Labels Don't Count: The Fifth Circuit Looks at Sham Partnerships.

When we think of federal tax law, we tend to think of statutes and regulations, but judicial principles developed through case law play an important role. One of the more important judicial principles in the area of taxation is the rule that the tax consequences of a transaction are based upon its substance, not its form.

The Fifth Circuit applied this principle last week in addressing two partnership transactions undertaken by Dow Chemical Company. *Chemtech Royalty Assocs., L.P. v. United States,* 2014 U.S. App. LEXIS 17490 (5th Cir. Sept. 10, 2014). In the transactions, Dow and a group of foreign banks set up two partnerships; after the IRS refused to treat the partnerships as legitimate entities, Dow filed a challenge to the final partnership administrative adjustment. After trial, the district court concluded that the partnerships were shams, and Dow then appealed.

The partnerships were financial products developed by Goldman Sachs and were known as Special Limited Investment Partnerships. Goldman promoted them as a tax shelter. *Id.*, slip op. at *3. The transactions involved a series of steps: first, a U.S. corporation would identify valuable assets with a tax basis at or near zero; second, the corporation would pick subsidiaries through which it would participate; third, the corporation had to locate foreign entities willing to participate, as the design was to yield tax benefits by assigning income to a foreign (and hence tax-indifferent) party; fourth, the parties would prepare the various governing agreements, which typically focused on asset leasing. *Id.*, slip op. at *3 & n.3.

The first partnership that Dow developed involved patents- it picked 73 patents to contribute to the partnership, which was formed in 1993. These patents had some common characteristics: they were among its most valuable patents; they had a minimal tax basis; and they were actively used by Dow or its operating units. *Id.*, slip op. at *4. The contributions to the partnership were limited in scope; Dow did not contribute all of the technology; the district court found that the technology contributed would not have permitted a third party to obtain a license from the partnership and Dow. *Id.*, slip op. at *4-*5. Dow created two subsidiaries, DTFC and Ifco, and used a wholly-owned foreign subsidiary, DESA, to carry out the transaction. Dow formed Chemtech Royalty Associates, L.P. as a Delaware Limited Partnership with a principal place of business in Switzerland, contributing, through its newly formed subsidiaries, 73 patents, $110 million in cash, and all of the stock of an existing shell corporation, CPI. *Id.*, slip op. at *5.

Five foreign banks agreed to be limited partners, and Ifco's partnership share was retired. The banks invested $200 million in the partnership. Once the partnership was capitalized, DESA, the newly formed foreign subsidiary and general partner, owned 1%, DTPC, the newly formed domestic subsidiary, owned 81%, and the foreign banks owned the remaining 18%. *Id.*, slip op. at *5-*6.

The partnership documents included a partnership agreement, a patent license agreement, and a variety of indemnity agreements. Dow continued to use the patents and was responsible for all of the associated costs; the partnership received royalties for Dow's right to use patents, but the royalties were payable even if the patents were not used. *Id.*, slip op. at *6. The partnership operated from April 1993 through June 1998. It earned $646 million from Dow's royalty payments, but reported only $61.7 million in profits due to depreciation. From its profits in paid a priority return to the banks, a 1% return to DESA and a small distribution to each partner to cover Swiss tax obligations. *Id.*, slip op. at *7. The balance was invested in Dow's subsidiary CPI,

which was owned by the partnership and which lent most of the cash back to Dow. *Id.*, slip op. at *10. Subsequently, Dow entered into a similar transaction in 1998, this time involving a chemical plant.

The district court concluded that the partnerships were shams, and on appeal, Dow argued that they could not be shams because the banks had interests in the partnerships that were not properly classified as debt. Since the banks did not hold debt, Dow asserted that the partnerships must have been legitimate partnerships without regard to any other criteria. *Id.*, slip op. at *14.

The Fifth Circuit commenced its analysis by focusing on the two requirements for a partnership: a good faith intent to act for a business purpose, and an intent to share profits and losses. *Id.*, slip op. at *19. In conducting this analysis, the Court rejected Dow's contention that it first had to focus on whether the interests of the banks was debt. *Id.*, slip op. at *21-*25. Instead, the court focused on whether Dow intended to share profits and losses with the banks. *Id.*, slip op. at *25.

Here, Dow came up short on the facts. The Fifth Circuit noted that the transactions were structured "to ensure that Dow paid the foreign banks a fixed annual return on their investment," and that return was not dependent upon the operating results of the partnerships. *Id.*, slip op. at *26. In addition, Dow indemnified the banks from any loss associated with either partnership operations or taxes. *Id.*, slip op. at *27. Finally, the banks had no realistic opportunity to share in any upside, which would have required the patents to appreciate in value, a scenario that none of the parties expected to occur. *Id.*, slip op. at *29. In light of these factors, the Fifth Circuit concluded that the district court's finding that the partnerships were shams was not clearly erroneous.

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