTRINE AS APPLIED BY SERVICE

In a wide variety of circumstances, the Service has successfully asserted the lack of an underlying business purpose for a transaction as a reason to overcome the tax consequences that would otherwise govern the form of the transaction. This business purpose requirement is presumably the same requirement as needs to be satisfied under the partnership anti-abuse regulation discussed above. Thus, most of the comments that we made about each part of the Transaction having economic substance apply equally in the business purpose doctrine context.

In Revenue Ruling 74-87, 1974-1 C.B. 72, the Service ruled that a transfer by three shareholders of their stock in a corporation, aggregating 10 percent in value of the corporation's stock, to a partnership formed by them would be disregarded where the partnership was formed as part of a plan to have the corporation transfer appreciated real property to the partnership in complete redemption of its aggregate 10 percent interest. Accordingly, the transaction was treated as a redemption of each individual shareholder's stock followed by a contribution of the appreciated property to the partnership, resulting in the termination of the shareholders' interests in the corporation and the recognition of gain by the corporation. A tax avoidance purpose was at the core of the transfer of stock to the partnership because it was effected to qualify the succeeding redemption under section 311(d)(2)(A)[31] and thereby to avoid gain recognition. The Service concluded that even if no tax avoidance purpose was present, as would be the case if the redeeming corporation were not in any way connected with the partnership formation and subsequent transfer to it of the minority stock interests, the transaction would still be recast because of the transitory nature of the intermediary step.

In G.C.M. 38393 (May 30, 1980), the Service decided that the transfer of a corporation's stock by its shareholders to a partnership immediately prior to a plan of complete liquidation would be recognized for federal income tax purposes, instead of being disregarded and treated as a transfer of assets to the corporation's shareholders followed by the shareholder's transfer of those assets to the partnership. Even though the transfer was part of the overall plan of liquidation, the transfer of the corporation's stock to the partnership was respected because the transfer was for valid business reasons. This method of transferring the assets to the partnership was chosen, instead of distributing the assets to the shareholders after a liquidation and then

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If this proposal were subsequently enacted prior to the occurrence of the exercise of PGH's Retirement Right, the basis of Oneida in its assets may be materially reduced as a result of the exercise of PGH's Retirement Right. However, the proposal does indicate that the JCT does not consider the intended result of PGH's exercise of its Retirement Right as inconsistent with subchapter K, but rather as inconsistent with the proper taxation of a corporation subject to subchapter C.

[31] Repealed Code section 311(d)(2)(A) provided that the general rule requiring recognition of gain realized through the use of appreciated property to redeem stock did not apply to a distribution in complete redemption of all of the stock of a shareholder who, at all times within the 12-month period ending on the date of distribution, owned at least 10 percent in value of the outstanding stock of the distributing corporation.

contributing the assets to the partnership, in order to avoid the imposition of a state real property transfer tax on the asset contribution by the shareholders. The Service noted that, while the partnership's possession of the stock was transitory, its continued participation in the business formerly carried on by the corporation was not. The Service distinguished its decision G.C.M. 38393 from Revenue Ruling 74-87 by placing great emphasis on the significance of the business purpose of avoiding state real property transfer tax.

3. CASE LAW APPLYING THE BUSINESS PURPOSE DOCTRINE

In the context of tax-free reorganizations, it is well-established that a taxpayer must prove the existence of a non-tax business purpose, however, only *one* satisfactory purpose is generally required. *Laure v. Commissioner*, 653 F.2d 253, 259 (6th Cir. 1981). Simply because a transaction is undertaken in part to decrease or avoid taxes does not preclude compliance with the business purpose requirement if the transaction serves a genuine and legitimate corporate business purpose. *See e.g., Munroe v. Commissioner*, 39 B.T.A. 685, 699 (1939) (tax-free reorganization treatment inapplicable if the sole purpose is "to effect a transfer of property ... in such a way as to decrease or avoid taxes"). *See also Riddlesbarger v. Commissioner*, 200 F.2d 165, 171-75 (7th Cir. 1952); *Coca-Cola Co. v. United States*, 47 F. Supp. 109, 117-18 (Ct. Cl. 1942).

Although only one business purpose is required, it must be a bona fide business purpose. In a recent and widely publicized business purpose doctrine case, *ACM Partnership v. Commissioner*, No. 97-7527, 1998 WL 710617 (3rd Cir. Oct. 13, 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), the Third Circuit analyzed whether the tax treatment afforded a transaction in which notes were purchased and sold in a short period of time under the installment sales provisions of section 453 should be respected for federal income tax purposes. In *ACM Partnership*, Colgate (through a newly-formed, wholly-owned subsidiary, Southampton) together with Kannex (a newly-formed, wholly-owned foreign subsidiary of a foreign bank) and MLCS (a newly-formed, wholly-owned subsidiary of Merrill Lynch) formed a partnership which purchased certain private placement debt obligations and sold those obligations after 24 days for cash and certain floating rate LIBOR notes. The partnership reported the transaction under the contingent payment sale provisions of section 453, thereby creating a gain which was allocated primarily to Kannex. Thereafter, Kannex's partnership interest was liquidated and, when the LIBOR notes were sold for a loss, the bulk of such loss was allocated to Southampton. The Tax Court disallowed the loss upon its finding that the investment strategy of the partnership had no economic substance. The taxpayer argued that the partnership "was rationally designed to address genuine liability management needs." *Id.*

The Tax Court stated that "[w]hether a transaction has economic substance is a factual determination . . . . Key to this determination is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions." The court further stated that "[a] rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the

transaction costs." The court analyzed each step of the transaction and found that no rational profit motive existed on the part of the partnership. With respect to the need for a profit motive in the economic substance analysis, the court stated that "the strategy must have provided [Southampton] a realistic possibility of recovering [the transaction costs] for the section 453 investment strategy to be deemed profitable." The court found that only in the most extreme of circumstances could the partnership have expected to make a profit. Thus, the court concluded that "the partnership, and ultimately Colgate, would almost certainly lose money."

The Tax Court derived support for its position from a number of leading business purpose doctrine cases. For example, the Tax Court pointed to *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), for the dividing line between a transaction with economic substance as compared to one without economic substance. The Tax Court cited *Frank Lyon* for the proposition "that the Government should honor the allocation of rights and duties effectuated by the parties 'where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached', [*Frank Lyon*] at 583-584." *ACM Partnership*, 73 T.C.M at 2215. The Supreme Court in *Frank Lyon* had upheld the tax treatment of the purported lessor-owner of a building as the owner for tax purposes, where the lessee was prohibited by banking regulations from owning the building but the panoply of agreements placed virtually all the burdens and benefits of appreciation and depreciation of the building with the lessee.

The Third Circuit affirmed the Tax Court's opinion except it found that ACM was entitled to deduct the portion of its loss that was not attributable to the installment sale accounting so that it reflected the actual economics of the transactions. The Third Circuit found that the Tax Court erroneously failed to recognize that ACM's ownership of the LIBOR notes had economic substance even if the contingent installment sale did not, and thus improperly disallowed deductions arising from its ownership of those notes, resulting in inconsistent tax treatment in light of ACM's reporting of the income generated by the notes. The court stated that, even where a transaction is not intended to serve business purposes, it may give rise to a deduction to the extent that it has separable objective economic consequences apart from tax benefits.

In another publicized business purpose doctrine case involving the same general structure as that in *ACM Partnership*, *ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998), the court held that AlliedSignal, an aerospace and automotive products manufacturing corporation, and a foreign bank failed to form a bona fide partnership in connection with an investment venture involving interest-bearing instruments. As a result, gains and losses relating to the sale of the instruments were not allocated to the bank

AlliedSignal expected to realize a large capital gain with respect to the sale of certain assets, but an investment bank developed a tax proposal that could create capital losses to shelter this gain. A foreign bank, which was not subject to U.S. taxation, and AlliedSignal formed a partnership. The partnership was capitalized with cash contributions, primarily from the foreign

partner, who would be the majority partner after the initial contributions. The partnership purchased high-grade, floating rate PPNs, which included put options, permitting the notes to be sold at par. The partnership sold the PPNs for consideration consisting of 80 percent cash and 20 percent indexed installment notes (LIBOR notes). The partnership reported the sale of the PPNs using the installment method under section 453 so that a small fraction of the PPNs' bases would be used to calculate the gain on the sale and the remaining basis would be allocated to the LIBOR notes. Thus, the PPN sale created a large capital gain and a future sale of the LIBOR notes would create a large capital loss. The gain was allocated according to each partner's partnership interest (i.e., the tax-exempt foreign bank recognized most of the gain). Thereafter, AlliedSignal bought a portion of the foreign bank's partnership interest and became the majority partner. The partnership distributed cash to the foreign bank and the LIBOR notes to AlliedSignal, who sold them and recognized a large capital loss.

The court noted that although a partnership agreement was executed, the bank did not have a profit expectation from the venture and did not intend partnership status. Furthermore, despite partnership agreement provisions to the contrary, the bank did not share in losses or expenses, nor did it play a significant management role. The relationship between the corporation and the bank was properly characterized as a debtor-creditor relationship. Evidence indicated that the corporation's only concerns were that the venture was financed by a reputable bank and that the conduct of the bank in assessing the credit risk in the transaction and maintenance of collateral was consistent with that of a lender. The court did not address whether the transaction had economic substance, as in *ACM Partnership*, because it found that there had been no partnership.

In another business purpose case, *Merryman v. Commissioner*, 89-1 U.S.T.C ¶ 9338 (5th Cir.), the court held that a partnership functioned merely as an instrument through which one of the partners could retain control of an oil rig while passing on various tax advantages to its partners. Therefore, the partnership was disregarded as a mere paper conduit of a related corporation and, as a result, losses and an investment tax credit were denied to its partners. The pattern of interconnected ownership and lack of obvious business purpose in the parties' dealings were considered evidence that the partnership's formation and activities lacked economic substance.

The corporation, its key employees and officers, and a family partnership formed the partnership. Under the partnership agreement, the corporation was the managing partner of the partnership and was given full and sole control over the partnership's affairs. The corporation sold the partnership an oil rig, which it had recently constructed, for the cost of construction and did not inform third parties of the change in ownership. The partnership waived all warranties and made no down payment, but rather issued an installment note for the purchase price. Also, the corporation and the partnership entered into a "Rig Management Agreement" which called for the corporation to manage all aspects of the operation of the oil rig. The corporation did not pay the accrued net operating profits to the partnership and the payments due on the partnership's promissory note to the corporation were not paid on time. The records indicated that the partnership had no office or employees, paid no salaries, and carried on no other business

dealings. The corporation entered into an indemnity agreement with the partnership, in which it undertook to indemnify the partners for any and all possible liabilities.

The court found that, although the partnership held assets and operated for a profit, its formation and role served no other purpose except tax avoidance. All liabilities arising from the partnership's activities were assumed by the corporation. The sale by the managing partner, the corporation, on exceedingly favorable terms to the partnership raised doubts about the existence of an arms-length deal and provided evidence of a transaction lacking economic substance. Also, the individual partners did not invest any capital in the partnership, and no risks were associated with their partnership investment. The Service alternatively claimed that, if the partnership was not disregarded for tax purposes, the management agreement entered into by the corporation and the partnership should have been considered a lease with an indefinite term, which would invalidate the investment tax credit.

In *Duhon v. Commissioner*, 62 T.C.M (CCH) 382 (1991), the court held that another partner in the *Merryman* transaction was not entitled tax benefits because the partnership was disregarded for federal income tax purposes. The partner argued that the main consideration in establishing the partnership was retaining key employees. The court found that the key employees of the corporation theoretically stood to benefit from net profits of the partnership remaining after note payments had been made on the promissory note, but it dismissed this argument because the key employees also stood to benefit from the significant tax benefits to be realized if the partnership was recognized for tax purposes. The taxpayer argued that, under state law, the partners would be liable for their individual shares of the debt of the partnership and that the partnership still was liable for its own negligent acts, so the partnership acquired the benefits and burdens of ownership. The court disregarded any liability that the partnership might have under state law because of the indemnity agreement protecting the partners.

In *Hunt v. Commissioner*, 59 T.C.M. (CCH) 635 (1990), the court held that a partnership formed by the wholly owned subsidiary of a gold and silver exploration corporation and three limited partners was not a financing arrangement lacking in economic substance. The limited partners and the subsidiary entered into a formal partnership agreement that provided for the contribution of capital by both. The limited partners had debts related to their investments in silver and their motivation to enter into the partnership was to refinance these debts and avoid bankruptcy. They were also motivated to enter into the partnership with the subsidiary for the purpose of retaining their silver investments until silver increased in price. The subsidiary believed that the public thought that the limited partners controlled it, so it was concerned that a bankruptcy filing by the limited partners would adversely affect its business relationships and credit rating. The subsidiary also thought that silver investments contributed to the partnership by the limited partners had significant appreciation potential and that it would profit handsomely.

The court found that the limited partners' obligation in the partnership agreement to guarantee a return of 98% of the partnership's capital contribution was consistent with the status of the arrangement as a partnership, and their motivation to enter into a partnership arrangement in order to refinance their debts was a valid business purpose. The limited partners did not

realize cancellation of indebtedness income upon the dissolution of the partnership and were entitled to deduct losses that flowed to them.

In *ASA Investerings Partnership*, AlliedSignal cited *Hunt* to support the contention that, even if the bank was entitled to a guaranteed return, that was not inconsistent with partnership treatment. The court distinguished *Hunt* in that the partnership agreement in *Hunt* provided for the guaranteed return, but in *ASA Investerings Partnership*, the bank's specified return was not provided in, and was contrary to, AlliedSignal and the bank's partnership agreement. Also, in *Hunt*, the partner receiving the guaranteed return was also eligible to receive partnership profits in excess of such partner's guaranteed return, but the bank was only entitled to its specified return and nothing more.

4. APPLICATION OF BUSINESS PURPOSE TEST

In the Transaction, PGH and the BT Partners have sound non-tax business reasons, as detailed above, for entering into the Transaction. From the perspective of PGH it has an intention to benefit economically, apart from tax savings and taking into account all transaction costs, as a result of the Transaction. In particular, as elaborated above in connection with the discussion of the partnership anti-abuse regulation, PGH by entering into the Transaction has enlisted the aid of the BT Partners in increasing the value of the Contributed Equipment and improving the profile of the portfolio of such Leased Assets through the active management of the portfolio both in the Partnership and in Oneida. PGH has shifted risk to the BT Partners. PGH has significant flexibility with respect to future Partnership operations. Likewise, the BT Partners have represented (through BT Corp.) that they intend to make a fair commercial return on the equity they have invested in the Partnership. Due to their profit and loss positions the BT Partners have an incentive to manage the portfolio of Leased Assets.

Moreover, the parties have represented that they expect the Partnership to continue in business for a prolonged period of time, holding the Contributed Equipment, any newly leased assets, and any other Permitted Investments. No exercise of the Retirement Right is permitted to occur for at least two years and the Transaction is not contingent on such exercise of the Retirement Right. Thus, the Partnership should not be considered a transitory entity for purposes of determining whether the business purpose requirement is satisfied.

5. SECTION 269

Section 269(a) provides, in relevant part:

> If any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation ... and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

Thus, if any person acquires, directly or indirectly, control of a corporation, and the principal purpose for such acquisition was the evasion or avoidance of federal income tax, then the deduction, credit or other allowance obtained by such acquisition may be disallowed.

For purposes of section 269, "control" means "the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation." Control may be "acquired" not only through a direct purchase of stock but also through tax-free acquisitions and indirect methods of acquiring control of a corporation. For example, acquisitions occur through the redemption of stock of other shareholders, the use of chains of controlled corporations, and possibly even the use of convertible debentures or options to acquire additional stock. *See, e.g., Swiss Colony, Inc. v. CIR*, 428 F.2d 49 (7th Cir. 1970) (control acquired through combination of repossession of previously sold stock and purchases from third parties); *Bobsee Corporation v. U.S.*, 411 F.2d 231, 235 (5th Cir. 1969) (creation of a corporation is the acquisition of it within the meaning of section 269(a)(1)). *But see Hermes Consol., Inc. v. US*, 14 Cl. Ct. 398, 1988-1 USTC 9220 (1988) (carefully structured acquisition to avoid crossing 50-percent-control line through use of voting power and value determination was successful), *The Challenger, Inc. v. Commissioner*, 23 T.C.M. (CCH) 2096, T.C. Memo 1964-338, T.C.Mem. (P-H) 640338 (1964) (the revival of dormant corporation is not a control acquisition under section 269).

a. Section 269 and the Revival of Oneida

The revival of a dormant corporation should not be treated as an "acquisition of control" under, section 269, because "control" is defined by the Code in terms of stock ownership, and a revival does not constitute the acquisition of ownership of stock. *See IRC*, section 269(a)(1); Treas. Reg. section 1.269; *Challenger, supra.*

In *Challenger, supra*, the United States Tax Court held that the revival of dormant corporations for use in entirely different circumstances with funds borrowed from related entities, was not the equivalent of the "acquisition" of the corporations under section 269 of the Code. An individual by the name of Graves owned a number of Idaho corporations, two of which are relevant to this discussion. One corporation, known as Saratoga, operated a small club with a restaurant, a bar and slot machines in Caldwell, Idaho. The second corporation, known as Waldorf, operated a cigar store with food, sporting goods, and slot machines in Nampa, Idaho. When slot machines were made illegal in Idaho during the early 1950s, each of these businesses were closed down.[32] The corporations sold most of their business assets, retaining only their slot machines and certain restaurant equipment. These assets were eventually moved to the State of Nevada.

[32] It is unclear from the facts exactly when each of these two businesses were closed down, but at the very latest it was in 1953 when the Idaho State Supreme Court ruled that slot machines were illegal. *See State v. Village of Garden City*, 74 Ida. 513, 265 P.2d 328 (1953).

Saratoga and Waldorf remained dormant until February, 1954, when they purchased stock in a Nevada corporation. Thereafter, the corporations invested in other clubs, and leased slot machines in Nevada as their primary business activities.[33] Apparently both corporations received payments from another corporation owned by Graves. The IRS claimed, *inter alia*, that Saratoga and Waldorf should not be allowed surtax credits because they were revived for the sole purpose of utilizing their surtax credits, i.e. for the purpose of avoiding taxes under section 269 of the Code. The IRS' argued in its brief that, "...the revival of dormant corporations for use in entirely different circumstances with funds borrowed from related entities, as was done here, is the equivalent of the 'acquisition' of the corporations under section 269 of the Internal Revenue code of 1954." The court disagreed. It concluded that under section 269, "control" is defined in terms of stock ownership, and that "[t]he revival of a dormant corporation does not constitute the acquisition of ownership of stock." Thus, because Graves owned the requisite percentage of shares to constitute control before the corporations entered Nevada, and this control was not broken prior to the transfer of slot machines, there could not have been an acquisition of control when the corporations entered into the slot machine business.

The court noted further that there is no language in section 269 to support the IRS' position, and that even the cases cited to by the IRS did not support its argument, because they all involved transactions where those who revived the corporations did not have control of them prior to the revival.

PGH owned all the stock of Oneida both before and after its revival. Thus, based on the foregoing discussion, we believe that the revival of Oneida should not be treated as an "acquisition of control" under section 269(a)(1) of the Code.

b. Section 269 and the De Facto Dissolution Doctrine

Courts have applied the de facto liquidation doctrine to prevent corporations which exist as mere "shells" from utilizing unused excess profit tax credits, or from carrying back net operating losses in situations not intended by Congress. Under this doctrine, such corporations are deemed to have been dissolved in a de facto liquidation such that the tax attributes ceased to exist prior to such corporations' improper use. *See* Rev. Rul. 61-191, p. 253-254, 1961-2 CB 251. *See also*, *American Well & Prosp. Co. v Commissioner of Internal Revenue*, 232 F.2d 934, 49 AFTR 1030, 56-1 USTC P 9388 (3rd Cir. 1956), cert. den. 77 S.Ct. 61, 1 L.E.2d 57 (1956), (corporation's use of unused excess profits tax credits disallowed based on the court's conclusion that it had been dissolved de facto prior to engaging in new business); *Wier Long Leaf Lumber Company v. Commissioner of Internal Revenue*, 173 F.2d 549, 551-553, 37 AFTR 1164, 49-1 USTC P 5930 (5th Cir., 1949), affirming and reversing in part 9 T.C. 990 (1947), (excess profits credit carry-back properly denied where liquidating corporation dissolved de facto); *Winter & Company, Inc. v. Commissioner of Internal Revenue*, 13 T.C. 108 (1949) (once a corporation is

[33] Nothing in the facts indicates that Saratoga or Waldorf ever reorganized as Nevada corporations.

de facto liquidated, its unused excess profits credits terminate, and may not be used again; and net operating loss carryback properly denied where corporation dissolved de facto). A corporation will be considered dissolved de facto for purposes of such credits or carrybacks, if it has, "disposed of all or most of its operating assets, terminated its business activities, and become a mere shell, a corporation in name and semblance only, without real corporate substance, serving no real corporate purpose, and having no valid or compelling reason for continuing its existence, even though not formally dissolved." Rev. Rul. 61-191, p. 253-254, 1961-2 CB 251. *But see, Anbaco-Emig Corp. v. Commissioner of Internal Revenue*, 49 T.C. 100, 103, 107 (1967), acq. in result, 1968-2 C.B., acq. in result 1968-1 C.B. (corporation not de facto dissolved where it merely "discontinued one line of endeavor and after a relatively short period of time entered into another," for purposes of carrying over net operating losses). The de facto liquidation doctrine heretofore has not been applied by the courts to treat the revival of a dormant corporation as an "acquisition of control" within the meaning of section 269 of the Code.

A corporation that retained only intangible assets consisting of credits on the parent corporation's books in respect of transferred tangible assets, and of accounts receivable, was considered de facto dissolved, and therefore could not take advantage of excess profits credits and net operating loss carrybacks. *See Winter & Co., supra* at 120. *See also, American Well & Prosp. Co., supra* at 1034-1035 (corporation dissolved de facto when it had sold all of its assets and been dormant for two years before entering new business). The corporation in question, Winter & Co., was a subsidiary that assembled pianos for sale to the parent company's customers. Intercompany transactions were settled by bookkeeping entries of offsetting credits and debits. When it was determined that Winter & Co. should be liquidated, all tangible assets were transferred to the parent corporation, leaving only credit entries on the parent corporation's books, it ceased all operations, and had no earnings or business expenses. The court's conception of the purpose for provisions for the carry-over and carry-back of unused excess profits credits from a current tax year was to level the burden of excess-profits taxes over a period not exceeding five years of a going concern. It was inconceivable to the court that Congress would have intended for the excess profits credit to apply to nonoperating years. Thus, the court's conclusion that the corporation in *Winter & Co.* had been dissolved de facto, was based on the specific facts, as well as on the court's belief that Congress would not have intended for the carrybacks to be taken under such circumstances. *Id.* at 117.

In a case where the corporation in question was actually revived, and substantially the same shareholders sought to carryover losses from the prior business, the Tax Court was unwilling to apply the de facto dissolution doctrine, because it was "resistant" to reading "a limitation into the statute which [was] not there as an express limitation." [34] *Anbaco-Emig*,

[34] In refusing to apply the de facto dissolution doctrine to loss carryforwards, the *Anbaco-Emig* court stated, "We note that Congress adopted the [] theory of de facto liquidation in excess profits credits cases when it passed sec. 432(e) of the 1939 Code in 1949. Such section eliminated the excess profits credit in cases where the courts had previously found a de facto liquidation. That no such legislation has been adopted in the net operating loss area by

supra at 107. In *Anbaco-Emig*, a corporation engaged in the tool and die business, had sold all of its machinery, fixtures, and inventory, and, after remaining inactive for two years, was revived by the same shareholders to engage in an entirely different business, the renting of a loft building. *See id.* at 100-101. The court concluded that it was the same "taxpayer" for purposes of the net operating loss provisions, and that therefore, the "revived" corporation could take advantage of the net operating losses incurred in the tool and die business. *Id.* at 107. In reaching this conclusion, the court stated that, "courts have looked not only to the facts of each individual case, but also to the different provisions of the tax law under consideration and the underlying purpose of Congress in enacting the various provisions," to determine whether or not to apply the de facto dissolution doctrine to prevent a corporation from utilizing certain tax benefits. *See Anbaco-Emig, supra* at 105-106. Thus, because there was ample authority to support a corporation's use of net operating loss carryovers to offset profits in a wholly new activity, as long as the ownership of the corporation remained substantially unchanged,[35] and Congress had not modified the statute to disallow such use of loss carryovers, the court believed that Congress did not intend for the de facto dissolution doctrine to apply in such circumstances. *Id.* at 107.

In a case involving the merger of a successful partnership into a loss corporation owned by the partners, the court was unwilling to apply the de fact dissolution doctrine, despite the facts that the loss corporation's main business activity was servicing its debt, and the corporation engaged in an entirely different business activity after the merger. *See Wofac Corporation v. U.S.*, 1607, 269 F. Supp. 654, 19 AFTR 2d 1601, 67-2 USTC P 9532 (1967). In *Wofac*, four partners engaged in the management consulting business had organized a New York corporation, Warsaw Button Co., to engage in the woodworking business. The management consulting business flourished, and the woodworking business failed and accumulated losses. After a number of years, during which one of the partners had left and been bought out in both enterprises, the three remaining partners wished to reorganize their partnership as a corporation. They did so by transferring the partnership assets and business to the already-established, New York corporation, Warsaw Button Co. In the same transaction, the name of Warsaw Button Co. was changed to The Work-Factor Company, Inc. The corporation was subsequently redomesticated to Delaware, and its name was ultimately changed to Wofac Corporation ("***Wofac***").

One of the arguments made by the IRS was that the corporation should be treated as dissolved de facto because other than servicing its debt, it had engaged in no business activities for a period of four years, and that the corporate "shell" had been maintained by the shareholders for the sole purpose of preserving its net operating losses. Thus, the IRS claimed that section 269 should apply to disallow the loss deductions from the old business by the new business. The court rejected this argument with respect to the partnership transfer, stating that "unless there

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Congress indicates recognition of the distinction between net operating loss deductions and excess profits tax credit deductions." *Anbaco-Emig*, 49 T.C. at 107, n.3.

[35] The court cites to Rev. Rul. 63-40, 1963-1 CB 46, to support this proposition.

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was in fact a dissolution of the loss corporation, the net operating losses were proper allowances..." *Id.* at 1611. The court proceeded to list the facts which would support a finding that the corporation continued as "an active, affirmatively functioning corporation." *Id.* It noted that the Warsaw Button Co. was not a mere "shell," for purposes of the de facto dissolution doctrine. It had sales of $1,120 between 1951-1953, and held assets worth approximately $45,000 between 1953-1957, the corporation continued to meet its mortgage and tax obligations, paid franchise fees, and filed tax returns.

Oneida is not attempting to take any excess profits credits or utilize net operating losses from its previous business activities. Moreover, there has been no change in the ownership of Oneida. Thus, based on the foregoing discussion, we believe that Oneida should not be treated as dissolved in a de facto liquidation, and, therefore, that the revival of Oneida for use in a new business activity should not constitute an acquisition of control within the meaning of section 269 of the Code.

c. Section 269 and the redomestication of Oneida

The redomestication of a corporation from one State to another (pursuant to section 368(a)(1)(F)) does not constitute an "acquisition of control" within the meaning of section 269(a)(1), as long as there has not been more than a minor change in stock ownership. *Wofac supra. See also, Southland Corp. v. Campbell*, 358 F.2d 333, 336, 17 AFTR.2d 673, 66-1 USTC P 9347 (5th Cir., 1966). Therefore, a redomesticated corporation should be treated as the same entity for federal income tax purposes. *See e.g., Wofac, supra* at 1607, *Newmarket Mfg. Co. v. U.S.*, 233 F.2d 493, 499, 49 AFTR 1254, 56-1 USTC P 9540 (1 Cir. 1956), cert. den. 353 U.S. 983 (1957) (after "F" reorganization, two corporate entities treated for substantive purposes in income tax as the same taxpayer); Rev. Rul. 96-29, 1996-1 CB 50; Rev. Rul. 87-110, 1987-2 CB 159 (a section 361 exchange of a partnership interest was not an "exchange" because in a section 368(a)(1)(F) reorganization, "there is virtually no change in the identity of the shareholders and their interests or in the assets involved"); Rev. Rul. 80-168, 1980-1 CB 178 (mere change in place of incorporation, qualifying under section 368(a)(1)(F), does not terminate corporation's election to be treated as possessions corporation under section 936); Rev. Rul. 73-526, 1973-2 CB (under section 1.381(b)-1(a)(2) of the regulations, acquiring corporation treated just as the transferor corporation would have been treated in the absence of a reorganization); Rev. Rul. 64-250, 1964-2 CB 333 ("F" reorganization did not cause termination of election under section 1372).

There was no "acquisition of control" under section 269 when taxpayers, who transferred assets and liabilities from a partnership to a previously-owned corporation, were the "sole owners of both the surviving corporation and the absorbed partnership." *See Wofac supra* at 1607. *See, also, Southland supra* at 336 (no "acquisition of control" within meaning of section 269, when merged subsidiaries owned by same shareholders); *Jackson Oldsmobile, Inc. v. United States*, 237 F.Supp. 779, 782, 15 AFTR.2d 35, 65-1 USTC P 9113 (1964), affirm., 371 F.2d 808 (5th Cir. 1967) (no "acquisition of control" within meaning of section 269 when

corporation owned by same shareholders engaged in entirely different business activity). As discussed above, in *Wofac*, the three partners transferred the partnership assets and business to the already-established, New York corporation, Warsaw Button Co., and in the same transaction, changed the name of Warsaw Button Co. to The Work-Factor Company, Inc. They subsequently formed a new shell corporation in the State of Delaware, known as The Work-Factor Company, Inc., transferred the assets and liabilities of the New York corporation bearing the same name to the new Delaware corporation, and dissolved the New York corporation. The name of the Delaware corporation was ultimately changed to Wofac Corporation.

Wofac claimed it was entitled to carryover net operating losses sustained from its prior activities in the woodworking business pursuant to section 172 of the Code. The IRS argued that section 269 should apply to disallow the deductions, because the transfer of the partnership assets and business and subsequent reorganization was part of a plan to avoid income taxes. The court rejected the IRS' argument based on its conclusion that there had been no "acquisition of corporate control" under section 269, because "the stockholders were the sole owners of both the surviving corporation and the absorbed partnership." *Wofac, supra* at 1607. The court stated that the.

> "...acquisition of control of one corporation by another corporation cannot arise where, as in the instant case, the stockholders were the sole owners of both the surviving corporation and the absorbed partnership. At the time of the transfer of the profitable partnership business to the loss-experience corporation, the stockholder-partners owned both. So that the 'acquisition of control' element of section 269 was not met." *Wofac, supra* at 1607.

The court concluded further that the change of the New York corporation to the Delaware corporation, constituted "a mere change in domicile" and that such a change had "no greater tax significance than a like change of domicile by an individual taxpayer." *Wofac, supra* at 1612. *See also, Newmarket, supra* at 498 ("...taxation is an intensely practical matter, which ought to turn upon economic realities rather than upon technical differences of the corporate entity consequent upon the migration of a corporation from one state to another").

Additionally, LTR 8908030 indirectly supports the conclusion that after an "F" reorganization, the new corporation is the same entity for tax purposes. It held that the new corporation in an "F" reorganization should be treated the same as the absorbed corporation under the stapled stock rules of the Code. In that ruling, corporation O was merged into corporation N in an "F" reorganization. Corporation O's stock was stapled to corporation A. Part of the ruling held that corporation N and corporation A would be considered stapled entities under section 269B(a)(1). However, because corporation O and corporation A were stapled entities on June 30, 1983, pursuant to the legislative history of section 269B, corporation O and corporation A were exempt from the stapled stock rules. The ruling held that corporation A would continue to be exempt from the stapled stock rules of section 269B. The ruling further held that corporation N, as a successor to corporation O, and corporation A would be considered

to have been stapled entities on June 30, 1983. The legislative history to section 269B states that those rules "do not apply to U.S. corporations stapled to Puerto Rican corporations on June 30, 1983." Therefore, the ruling held indirectly that corporation N was considered to be the same corporation as corporation O for tax purposes.

Oneida merely changed its domicile from Oregon to Delaware pursuant to section 368(a)(1)(F). Moreover, there was no change in stock ownership. Therefore, based on the foregoing discussion, we believe that the redomestication of Oneida in Delaware should not constitute an "acquisition of control" under section 269(a)(1).

d. Indirect Control Through Partnership

Should PGH reacquire the shares of Oneida in the future, a determination of whether PGH has "maintained" control or "acquired" control may be necessary. The legislative history of the predecessor of section 269 describes the scope of the "control" requirement in pertinent part as follows:

> If a controlled or affiliated group existed on October 8, 1940 [the effective date of the predecessor of current section 269], transfers thereafter within the group could not amount *to the acquisition of such control by the parent or its controlling interest. Control once acquired could not be again acquired, unless the group was in some way broken. A mere shift in the form of control--from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect--can not, therefore, amount to the acquisition of control within the meaning of section 115 of the bill.*

S. Rep. No. 627, 78th Cong., 1st Sess. 61 (1943), 1944 C.B. 973, 1016 (emphasis added).

The Treasury Regulations under section 269 faithfully implement the intent of Congress as confirmed in the above passage:

> For control to be "acquired on or after October 8, 1940," it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940, and at all times thereafter, owns 40 percent of the stock of X Corporation and acquires on October 8, 1940, an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940, such assets to a newly organized Y Corporation in exchange for all the stock of Y Corporation, an acquisition within the meaning of such phrase is made by B on October 8, 1940. *If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Z Corporation, then an acquisition within the meaning of such phrase is also made by Z Corporation, on October 8, 1940,*

> *as well as by the shareholders of Z Corporation taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of Z on such date.*

Treas. Reg. section 1.269-1(c) (emphasis added).

The Tax Court recognized this fundamental aspect of section 269 in *Brick Milling Co. v. Commissioner*, 22 T.C.M. (CCH) 1603 (1963). Stating that the stock attribution rules of section 318 did not apply in the section 269 context,[36] the Tax Court carefully distinguished between *constructive* ownership under the attribution rules of section 318 and *indirect* ownership:

> The indirect control provision of section 269(a) requires that there be ownership *although it may be one or more steps removed, as in the case of a subsidiary of a directly owned parent corporation. See* S. Rept. No. 627, 78th Cong., 1st Sess., pp. 60-61 (1943), 1944 C.B. 973, 1016; sec. 1.269-1(c), Income Tax Regs. It has been held that when two brothers acquire ownership of in excess of 50 percent of a taxpayer's outstanding shares, no constructive ownership between brothers is dictated by . . . section 267 . . . . Also, the attribution rules of section 318 are inapplicable since they apply only to subchapter C of the 1954 Code . . . .

(Emphasis added).

The analysis in Revenue Ruling 80-46, 1980-1 C.B. 62, also is instructive on the indirect control issue. In that ruling, individual A owned 100 percent of the stock of M corporation and 10 percent of the stock of X corporation. M owned 45 percent of X's stock, and X itself owned all the stock of Y corporation and Z corporation. In the transaction, X merged into M Corporation for the proscribed principal purpose. By reason of the merger, M Corporation directly acquired all the stock of Y Corporation and Z Corporation.

The principal issue addressed by the ruling was "whether the X stock owned directly by A before the merger can be attributed to M so that M had control of X before the merger and therefore did not acquire it within the meaning of section 269(a)(1)." Implicit in this formulation of the issue (and explicit in the ruling's rationale) were that M indirectly owned 45 percent of the stock of Y and Z for purposes of the section 269 control analysis.

Relying on the Tax Court's *Brick Milling* opinion, the Service in Revenue Ruling 80-46 reasoned as follows:

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[36] The attribution rules contained in section 318 are not applicable for purposes of section 269 because those rules apply only to subchapter C of the Code, whereas section 269 is in subchapter B.

> In the present situation, M directly owned only 45 percent of X and thereby indirectly owned *only 45 percent of Y and Z* before the merger. The 10 percent interest in X held by A cannot be attributed to M because there are no rules of constructive ownership of stock expressly made applicable to section 269.

(Emphasis added). Had M directly owned 50 percent of X, M clearly would have been deemed to be in indirect control of Y and Z, so that the transaction there at issue, although undertaken for a bad purpose, would not have been within the scope of section 269(a)(1).[37]

Thus, to the extent that pursuant to the exercise of its Retirement Right, PGH selects for distribution the stock of Oneida, the distribution by the Partnership and acquisition by PGH of 100% of the stock of Oneida should not be considered an acquisition of "control" within the meaning of section 269(a). It must be remembered that the "directly or indirectly" language of section 269 only deems control to have continuously existed where the upstream/downstream relationship of the benefited parties is maintained. Accordingly, as the 95% partner (by profits and capital) of the Partnership, PGH should be treated as having indirect ownership of more than Oneida held by the Partnership. Since Oneida has been an "old and cold" subsidiary of PGH since prior to the contemplation of the Transaction, Oneida should be treated as continuously controlled by PGH, even after the contribution of its stock to the Partnership.

6. CONCLUSION

Based on the foregoing analysis, we believe that the opinions expressed in section A through H above should not be subject to change under the business purpose doctrine, section 269 of the Code, the substance-over-form doctrine, or the partnership anti-abuse regulations promulgated under section 701 of the Code.

Sincerely,

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.

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37 Nor would the transaction have been within the scope of section 269(a)(2), since the property--the stock of Y and Z--would have been acquired by M from a corporation--X--that M controlled (directly) immediately before the acquisition.