

No. \_\_\_\_\_

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IN THE  
Supreme Court of the United States

—  
PIMLICO, LLC,  
*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

—

On Petition for a Writ of Certiorari to the  
United States Court of Appeals for the Second Circuit

—

**PETITION FOR A WRIT OF CERTIORARI**

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**QUESTIONS PRESENTED**

1. Whether the United States Court of Appeals for the Second Circuit erred in refusing to review the evidentiary error that infected the Tax Court’s opinion, issued nine years after trial, on the grounds that, although the appellant made extensive arguments regarding the error in the body of its brief, it waived its right to have the error considered under the plain error standard of review by citing to that standard of review in a footnote.
2. Whether the Internal Revenue Service’s anti-textual anti-abuse rule, 26 C.F.R. § 1.701–2, which permits the Commissioner to “recast” a partnership transaction to achieve the Commissioner’s preferred tax result even if, as here, the transaction “fall[s] within the literal words of a particular statutory or regulatory provision,” is invalid under this Court’s decision in *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024).

## LIST OF PARTIES AND PROCEEDINGS

Petitioner is PIMLICO, LLC. Respondent is the Commissioner of Internal Revenue.

Pursuant to this Court's Rule 29.6, Petitioner states that it has no parent corporation and that no publicly held company owns 10% or more of its stock.

Related proceedings:

*PIMLICO, LLC v. Commissioner of Internal Revenue*, No. 24-1982, U.S. Court of Appeals for the Second Circuit. Judgment of Tax Court affirmed on August 11, 2025. Panel rehearing and rehearing en banc denied on November 4, 2025.

*PICCIRC, LLC, PIMLICO, LLC, A Partner Other than the Tax Matters Partner, Petitioner v. Commissioner of Internal Revenue, Respondent*, No. 4308-12, U.S. Tax Court. Judgment entered on April 22, 2024.

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## **PETITION FOR A WRIT OF CERTIORARI**

PIMLICO, LLC respectfully petitions for a writ of certiorari to review the decision of the United States Court of Appeals for the Second Circuit.

### **OPINIONS BELOW**

The decision of the Second Circuit (Pet. App. 1a–7a) is reported at 2025 WL 2304663. The Tax Court’s judgment (Pet. App. 8a–26a) is reported at 2024 WL 1716496. The Second Circuit’s denial of panel rehearing and rehearing en banc (Pet. App. 27a–28a) is unreported.

### **JURISDICTIONAL STATEMENT**

The Second Circuit entered its order affirming the judgment of the Tax Court on August 11, 2025. The Second Circuit denied panel rehearing and rehearing en banc on November 4, 2025. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

### **PROVISIONS INVOLVED**

This case involves 26 U.S.C. § 704 (Pet. App. 29a–32a); 26 U.S.C. § 707 (Pet. App. 33a–34a); 26 C.F.R. § 1.701–2 (Pet. App. 35a–66a); and 26 C.F.R. § 1.707–3 (Pet. App. 67a–82a).

### **INTRODUCTION**

This case concerns a tax deduction recognized by a partnership, PICCIRC, LLC (the “Partnership”), over twenty years ago, in 2002. The Partnership’s 2002 deduction flowed to Petitioner-Appellant,

PIMLICO, LLC (“Petitioner”)—which was itself a partnership—and was recognized by Petitioner’s tax matters partner, John D. Howard, on his individual income tax returns for 2003 and 2004. Before claiming the deduction on his returns, Howard confirmed the deduction’s validity by obtaining opinion letters from an internationally recognized accounting firm, BDO Seidman LLP (“BDO”), and a prominent law firm, Proskauer Rose LLP (“Proskauer”). Additionally, Howard’s return preparer, PricewaterhouseCoopers (“PwC”), agreed that Howard was entitled to the deduction and included it on his return.

The deduction at issue was not only proper but was, in fact, *required* by the Internal Revenue Code (the “Code”) in effect in 2002. Indeed, Congress amended the relevant statutory provisions through the American Jobs Creation Act of 2004 (the “AJCA”) with the express purpose of eliminating *on a going forward basis* lawful tax deductions like the one recognized in this case. Notwithstanding the law in effect at the time, as confirmed by three leading professional firms, in November 2011, after a prolonged audit process, the Internal Revenue Service (“IRS”) issued a Notice of Final Partnership Administrative Adjustment (the “FPAA”) disallowing the approximately \$23 million deduction claimed on the Partnership’s 2002 tax return (the “2002 Deduction”).

Petitioner promptly filed an action in the United States Tax Court challenging the FPAA. A trial was held in March 2015, and the parties

completed their post-trial briefing in July 2015. After an unconscionable delay of nearly *nine years*, on April 22, 2024, the Tax Court issued a cursory twelve-page Memorandum Findings of Fact and Opinion (the “Memorandum Opinion”)—which relied almost exclusively on the parties’ pre-trial stipulated facts and contained less than six pages of legal analysis—sustaining the IRS’s determinations in the FPAA. In relevant part, the Tax Court’s opinion had two fatal flaws: (1) relying on clearly inadmissible hearsay, the Tax Court erroneously found that the transactions underlying the tax deduction at issue constituted a “disguised sale,” pursuant to the presumption under 26 U.S.C. § 707(a)(2)(B) and 26 C.F.R. § 1.707–3(c)(1) and (2) the Tax Court incorrectly concluded that the 2002 Deduction should be invalidated under the anti-abuse rule codified at 26 C.F.R. § 1.701–2(b), which permits the Commissioner to unilaterally “recast [a partnership] transaction for federal tax purposes” even if that transaction “fall[s] within the literal words of a particular statutory or regulatory provision.”<sup>1</sup>

Petitioner timely appealed to the United States Court of Appeals for the Second Circuit, challenging each of the bases for the Tax Court’s opinion, including the Tax Court’s reliance on hearsay evidence in concluding that the disguised sale presumption applied, and arguing that the anti-textual anti-abuse rule is invalid under *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024). The

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<sup>1</sup> Citations to the Code and Treasury regulations are to the versions in effect in 2002.

Second Circuit affirmed the judgment of the Tax Court in a summary order that improperly applied the disguised sale presumption based on plainly inadmissible hearsay evidence. The Second Circuit declined to address the applicability of *Loper Bright*.

In reaching its decision, the panel deemed Petitioner to have waived its argument that the decision of the Tax Court should be reversed under the plain error standard of review by presenting that argument in a footnote. In doing so, the panel ignored the extensive arguments that Petitioner had presented in the body of its brief addressing the same claim of error under the *de novo* standard of review. In deeming Petitioner to have waived its argument as to plain error, the Second Circuit also abdicated its “responsibility to decide cases properly before it, even those it would gladly avoid.”

*Zivotofsky ex rel. Zivotofsky v. Clinton*, 566 U.S. 189, 194 (2012) (internal quotation marks omitted). The Second Circuit’s decision conflicts with the rule applied in at least six other circuits, under which appellate courts are *obligated* to apply the correct standard of review regardless of the parties’ arguments. *U.S. Tobacco Coop. Inc. v. Big S. Wholesale of Va., LLC*, 899 F.3d 236, 256 n.6 (4th Cir. 2018) (collecting cases). Its error goes to the heart of the role of federal Courts of Appeals, and therefore presents an exceptionally important question warranting grant of the petition.

The petition also should be granted because the anti-abuse rule, which permits the Commissioner to “recast” a partnership transaction to achieve the

Commissioner's preferred tax result even if the transaction "fall[s] within the literal words of a particular statutory or regulatory provision," and which the Tax Court invoked in affirming the IRS's treatment of the 2002 Deduction, is invalid under this Court's decision in *Loper Bright*. This case demonstrates clearly the dangers of the anti-abuse rule. The tax deduction recognized in the Partnership's 2002 tax return was *required* under the Code as it stood at the time of the underlying transaction and, while the AJCA altered the treatment of similar transactions on a going-forward basis, Congress did not make those changes retroactive. Nevertheless, the Commissioner invoked the anti-abuse rule in this case to retroactively impose tax liability. Leaving the Tax Court's endorsement of the Commissioner's use of the anti-abuse rule intact will prejudice taxpayers across a wide array of cases—even those that bear no factual resemblance to this one. Grant of the petition is warranted to avoid prejudice in future cases.

## **STATEMENT OF THE CASE**

### **I. Factual Background**

#### **A. The Investment Opportunity**

Petitioner's tax matters partner, John D. Howard, has over four decades of experience investing in distressed companies and assets. CA2

A-40-41, 1550-66.<sup>2</sup> During the relevant period, Mr. Howard's personal investments had a particular focus on distressed companies and assets, reflecting his belief that, although there had been a major economic downturn in the early 2000s, there would be a quick correction. CA2 A-1559-62. In 2002, the global accounting firm BDO introduced Howard to Gramercy Advisors LLC ("Gramercy"), a well-known investment advisory firm specializing in investing in distressed foreign assets. CA2 A-37-39, 1357, 1570-71.

Following a presentation by Gramercy, Howard entered into an investment opportunity involving a pool of Brazilian receivables (the "Investment Opportunity"). Howard testified that he understood the Investment Opportunity could generate a substantial profit from the development and sale of Brazilian receivables referred to as "duplicatas" (the "Duplicatas"). CA2 A-42, 1573. Under Brazilian law, *duplicatas* are orders for payments issued by a creditor to a debtor related to the sales of goods or services that are evidenced by an invoice. CA2 A-1073-75. Howard saw the Investment Opportunity as having "significant upside" based on his understanding that, in the past, Gramercy had generated "significant recoveries" from similar investments. CA2 A-1573. BDO explained to Howard that the Investment Opportunity also carried with it an added benefit: if the Duplicatas did not generate a return on Howard's investment, the structure of the

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<sup>2</sup> Citations in the Form "CA2 A" and "CA2 SPA" refer to pages in the appendices submitted to the Second Circuit.

Investment Opportunity presented “potentially significant tax benefits.” CA2 A-1633.

The Duplicatas were originally owned by a Brazilian company named Santa Bárbara Indústria e Comércio de Ferro Ltda. (“Santa Bárbara”), a privately owned Brazilian metal products supplier. Santa Barbara issued the Duplicatas to Encol S/A Eng. Comércio Indústria (“Encol”), a Brazilian construction company, in 1996. CA2 A-42, 111–407. The Duplicatas had a face value of 28,740,000 Brazilian Reals, or approximately \$28 million under the exchange rates in effect when the Duplicatas were issued. CA2 A-42–43.

The Investment Opportunity was carried out through a multi-tiered partnership structure, in which Santa Bárbara first contributed the Duplicatas in exchange for a partnership interest in an entity named XBOXT LLC (“XBOXT”). XBOXT then contributed a portion of the Duplicatas in exchange for a partnership interest in Petitioner, which interest was subsequently acquired by Howard. Finally, Petitioner contributed all of the Duplicatas it had received from XBOXT to the Partnership in exchange for an interest in the Partnership. CA2 A-42–47.

After Petitioner contributed the Duplicatas to the Partnership, Howard was not involved in the management of those assets. CA2 A-1582–83. Rather, he relied on Gramercy, which had expertise in foreign distressed debt investments, to maximize the value of the Duplicatas. CA2 A-1582–83. Unbeknownst to Howard, on December 26, 2002, the

Partnership sold its entire interest in the Duplicatas for \$357,144.29. CA2 A-49, 1583.

### B. The Tax Impact of the Sale of the Duplicatas

When a partner contributes property in exchange for an interest in a partnership, “the transaction is tax-free to both the partner and the partnership.” *BC Ranch II, L.P. v. Comm'r of Internal Revenue*, 867 F.3d 547, 556–57 (5th Cir. 2017) (citing 26 U.S.C. § 721). Instead of being taxed at the time of the contribution, the partnership assumes the contributing partner’s tax basis in the property, and taxation is deferred until the property is sold. *See Southgate Master Fund, L.L.C. v. United States*, 659 F.3d 466, 471 & n.9–10 (5th Cir. 2011) (citing 26 U.S.C. § 723; 26 C.F.R. § 1.723–1).<sup>3</sup>

Ordinarily, a contributing partner’s basis in contributed property is the cost of the property to that partner. Willis et al., *Partnership Taxation* (“Willis”) ¶ 5.02 n.25 (Sept. 2025 ed.). If the fair market value of the contributed property is lower than the property’s cost to the contributing partner, the property is referred to as having a “built-in loss” because the partner’s basis in the property passes to the partnership under 26 U.S.C. § 723. *Southgate*, 659 F.3d at 472. In 2002, Section 704(c) of the Code required that, when a partner (here, XBOXT) transferred its partnership interest to another

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<sup>3</sup> “Tax basis is the amount used as the cost of an asset when computing how much its owner gained or lost for tax purposes when disposing of it.” *United States v. Woods*, 571 U.S. 31, 35 (2013).

partner (Howard), the transferee stepped into the transferor's shoes, assuming its share of any built-in loss. *See* 26 U.S.C. § 704(c)(1); 26 C.F.R. § 1.704–3(a)(7).

Consistent with the governing statutes, Santa Bárbara's basis in the Duplicatas was their cost to Santa Bárbara (their face value). Pursuant to Sections 704, 721, and 723 of the Code, the built-in loss followed the Duplicatas as they were contributed first to XBOXT, then to Petitioner, and ultimately to the Partnership. Accordingly, when the Partnership sold the Duplicatas for less than their face value, the Partnership was *entitled* to an ordinary loss deduction of \$22,718,351, which it claimed on its 2002 partnership return (*i.e.*, the 2002 Deduction). CA2 A-47–49, 952.

In 2004, Congress amended the Code to preclude, on a going forward basis, the type of deduction that the Partnership recognized in its 2002 return. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(a), (d), 118 Stat. 1418, 1589, 1592 (2004) (limiting the built-in loss that may be recognized by partners other than the original contributing partner). In doing so, however, Congress expressly recognized that the version of the Code in effect at the time of the transaction at issue in this case “allowed” for tax deductions like the 2002 Deduction and did not make the change retroactive. H.R. Rep. 108-548(I), 2004 WL 1380512, at \*283 (2004).

As a partner in Petitioner, Howard claimed flow-through deductions from the Partnership's 2002

Deduction proportionate to his interest in Petitioner and Petitioner's interest in the Partnership. CA2 A-2001, 2047. Before claiming the deduction, Howard received separate opinion letters from BDO and Proskauer confirming the validity of the 2002 Deduction, and approval from PwC when the firm prepared and signed Howard's individual tax returns. CA2 A-722-24, 813-15, 1588.

### **C. The Final Partnership Administrative Adjustment**

On November 15, 2011, more than eight years after the Partnership filed its 2002 return, the IRS issued a Final Partnership Administrative Adjustment (the "FPAA"). CA2 A-960-71. The FPAA disallowed the 2002 Deduction on several grounds. Insofar as is relevant to this Petition, the FPAA concluded that: (1) Santa Bárbara's contribution of the Duplicatas was a disguised sale, as opposed to a true partnership contribution; and (2) the Partnership's principal purpose was to reduce its partners' tax liabilities, and therefore should be disregarded under Treasury Regulation 1.701-2, the anti-abuse rule. CA2 A-968-70.

## **II. The Proceedings Below**

### **A. Tax Court Proceedings**

Petitioner timely filed a petition for readjustment of the FPAA pursuant to 26 U.S.C. § 6226(d) in the Tax Court on February 15, 2012. CA2 A-2. A trial was held on March 2-3, 2015. At trial, several witnesses testified at length regarding

objective factors related to the state of the Brazilian economy in 2002 that made the Duplicatas attractive to investors like Howard. CA2 A-1643, 1704–06. Howard also testified that, based on his many years of experience investing in distressed assets, he believed the Duplicatas had “significant upside” value, and that he did not have any predetermined agreement that the Investment Opportunity would generate tax losses. CA2 A-1573, 1633–34.

The parties submitted their post-trial briefing to the Tax Court on July 2, 2015. Nearly *nine years* later, on April 22, 2024, the Tax Court issued a cursory, twelve-page Memorandum Opinion. CA2 A-12–13. The Memorandum Opinion contained no record citations, no credibility findings, and no reference to the trial testimony of either Howard or the experts offered by the parties. CA2 SPA-1–5. Rather, the Tax Court’s four pages of “Findings of Fact” consisted almost exclusively of facts to which the parties had stipulated before trial. *See* CA2 A-34–58.

The primary basis for the Tax Court’s affirmation of the FPAA was its conclusion that Santa Bárbara’s original contribution of the Duplicatas to XBOXT was a disguised sale, which rendered the ordinary nonrecognition rule under Section 721 of the Code inapplicable and nullified the built-in loss associated with the Duplicatas. At trial, the IRS failed to present any direct evidence that XBOXT had paid Santa Bárbara for the Duplicatas. Nonetheless, the Tax Court concluded that Santa Bárbara received a payment from XBOXT by making

several inferential leaps based on balances reflected in bank account statements that plainly constituted hearsay evidence. CA2 SPA-7. The Tax Court relied upon these account statements despite a lengthy post-trial colloquy in which it acknowledged that other records from the same bank that were legally indistinguishable from the records cited in the Memorandum Opinion were inadmissible hearsay. CA2 A-1961-69.

During that colloquy, the Tax Court chided the Commissioner's trial counsel for failing to secure a business records certification that would render the disputed bank records admissible, stating: "[W]hat was your theory for getting these in without a certification...? Why wasn't it already done?...I assumed that they were going to be covered by a certification....And I'm just not sure why we find ourselves at this juncture now." CA2 A-1966-67. The Tax Court explained that if there had been some "extenuating circumstances" justifying the Commissioner's failure to secure a certification, it would "be more inclined to leave the record open, but...[it was] not persuaded that there [were].” CA2 A-1967.

Despite this colloquy, nine years later, when the Tax Court finally issued its belated decision on a cold record, it ignored its clearly articulated recognition that the bank records were inadmissible hearsay and made them the central feature of its disguised sale analysis.

The Tax Court's application of the disguised sale presumption was the lynchpin to its decision.

That presumption imposed an exceptionally high burden on Petitioner (to “clearly establish” a negative proposition: that Santa Bárbara’s contribution was *not* a disguised sale). Without addressing Petitioner’s arguments demonstrating that it had, in fact, overcome the presumption, the Tax Court concluded that Petitioner had “failed to meet its burden of proof.” CA2 SPA-7–8.

The Tax Court alternatively affirmed the FPAA on several grounds, including, as relevant here, by applying the IRS’s anti-abuse rule, which authorizes the IRS to ignore the plain text of the Code whenever it concludes that the straightforward application of that text would be “inconsistent with the intent of subchapter K.” 26 C.F.R. § 1.701–2(c).<sup>4</sup> In this case, the Tax Court applied the anti-abuse rule to recast the transactions involved in the Investment Opportunity as the sale of the Duplicatas from Santa Bárbara to Howard. CA2 SPA-11.

## **B. The Second Circuit Panel’s Summary Order**

Petitioner timely appealed from the Tax Court’s judgment, challenging each of the bases for the Tax Court’s decision. As to the Tax Court’s conclusion that the disguised sale presumption applied, Petitioner argued that the Tax Court improperly relied on hearsay bank records that were admitted without a business records certification. *See* Br. 27–28, 32–34; Reply 2–9. Petitioner further argued that its objection before the Tax Court was

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<sup>4</sup> Subchapter K is the portion of the Code governing the taxation of partnerships.

sufficient to preserve the issue for appeal. *See* Br. 34, Reply 3–7. But anticipating that the Commissioner might argue that the objection was not adequately preserved, Petitioner argued in a footnote that the improper consideration of hearsay evidence also satisfied the requirements of the plain error standard of Federal Rule of Evidence 103(e), which allows appellate courts to consider unpreserved claims of error. *See* Br. 35 n.7. When the Commissioner did, in fact, argue that the hearsay issue had not been preserved, Petitioner expanded upon its plain error argument in its reply brief. *See* Reply 8–9.

Petitioner also argued that the Tax Court erred in applying the anti-abuse rule because that rule was inconsistent with the IRS’s statutory authority and violated this Court’s instruction in *Loper Bright* that, in evaluating the validity of a regulation, “[c]ourts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority” rather than simply deferring to the agency’s interpretation. Br. 48–52 (citing *Loper Bright*, 603 U.S. at 412); *see also* Reply 22–23.

On May 20, 2025, a Second Circuit panel heard oral argument. In a summary order dated August 11, 2025, the Second Circuit affirmed the Tax Court’s decision disallowing the 2002 Deduction, concluding that Santa Bárbara’s contribution of the Duplicatas to XBOXT constituted a disguised sale. In doing so, the court relied on the same set of hearsay bank records and applied the same faulty

inferences regarding the transfer of funds from XBOXT to Santa Bárbara as the Tax Court. *See PIMLICO*, 2025 WL 2304663, at \*2–3. Critically, the court declined to consider PIMLICO’s evidentiary challenge to the bank records, disregarding the extensive trial colloquy on the issue and concluding that the objection to the hearsay bank records was not raised before the Tax Court and was therefore waived. In a footnote, the panel further stated that Petitioner “abandoned any claims of plain error, as it only dedicated one sentence—in a footnote—to the argument in its opening brief.” *Id.* at \*2 n.1.

Having concluded that PIMLICO failed to rebut the disguised sale presumption, the Second Circuit affirmed the judgment in full. The panel’s summary order was silent on the Tax Court’s application of the anti-abuse rule, leaving the Tax Court’s endorsement of that regulation intact as precedent that the IRS can cite in future litigation.<sup>5</sup>

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<sup>5</sup> The panel’s summary order was also silent as to two fact-intensive, alternative grounds set forth in the Tax Court’s decision: (1) that the Tax Court could not determine the original contributing partner’s tax basis in the Duplicatas ultimately contributed to the Partnership; and (2) that two of the entities involved in this case, including the Partnership, were not bona fide partnerships. Unlike the anti-abuse rule, these alternative grounds required analysis of substantial record evidence ignored by the Tax Court, which failed to make the factual findings and credibility determinations necessary to reach its conclusions. Br. 40–48, Reply 14–16. In any event, these fact-bound alternative grounds for the Tax Court’s decision are different in kind from the Tax Court’s reliance on the anti-abuse rule, and create no obstacle to this Court’s grant of the petition to resolve the

## REASONS FOR GRANTING THE WRIT

### I. The Court Should Grant the Petition with Respect to the First Question Presented

#### A. The Second Circuit’s Refusal to Conduct a Plain Error Review Presents an Exceptionally Important Question

It is a core principle of American law that federal courts—including the Courts of Appeals—have a “virtually unflagging obligation...to exercise the jurisdiction given them.” *Colorado River Water Conservation Dist. v. United States*, 424 U.S. 800, 817 (1976). “[T]he Judiciary has a responsibility to decide cases properly before it, even those it would gladly avoid.” *Zivotofsky*, 566 U.S. at 194 (internal quotation marks omitted). As this Court has instructed: “With whatever doubts, with whatever difficulties, a case may be attended, we must decide it, if it be brought before us. We have no more right to decline the exercise of jurisdiction which is given, than to usurp that which is not given. The one or the other would be treason to the constitution.” *Cohens v. Virginia*, 19 U.S. 264, 404 (1821).

Rule 28 of the Federal Rule of Appellate Procedure requires appellants to present their “contentions and the reasons for them, with citations to the authorities and parts of the record on which the appellant relies.” As caseloads dramatically increased in the decades following this Court’s

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exceptionally important questions of law presented by the Tax Court’s and Second Circuit’s decisions.

promulgation of the Federal Rules of Appellate Procedure in 1967, however, the federal Courts of Appeals adopted ad hoc prudential rules to determine if arguments were inadequately presented and therefore did not warrant the court’s attention. *See* Christopher F. Edmunds, *The Judicial Sieve: A Critical Analysis of Adequate Briefing Standards in the Federal Circuit Courts of Appeals*, 91 Tul. L. Rev. 561, 569–71 (2017); *see also*, e.g., *Carducci v. Regan*, 714 F.2d 171, 177 (D.C. Cir. 1983) (Scalia, J.). (“The premise of our adversarial system is that appellate courts do not sit as self-directed boards of legal inquiry and research, but essentially as arbiters of legal questions presented and argued by the parties before them.”). The Courts of Appeals have developed a doctrine of waiver under which they will “not ordinarily entertain arguments made solely in a footnote because they lack the development required by Federal Rule of Appellate Procedure 28.” *United States v. Arbaugh*, 951 F.3d 167, 174 n.2 (4th Cir. 2020); *see also*, e.g., *United States v. Restrepo*, 986 F.2d 1462, 1463 (2d Cir. 1993) (“We do not consider an argument mentioned only in a footnote to be adequately raised or preserved for appellate review.” (citing Fed. R. App. P. 28)). The Second Circuit applies this doctrine aggressively, and routinely deems arguments to be abandoned when they are made in a footnote (even if they overlap significantly with arguments made in the body of the brief) or without (what the circuit considers to be) sufficient

detail; last year alone, it did so in at least 20 other cases.<sup>6</sup>

The Second Circuit shirked its responsibility to decide issues presented for its review when it concluded that Petitioner had waived even a plain-error challenge to the Tax Court's reliance on hearsay. The key issue in this case was whether the Tax Court had properly applied the disguised sale presumption set out in Treasury Regulation 1.707-3(c)(1). To apply that presumption, the court had to find that XBOXT had transferred funds to Santa

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<sup>6</sup> See *United States v. Scott*, 2025 WL 3537339, at \*3 n.3 (2d Cir. Dec. 10, 2025); *CITGO Petrol. Corp. v. Ascot Underwriting Ltd.*, 158 F.4th 368, 388 (2d Cir. 2025); *Giambalvo v. Suffolk Cnty.*, 155 F.4th 163, 180 n.6 (2d Cir. 2025); *United States v. Garlick*, 2025 WL 2318753, at \*1 n.1 (2d Cir. Aug. 12, 2025); *Singh v. Bondi*, 2025 WL 2055646, at \*1 n.1 (2d Cir. July 23, 2025); *Neurological Surgery Prac. of Long Island, PLLC v. United States Dep't of Health & Hum. Servs.*, 145 F.4th 212, 227 n.5 (2d Cir. 2025); *Quezada Palacios v. Bondi*, 2025 WL 1983482, at \*4 n.1 (2d Cir. July 17, 2025); *Figueroa-Serrano v. Bondi*, 2025 WL 1949965, at \*1 n.1 (2d Cir. July 16, 2025); *Gelb v. Niblack*, 2025 WL 1502015, at \*2 (2d Cir. May 27, 2025); *United States v. Colasuonno*, 2025 WL 1377876, at \*2 (2d Cir. May 13, 2025); *United States v. Cook*, 2025 WL 1336929, at \*1 n.1 (2d Cir. May 8, 2025); *Smart v. USA Lab. for Hire, Inc.*, 2025 WL 1217365, at \*2 n.3 (2d Cir. Apr. 28, 2025); *Elavon, Inc. v. Katz*, 2025 WL 1202075, at \*3 n.4 (2d Cir. Apr. 25, 2025); *United States v. Malka*, 2007 WL 10146084, at \*2 n.2 (2d Cir. Apr. 8, 2025); *Shin v. Party Well Rest. & Oriental Bakery, Inc.*, 2025 WL 783737, at \*2 (2d Cir. Mar. 12, 2025); *Davitashvili v. Grubhub Inc.*, 131 F.4th 109, 118 (2d Cir. 2025); *Cannon Corp. & Subsidiaries v. Comm'r of Internal Revenue*, 2025 WL 517664, at \*4 n.2 (2d Cir. Feb. 18, 2025); *United States v. Holley*, 2025 WL 384616, at \*1 n.1 (2d Cir. Feb. 4, 2025); *Valentino S.p.A. v. Mrinalini Inc.*, 2025 WL 341867, at \*1 n.1 (2d Cir. Jan. 30, 2025); *Walker v. Thibault*, 2025 WL 294507, at \*3 (2d Cir. Jan. 24, 2025).

Bárbara within two years of Santa Bárbara’s contribution of the Duplicatas to XBOXT. And to support its conclusion that such a transfer had been made, the Tax Court relied on inferences drawn from a set of bank records purportedly showing beginning and ending balances for XBOXT’s bank account in December 2002 and January 2003 (as opposed to documents reflecting payments to Santa Bárbara). These records were plainly inadmissible hearsay, however, because the IRS never obtained the requisite custodian’s certification. *See* Fed. R. Evid. 803(6)(D) (permitting, in the absence of a qualified witness, “[a] record of an act” or “event” to be admitted with a business records certification).

Petitioner made extensive arguments before the Second Circuit concerning the Tax Court’s error. In the body of its brief, Petitioner sought *de novo* review of the Tax Court’s legal conclusion that the disguised sale presumption applied. Br. 30. Petitioner dedicated several pages of its opening brief to challenging the Tax Court’s reliance on the hearsay bank records, including arguing that its objection to the Tax Court’s reliance on such hearsay evidence was sufficient to preserve the issue for appeal. Br. 27–28, 32–34 & n.7. The Commissioner responded by arguing extensively that the record evidence supported the Tax Court’s decision, that Petitioner had waived the issue below, and that, in any event, Petitioner had failed to satisfy the plain error standard. IRS Br. 31–41. In reply, Petitioner both disputed the Commissioner’s arguments on the merits and argued that the objection had been preserved. Reply 2–9.

As a fallback position, Petitioner further argued in a footnote to its main brief and in the body of its reply brief that, even if the objection had not been adequately preserved, the exact same error satisfied the plain error standard of Federal Rule of Evidence 103(e). *See* Br. 35 n.7; Reply 8–9. Thus, the parties fully briefed (1) whether the Tax Court had improperly relied on hearsay evidence; (2) whether Petitioner’s objections had sufficiently preserved the issue; and (3) if not, whether the Tax Court’s reliance on the bank records constituted plain error.

In concluding that Petitioner abandoned its claim of error, the Second Circuit ignored the fact that Petitioner presented its argument as to the erroneous admission of hearsay records in the body of its brief under the standard of review it believed applied (*de novo*), while invoking the plain error standard of review in a footnote in the event that the Second Circuit disagreed that the error had been preserved. It also disregarded the fact that the Commissioner had fully briefed the plain error standard and that it had been squarely presented for the court’s review. This amounts to an abdication of the Courts of Appeals’ “unflagging obligation...to exercise the jurisdiction given them.” *Colorado River*, 424 U.S. at 817. Whether a court may avoid addressing the merits of a legal issue because, although the appellant extensively addressed its claim of error in the body of its brief, it invoked the plain error standard of review only in a footnote, goes to the heart of the Judiciary’s “responsibility to decide cases properly before it, even those it would

gladly avoid.” *Zivotofsky*, 566 U.S. at 194 (internal quotation marks omitted). It therefore presents an exceptionally important question warranting grant of the petition.

The Second Circuit’s approach to the review of claimed errors, if accepted by this court, will inevitably threaten litigants beyond this case.

Appellants frequently seek review of errors that the appellant believes were adequately preserved for appellate review, and so present their arguments under the applicable standard of review. Appellees frequently contest appeals on the grounds that the issue was not adequately preserved. The Second Circuit’s approach would tilt the scales in favor of the appellees in every such appeal: requiring every appellant to fully brief under the plain error standard issues they believe were preserved in their opening papers or risk being found to have waived review if the appellee argues (and the court finds) that the issue was not properly preserved.

This approach threatens the judicial process for appellants in both criminal and civil cases. Federal Rule of Evidence 103(e), applicable to both civil and criminal cases, provides that “[a] court may take notice of a plain error affecting a substantial right, even if the claim of error was not properly preserved.” Federal Rule of Criminal Procedure 52 similarly ensures that “[a] plain error that affects substantial rights may be considered even though it was not brought to the court’s attention.” Litigants rely on courts to apply plain error review when “necessary to safeguard the integrity and reputation

of judicial process or to forestall a miscarriage of justice.” *United States v. Lancellotti*, 761 F.2d 1363, 1367 (9th Cir. 1985).

The Second Circuit’s approach turns Rules 103(e) and 52 on their heads, creating an off-ramp for appellate courts to avoid facing difficult issues in the application of plain error review. It effectively rewrites both rules to provide that: “a plain error that affects substantial rights *need not be noticed or considered* if the appellant presents its claim of error in the body of its opening brief but cites the plain error standard of review in a footnote.” This is inconsistent with both rules, and threatens to derail the appeals of cases in which the preservation of an issue for appeal is disputed.

This case demonstrates the importance of ensuring that courts do not avoid their responsibility to conduct plain error review. The Tax Court violated blackletter rules of hearsay by admitting the bank records without the certification of a custodian. *See Fed. R. Evid. 803(6)(D)*. After a nine-year delay, it compounded its error by relying on these unverified records, which were over a decade old by the time of trial, to invoke the disguised sale presumption. Affirming such a substantial tax liability on so scant a record “seriously affect[s] the fairness, integrity or public reputation of [the]...proceeding.” *United States v. Marcus*, 628 F.3d 36, 42 (2d Cir. 2010). As this Court has recognized, tax liability is a matter of “fundamental justice” and Courts of Appeals must “consider questions...which were neither pressed nor passed

upon below” “where injustice might otherwise result.” *Hormel v. Helvering*, 312 U.S. 552, 557 (1941). At base, “[r]ules of practice and procedure are devised to promote the ends of justice, not to defeat them.” *Id.* “A rigid and undeviating judicially declared practice under which courts of review would invariably and under all circumstances decline to consider all questions which had not previously been specifically urged [in the lower court] would be out of harmony with this policy.” *Id.*

Nor can the waiver doctrine developed under Federal Rule of Appellate Procedure 28 provide an adequate basis for the Second Circuit’s decision here. It is well-established that a party can abandon entire legal issues by failing to meaningfully develop them for appellate review. *See, e.g., Turner Broad. Sys., Inc. v. F.C.C.*, 520 U.S. 180, 224 (1997) (“[P]rudence dictates that we not decide this question based on such scant argumentation.”); *Socialist Lab. Party v. Gilligan*, 406 U.S. 583, 587 (1972) (declining to address issue where the record was “extraordinarily skimpy”). The Second Circuit’s decision stretches this discretionary doctrine to its breaking point: Petitioner here *did* meaningfully develop the claim of legal error presented for appellate review in the body of its brief, and invoked the plain error standard of review in the event that the Second Circuit concluded (mistakenly in Petitioner’s view) that the Tax Court’s error had not been adequately preserved.

No justification exists for the application of the discretionary doctrine in a case where, as here, two potential standards of review apply and an

appellant presents arguments as to both.

Petitioner's claim of legal error was not "perfunctory" or "unaccompanied by some effort at developed argumentation." *United States v. Zannino*, 895 F.2d 1, 17 (1st Cir. 1990), *cert. denied*, 494 U.S. 1082. Nor would the Second Circuit's resolution of the issue be inconsistent with an "adversarial system": both Petitioner and the Commissioner presented arguments concerning the Tax Court's legal error under both potentially applicable standards of review. *Carducci*, 714 F.2d at 177. Similarly, because both sides fully briefed the issue, addressing Petitioner's claim of error would not have required the Second Circuit to "scour through footnotes in search of some possibly meritorious point that counsel did not consider of sufficient importance to include as part of the argument." *Restrepo*, 986 F.2d at 1463.

The Second Circuit's refusal to engage with the merits of Petitioner's claim of plain error defies the judiciary's obligation to decide cases properly before it, undermines the essential safeguard of plain error review by rewriting the applicable rules, exploits procedural technicalities, invites miscarriages of justice in both civil and criminal appeals, and conflicts with the fundamental principle that rules of practice exist to promote fairness, not defeat it. The Court should grant certiorari to reaffirm that appellate courts cannot shirk their duty to resolve legal disputes simply because an appellant failed to invoke what an appellate court ultimately determines to be the correct standard of review in the body of its opening brief, especially

where, as here, the parties fully briefed that standard.

### **B. The Second Circuit’s Refusal to Apply the Plain Error Standard Conflicts with the Approaches of the Other Federal Circuits**

Grant of the petition also is warranted because, in reasoning that Petitioner had waived its argument that the Tax Court had committed plain error, the Second Circuit departed from the rule applied in other circuits. Although Courts of Appeals agree that appellants can abandon entire *legal issues* by failing to adequately address them in their opening brief, multiple Courts of Appeals have held that it “is always the duty of [an appellate court] to apply the proper *standard of review* to a district court’s decision without regard to the parties’ arguments,” and thus regardless of whether an appellant invokes the wrong standard of review in presenting their claim of error. *U.S. Tobacco Coop.*, 899 F.3d at 256 n.6 (emphasis added) (collecting cases); *see also United States v. Fonseca*, 744 F.3d 674, 682 (10th Cir. 2014) (“[T]he court, not the parties, must determine the standard of review, and therefore, it cannot be waived.”). By contrast, the Second Circuit has explicitly recognized the rule applied in these other circuits but avoided adopting it. *See United States v. Sullivan*, 118 F.4th 170, 199 (2d Cir. 2024) (noting that “several of our sister circuits have held that a party cannot waive, concede, or abandon the applicable standard of review,” but “[f]ortunately, we need not decide whether Defendants are capable of waiving the

proper standard” because the claim of error failed under the more favorable standard of review).

Applying the rule that a party can never waive the proper standard of review, the Eighth and Fifth Circuits have each reviewed an appellant’s claim of error under the plain error standard of review even where the appellant sought review of the claimed error under a different standard of review. *See United States v. Bain*, 586 F.3d 634, 639 (8th Cir. 2009) (reviewing for plain error where both appellant and appellee argued that the abuse of discretion standard applied); *United States v. Vontsteen*, 950 F.2d 1086, 1092 (5th Cir. 1992) (en banc) (reviewing for plain error even where *neither* party raised the proper standard of review until oral argument before Fifth Circuit panel, and noting that the court had “addressed standards of review raised for the first time at oral argument before”).

Other circuits have applied the rule that a standard of review is not waivable to conduct a review for clear error where the appellant sought *de novo* review of their claim of error, *see Worth v. Tyer*, 276 F.3d 249, 262 n.4 (7th Cir. 2001), and a review for abuse of discretion where the appellant sought *de novo* review and made an argument as to abuse of discretion only in a footnote, *see U.S. Tobacco Coop.*, 899 F.3d at 256 n.6.

This Court has yet to address whether a party can be deemed to waive review of a claimed legal error by presenting their arguments under a standard of review that the court of appeals determines does not apply. Without guidance from

the Court, a split has developed among the circuits as to the correct answer. Under the rule followed in other circuits, the Second Circuit panel, having been presented with a legal issue for review, had a “duty...to apply the proper standard of review” in resolving it. *Id.* Because the panel deviated from the rule applied in numerous other circuits, the panel’s decision creates a circuit conflict warranting this Court’s grant of the petition.

## **II. The Second Question Presented Is Exceptionally Important**

Because the anti-abuse rule is contrary to law, and failure to grant the petition will permit the IRS to continue its anti-textual approach to transactions that meet the statutory requirements adopted by Congress but yield results that it does not like, the second question presented is exceptionally important and warrants grant of the petition.

The anti-abuse rule provides that “if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K.” The rule further provides that even if the transaction in question “fall[s] within the literal words of a particular statutory or regulatory provision,” the IRS “can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K.” 26 C.F.R. § 1.701–2(b).

This rule is an artifact of *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), under which agencies promulgating regulations expected courts simply to defer to their interpretations of statutes. In overruling *Chevron*, this Court recognized that “statutory ambiguity...is not a delegation to anybody, and a court is not somehow relieved of its obligation to independently interpret the statute” simply because “Congress’s instructions have supposedly run out, leaving a statutory gap.” *Loper Bright*, 603 U.S. at 400 (internal quotation marks omitted). In such a case, it is the role of the courts to “use every tool at their disposal to determine the best reading of the statute and resolve the ambiguity,” not the role of the agency to unilaterally rewrite the statute to expand its own authority. *Id.* Yet this is precisely what the IRS did here, deploying the anti-abuse rule to preclude a tax deduction plainly permitted under the language of the Code at the time the deduction was taken, disregarding Congress’s judgment that an amendment to the statutorily mandated treatment should not be applied retroactively. This is clearly improper under *Loper Bright*.

“The legislative power of the United States is vested in the Congress, and the exercise of quasi-legislative authority by governmental departments and agencies must be rooted in a grant of such power by the Congress and subject to limitations which that body imposes.” *Chrysler Corp. v. Brown*, 441 U.S. 281, 302 (1979). Accordingly, “[t]he power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations

to that end is not the power to make law, for no such power can be delegated by Congress, but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.” *Manhattan Gen. Equip. Co. v. Comm’r of Internal Revenue*, 297 U.S. 129, 134 (1936). “[A] regulation, in order to be valid,” must “be consistent with the statute” authorizing the agency’s action. *Id.* In evaluating the validity of a regulation, “[c]ourts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority.” *Loper Bright*, 603 U.S. at 412.

In promulgating the anti-abuse rule, the IRS acted outside of its statutory authority. The IRS relied on 26 U.S.C. § 7805 as the purported source of authority for the anti-abuse rule. *See Subchapter K Anti-Abuse Rule*, 60 Fed. Reg. 18,741 (Apr. 13, 1995) (citing 26 U.S.C. § 7805 as the “[a]uthority” for its promulgation of the regulation). Far from inviting the IRS to ignore the literal words of the Code, that general grant of authority merely provides that “the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.” 26 U.S.C. § 7805(a).

The anti-abuse rule, however, explicitly empowers the Commissioner to *ignore* “the literal words of a particular statutory...provision” if applying the Code as written would conflict with “the intent of subchapter K.” 26 C.F.R. § 1.701–2(b). This is plainly contrary to blackletter law regarding

the permissible scope of agency authority. *See* *Manhattan Gen. Equip. Co.*, 297 U.S. at 134. As this Court has recognized, general delegations of authority to agency principals to issue regulations necessary to carry out statutory enactments do not authorize regulations contrary to law. *See, e.g.*, *Ragsdale v. Wolverine World Wide, Inc.*, 535 U.S. 81, 86–88 (2002) (holding that regulations issued by the Secretary of Labor were contrary to the Family Medical Leave Act and that the Secretary had exceeded his authority to issue regulations “necessary to carry out” the statute). By enacting regulations contrary to laws enacted by Congress, an agency also runs afoul of the nondelegation doctrine. Indeed, by permitting the IRS to ignore the text of the Code, the anti-abuse rule has freed the agency from the “intelligible principle[s]” Congress provided in order “to guide [the agency’s] use” of its limited regulatory powers. *Jarkesy v. S.E.C.*, 34 F.4th 446, 461 (5th Cir. 2022) (internal quotation marks omitted), *affirmed on other grounds*, 603 U.S. 109 (2024); *see also F.C.C. v. Consumers’ Rsch.*, 606 U.S. 656, 673 (2025) (“To distinguish between the permissible and the impermissible in this sphere, we have long asked whether Congress has set out an ‘intelligible principle’ to guide what it has given the agency to do.”).

Nor is the anti-abuse rule rescued by its language permitting the recasting of a partnership transaction “to achieve tax results that are consistent with the intent of subchapter K.” 26 C.F.R. § 1.701–2(b). “An agency has no power to tailor legislation to bureaucratic policy goals by

rewriting unambiguous statutory terms. Agencies exercise discretion only in the interstices created by statutory silence or ambiguity; they must always give effect to the unambiguously expressed intent of Congress.” *Util. Air Regul. Grp. v. E.P.A.*, 573 U.S. 302, 325–26 (2014) (internal quotation marks omitted). Congress’s intent is expressed through the words in the statutes it enacts. *See Magwood v. Patterson*, 561 U.S. 320, 334 (2010); *Rep. of Arg. v. Weltover, Inc.*, 504 U.S. 607, 618 (1992). Here, the relevant statutory provisions mandated that the Partnership take the 2002 Deduction on its tax return. The Commissioner’s application of contrary “tax results” cannot be justified by its invocation of Congress’s purported intent, especially where the “tax results” sought by the Commissioner contradict the statutory language. *See, e.g., United States v. Calamaro*, 354 U.S. 351, 357 (1957) (“Neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon.”).

Courts have not hesitated to invalidate Treasury regulations that have granted the IRS unfettered authority to disregard the text of the Code where the regulation was promulgated pursuant to Section 7805 or even more specific delegations of regulatory authority. *See, e.g., Edward L. Stephenson Tr. v. Comm’r*, 81 T.C. 283, 287, 294–95 (1983) (invalidating regulation promulgated under Section 7805 permitting the Commissioner to consolidate trusts for tax purposes as inconsistent with statute); *RLC Indus. Co. v. Comm’r*, 58 F.3d 413, 417 (9th Cir. 1995) (invalidating regulation that

vested discretion in IRS to disregard provisions of the Code in readjusting a taxpayer's blocks of timber as needed to reach a reasonable depletion allowance). The general grant of authority in Section 7805 therefore cannot salvage the anti-abuse rule. *See United States v. Kahn*, 5 F.4th 167, 173 (2d Cir. 2021) (“[A] statute’s general provision that an administrator may issue such other regulations as he ‘considers necessary’ does not constitute authorization to issue a regulation that contradicts an express provision of the statute.”).

Indeed, no court has *ever* upheld the anti-abuse rule when faced with a challenge to its validity, and several courts have gone out of their way to avoid relying upon it. *See, e.g., AD Global FX Fund, LLC v. United States*, 2014 WL 1285503, at \*4 n.9 (S.D.N.Y. Mar. 31, 2014); *Southgate*, 659 F.3d at 494, n.94; *New Millennium Trading, LLC v. Comm'r*, 2017 WL 89130, at \*11 n.18 (T.C. Jan. 10, 2017). The IRS has even withdrawn reliance on the anti-abuse rule in previous litigation after its validity was challenged. *See Jade Trading, LLC v. United States*, 60 Fed. Cl. 558, 561 (2004). This Court’s decision in *Loper Bright* makes clear that the anti-textual anti-abuse rule constitutes an improper exercise of administrative authority by the IRS, and cannot stand.

Given the expressly anti-textual premise of the anti-abuse rule, only a small handful of district court decisions have ever relied upon that regulation to find in favor of the IRS, and no court has ever upheld its validity in the face of a challenge. *See*

McKee et al., *Federal Taxation of Partnerships & Partners* ¶ 1.05[2][a] (rev. 2025) (“McKee”). The courts are not alone in their skepticism of the anti-abuse rule. Since its enactment in 1995, the anti-abuse rule has been subject to consistent criticism.

*See Commentators Say Partnership Antiabuse Rule Doesn't Satisfy Fundamental Principles for a Workable Tax System*, 95 Tax Notes Today 175-28 (Aug. 18, 1995); Willis ¶ 1.05[1] (“[T]he anti-abuse Regulation has created a strong negative reaction from the organized tax bar” in light of “its vague and ambiguous language” and “the indication that taxpayers cannot rely on the specific provisions of the Code and the Regulations to structure a transaction that will avoid a challenge.”); McKee ¶ 1.05[2][a].

In sum, the anti-abuse rule is expressly anti-textual, grants the IRS free reign to disregard partnership transactions that comply with the Code, and is completely unpredictable in its application. Nothing in the Code authorizes the IRS to exercise such broad powers.

This case shows plainly how the IRS has applied the anti-abuse rule to generate results contrary to law. Indeed, the application of the anti-abuse rule in this case directly contradicted the then-operative provision of the Code. As discussed above, *supra* 8-9, the provisions of the Code in effect in 2002 not only permitted, but *required*, the Partnership to recognize the built-in loss of the Duplicatas when they were sold. That was no accident. In 1984, Congress revised Section 704(c) of

the Code to require that, when contributed property with a built-in gain or loss is sold by a partnership, the gain or loss must be allocated to the contributing partner if they are still a member of the partnership. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 71, 98 Stat. 494, 589 (1984). Congress recognized, however, that the 1984 legislation left open the issue of how a built-in gain or loss should be recognized if the contributing partner had transferred his partnership interest before the contributed property was sold. *See* H.R. Rep. No. 98-861 at 857 (1984) (Conf. Rep.).

That open issue was squarely addressed in 1989, when Congress enacted Section 704(c)(3) of the Code, which *requires* successor partners to stand in the shoes of contributing partners in all respects, including when recognizing built-in gains and losses from contributed property. *See* Omnibus Budget Reconciliation Act, Pub. L. 101-239, § 7642, 103 Stat. 2106, 2379-80 (1989); H.R. Rep. 101-247 at 1357 (1989); S. Rep. No. 101-56 at 197 (1989). This result was reinforced by Treasury Regulation 1.704-3(a)(7), which provides that, if a contributing partner transfers a partnership interest before the contributed property is sold, built-in gains or losses “must be allocated to the transferee partner.” 26 C.F.R. § 1.704-3(a)(7).

Under the Code provisions in effect in 2002, the Partnership thus had no choice but to recognize the 2002 Deduction after the Duplicatas were sold, because the built-in losses in the Duplicatas passed from Santa Barbara, to XBOXT, to Petitioner, and

ultimately to the Partnership. The 2002 Deduction was a straightforward application of the partnership property contribution provisions that Congress had carefully crafted over several years and multiple pieces of legislation.

Indeed, the lawful nature of the 2002 Deduction is reinforced by legislation enacted *after* the transactions at issue here, which deliberately altered the way in which built-in losses are recognized by partners other than original contributing partners. As part of the AJCA, Congress amended the Code to curtail the shifting of built-in loss from a contributing partner to successor partners. *See* Pub. L. No. 108-357, § 833(a)–(b), 118 Stat. at 1589. The Conference Report accompanying the AJCA explained that, under the law prior to 2004, “[t]here [was] no specific guidance preventing the allocation of [a] built-in loss to the remaining partners” when a contributing partner transferred its partnership interest. H.R. Rep. No. 108-755 at 622 (2004) (Conf. Rep.). It thus “appear[ed]” to Congress “that losses [could] be ‘transferred’ to other partners where the contributing partner no longer remain[ed] a partner.” *Id.* Accordingly, the statutory changes effected by the AJCA were “intended...to prevent shifting a built-in loss from a tax indifferent foreign entity to a U.S. taxpayer through the use of a partnership.” *Superior Trading, LLC v. Comm'r*, 137 T.C. 70, 79 (2011).

Enactment of the AJCA amendments post-dated the Investment Opportunity and the Partnership’s 2002 return and the amendments were

not made retroactive. *See* Pub. L. No. 108-357, § 833(d), 118 Stat. at 1592. The fact that Congress passed legislation with the express purpose of altering the federal tax implications of transactions like the ones at issue in this case, without making those changes retroactive, is powerful evidence that Congress viewed the 2002 Deduction as proper when it was recognized by the Partnership. *See Landgraf v. USI Film Prods.*, 511 U.S. 244, 265 (1994) (“[T]he presumption against retroactive legislation is deeply rooted in our jurisprudence.”); *Scott v. Boos*, 215 F.3d 940, 947 (9th Cir. 2000) (“Because we have found that Congress has not expressly provided the statute’s temporal reach and that the statute has retroactive effect, the presumption against retroactivity applies unless Congress’s intent to the contrary is clear.”).

If this Court does not grant the petition and reject the Tax Court’s extraordinary application of the anti-abuse rule, the Second Circuit’s failure to repudiate the anti-abuse rule may well embolden the IRS and negatively impact a wide-range of taxpayers. The Tax Court’s opinion is a dangerous precedent—indeed, the Tax Court’s Memorandum Opinion has already been cited by a leading partnership tax treatise as the lone decision in which the Tax Court has “upheld the [IRS’s] application of the anti-abuse Regulation.” Willis ¶ 1.05 (n.283 and accompanying text).

This case perfectly demonstrates how the anti-abuse rule’s anti-textual nature could be used to penalize taxpayers who, like Howard, take

precautions to comply with existing law. The Tax Court relied on the anti-abuse rule to effectively overrule Congress and make the 2004 statutory changes retroactive. It did so in an opinion issued over nine years after trial that ignored significant evidence that the 2002 Deduction was a legitimate partnership transaction. That the anti-abuse rule could be applied in an opinion so untethered from the factual record, distant from trial, and contrary to the record of congressional enactments, shows clearly the risks of the anti-abuse rule—and why this Court’s grant of the petition is warranted.

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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## **APPENDIX**

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APPENDIX A — SUMMARY ORDER OF THE  
UNITED STATES COURT OF APPEALS FOR THE  
SECOND CIRCUIT, FILED AUGUST 11, 2025

UNITED STATES COURT OF APPEALS  
FOR THE SECOND CIRCUIT

24-1982

PIMLICO, LLC,

*Petitioner-Appellant,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent-Appellee.\**

Filed August 11, 2025

Present:

DEBRA ANN LIVINGSTON,  
*Chief Judge,*  
AMALYA L. KEARSE,  
*Circuit Judge,*  
J. PAUL OETKEN,  
*District Judge.\**

Appeal from a judgment of the United States Tax  
Court (Gale, *J.*).

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\* Judge Oetken, of the United States District Court for the  
Southern District of New York, sitting by designation.

\* The Clerk is respectfully directed to amend the caption.

*Appendix A*

**UPON DUE CONSIDERATION, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED** that the judgment of the Tax Court is **AFFIRMED**.

**SUMMARY ORDER**

Petitioner-Appellant PIMLICO, LLC (“PIMLICO”) appeals a final decision entered by the U.S. Tax Court (Gale, *J.*), upholding adjustments by the Commissioner of the Internal Revenue Service (“IRS”) to the ordinary income of PICCIRC, LLC, of which PIMLICO was a member. PICCIRC attempted to claim a \$22.7 million tax loss from its sale of distressed trade receivables, called *duplicatas*. Santa Bárbara Indústria e Comércio de Ferro Ltda. (“Santa Bárbara”), a Brazilian company, had originally contributed the *duplicatas* to XBOXT, LLC (“XBOXT”), a member of PIMLICO. XBOXT contributed most of these receivables to PIMLICO which, in turn, contributed them to PICCIRC. PICCIRC then sold the *duplicatas* at a loss. The tax court determined PICCIRC was not entitled to claim the tax loss because, *inter alia*, Santa Bárbara’s contribution of the *duplicatas* was actually a disguised sale. We assume the parties’ familiarity with the underlying facts, procedural history, and issues on appeal, which we reference only as necessary to explain our decision to **AFFIRM**.

We review the legal conclusions of the Tax Court *de novo* and its factual findings for clear error. *Soni v. Comm'r*, 76 F.4th 49, 57 (2d Cir. 2023). A factual finding is clearly erroneous where, “although there is evidence to support it, the reviewing court on the entire evidence is

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left with the definite and firm conviction that a mistake has been committed.” *Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 573 (1985) (citation omitted). On appeal, PIMLICO argues that the Tax Court erred in applying the presumption of a disguised sale and in concluding that PIMLICO did not present facts rebutting the presumption. For the following reasons, we disagree.

Generally, partnership contributions and distributions are not taxed. 26 U.S.C. §§ 721(a), 731(a). In contrast, a partner who sells an asset to a partnership is not considered to be acting in its capacity as a partner, and therefore the sale is taxed. *See id.* § 707(a)(1), (2); *Va. Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129, 138-39 (4th Cir. 2011). The distinction between sales and contributions for tax purposes is “susceptible to manipulation by persons wishing to shield transactions that are more accurately characterized as sales from their proper tax consequences.” *Va. Historic*, 639 F.3d at 138. To prevent such manipulation, Treasury regulations clarify when a contribution, followed by a subsequent transfer of consideration, in effect, operates as a disguised sale. *Route 231, LLC v. Comm'r*, 107 T.C.M. (CCH) 1155, 2014 WL 700397, at \*11-12 (T.C. 2014), *aff'd*, 810 F.3d 247 (4th Cir. 2016); *see* 26 U.S.C. § 707(a)(2)(B). A contribution is taxed as a sale if, “based on all the facts and circumstances,” 1) the transfer “of money or other consideration would not have been made but for the transfer of property,” and 2) if the transfers are not made simultaneously, “the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.” 26 C.F.R. § 1.707-3(b)(1). If the alleged contribution and distribution are made within

### *Appendix A*

a two-year period, “the transfers are *presumed* to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.” *Id.* § 1.707-3(c)(1) (emphasis added).

The Tax Court correctly determined that the presumption of a disguised sale is applicable here. Santa Bárbara contributed the *duplicatas* to XBOXT in August 2002. XBOXT then contributed these *duplicatas* to PIMLICO, which contributed them to PICCIRC. On the day PICCIRC was created, John Howard, a U.S. investor, joined PIMLICO by purchasing part of XBOXT’s interest in the partnership for \$300,164, a transaction reflected in XBOXT’s bank account records. On December 16, 2002, Santa Bárbara requested to partially withdraw its interest in XBOXT for \$300,164. By January 31, 2003, XBOXT’s bank account no longer reflected the \$300,164 it had received from Howard. The natural inference from this evidence is that XBOXT transferred the \$300,164 it received from Howard to Santa Bárbara. Accordingly, the contribution and distribution were made within two years. Because PIMLICO did not object below to the records the Tax Court relied on to reach this conclusion, it has waived its evidentiary challenges to the Tax Court’s presumption of a disguised sale. *Millea v. Metro-N. R.R. Co.*, 658 F.3d 154, 163 (2d Cir. 2011).<sup>1</sup>

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1. PIMLICO has abandoned any claims of plain error, as it only dedicated one sentence—in a footnote—to the argument in its opening brief. *Coal. on W. Valley Nuclear Wastes v. Chu*, 592 F.3d 306, 314 (2d Cir. 2009) (concluding that a “two-sentence legal analysis in [an] opening brief is insufficient to preserve [an] issue for appellate review”).

*Appendix A*

We next turn to whether the relevant facts and circumstances rebut the presumption of a disguised sale. Some relevant facts tending to show a disguised sale include: 1) whether the contributing partner has “a legally enforceable right to the subsequent transfer”; 2) whether any person made contributions that “permit the partnership to make the transfer of money” to the contributing partner; 3) whether the “partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property”; 4) whether the “transfer of money . . . by the partnership to the partner is disproportionately large in relationship to the partner’s general and continuing interest in partnership profits”; and 5) whether “the partner has no obligation to return or repay the money or other consideration to the partnership.” 26 C.F.R. §§ 1.707-3(b)(2)(ii), (iv), (viii), (ix), (x). These facts are by no means exclusive or determinative. *See id.* § 1.707-3(b)(2). Some facts may be irrelevant in a particular context. *See Superior Trading, LLC v. Comm'r*, 103 T.C.M. (CCH) 1604, 2012 WL 1319748, at \*11 n.13 (2012), *aff'd*, 728 F.3d 676 (7th Cir. 2013). Other facts not enumerated in the regulations, such as the “transitory” status of a contributing partner, can also support finding a disguised sale occurred. *See Va. Historic*, 639 F.3d at 138, 144.

The Tax Court did not err in concluding that the facts and circumstances here did not rebut the presumption of a disguised sale. As the relevant bank account records demonstrate, Howard’s contribution of \$300,164 to XBOXT permitted the partnership to make a transfer of money to Santa Bárbara. *See Buyuk LLC v. Comm'r*, 106 T.C.M. (CCH) 502, 2013 WL 5942309, at \*21 (T.C. 2013) (concluding a disguised sale occurred, in part because “[t]he cash distributions [to

### *Appendix A*

the contributing partner] were entirely funded by money provided by [U.S. taxpayers]”). And because Santa Bárbara partially withdrew from XBOXT by selling its interest for \$300,164, the transfer was disproportionate to its continuing interests in the partnership. *See Superior Trading*, 2012 WL 1319748, at \*11 n.13 (finding a disguised sale occurred where a partner was “redeemed out of the . . . partnership as a consequence of the cash payments”). The close timing between the creation of the partnership, Howard’s purchase of an interest in XBOXT, and Santa Bárbara’s partial sale of its interest in XBOXT—for the *same exact sum*—was not mere coincidence. As the Tax Court observed, these actions had the effect of engineering a tax windfall for Howard.<sup>2</sup> Viewed in this light, “[t]he circumstances surrounding Santa Bárbara’s partial redemption of its XBOXT interest suggest that it was a preconceived step” to shift the benefits of ownership of the *duplicatas*—vis-á-vis tax loss—to Howard. SPA-7; 26 C.F.R. § 1.707-3(b)(2)(viii); *Buyuk*, 2013 WL 5942309, at \*20-24 (determining a disguised sale occurred based on a similar timeline and scheme).

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2. Prior to 2004, Treasury regulations allowed a new partner to buy an existing partner’s interest—and, in so doing, claim the built-in loss from the asset the existing partner had contributed. *See* 26 U.S.C § 704(c)(1)(B) (2004); 26 C.F.R. § 1.704-3(a)(7) (2004). By purchasing XBOXT’s interest, then, Howard became entitled to the tax loss XBOXT would have claimed from PICCIRC’s sale of the *duplicatas* it contributed. 26 U.S.C. § 704(c)(1)(B) (2004) (entitling a partner who contributed an asset to the partnership to the tax loss from its sale); 26 C.F.R. § 1.704-3(a)(7) (2004). This loophole was eliminated by statute after the relevant events of this appeal. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833, 118 Stat. 1418, 1589 (2004) (codified as amended at 26 U.S.C § 704(c)(1)(C)).

*Appendix A*

PIMLICO fails to offer an alternate explanation for this account activity, instead pointing to certain facts and circumstances that are not present here. Although PIMLICO is correct to note that Santa Bárbara's contribution agreement evinced no right to the distributions and that the partnership did not take on debt to pay Santa Bárbara, 26 C.F.R. § 1.707-3(b)(2)(ii), (vi), these facts are not inconsistent with the existence of a disguised sale. *See Buyuk*, 2013 WL 5942309, at \*20-24 (concluding a disguised sale occurred even though the contributing partner never had a legally enforceable right to the distribution). Treasury regulations make clear that the delineated "facts and circumstances" are guiding inquiries and are not factors to "tick through . . . mechanically." *Va. Historic*, 639 F.3d at 144; *see* 26 C.F.R. § 1.707-3(b)(2). Accordingly, the Tax Court did not clearly err in finding that the "distribution" of money to Santa Bárbara would have not occurred but for the transfer of the *duplicatas* and was independent of the entrepreneurial risks of the partnership. *See SPA-7-8*; 26 C.F.R. § 1.707-3(b)(1).

\* \* \*

We have considered PIMLICO's remaining arguments and find them to be without merit. Accordingly, we **AFFIRM** the judgment of the Tax Court.

FOR THE COURT:

Catherine O'Hagan Wolfe,  
Clerk of Court

s/ Catherine O'Hagan Wolfe

**APPENDIX B — MEMORANDUM FINDINGS OF  
FACT AND OPINION OF THE UNITED STATES  
TAX COURT, FILED APRIL 22, 2024**

UNITED STATES TAX COURT

T.C. Memo. 2024-50

PICCIRC, LLC, PIMLICO, LLC, A PARTNER  
OTHER THAN THE TAX MATTERS PARTNER,

*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

Docket No. 4308-12.

Filed April 22, 2024.

**MEMORANDUM FINDINGS OF FACT  
AND OPINION**

GALE, *Judge*: This case is a partnership-level proceeding subject to the unified audit and litigation procedures of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 402(a), 96 Stat. 324, 648.<sup>1</sup> In a notice of final partnership administrative

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1. Before its repeal for taxable years beginning after December 31, 2017, TEFRA, codified at sections 6221 through 6234, prescribed procedures for audit and litigation concerning returns filed by partnerships. Respondent followed these procedures in this case. Unless otherwise indicated, statutory

*Appendix B*

adjustment (FPAA), respondent disallowed a \$22,718,351 ordinary loss deduction that PICCIRC, LLC (PICCIRC), claimed on its 2002 Form 1065, U.S. Return of Partnership Income, in connection with the sale of distressed Brazilian trade receivables. Respondent adjusted the partnership's basis in the receivables to zero and determined that accuracy-related penalties under section 6662 applied to any underpayments of tax attributable to the disallowance. PIMLICO, LLC (PIMLICO or petitioner), a partner other than the tax matters partner of PICCIRC, timely filed a Petition for review under section 6226. We sustain respondent's determinations concerning the loss deductions and penalties, as set forth below.

**FINDINGS OF FACT**

Some of the facts are stipulated and are so found. The Stipulation of Facts and its Exhibits are incorporated herein by this reference. PICCIRC's principal place of business was Greenwich, Connecticut. PICCIRC's tax matters partner is Tall Ships Capital Management, LLC (Tall Ships). Petitioner's principal place of business was in New York when the Petition was timely filed. PIMLICO's tax matters partner is John D. Howard.

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references are to the Internal Revenue Code (Code), Title 26 U.S.C., in effect at all relevant times, regulation references are to the *Code of Federal Regulations*, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure. All monetary amounts are rounded to the nearest dollar.

*Appendix B***Overview**

This case concerns the tax treatment of a structured distressed debt investment transaction (transaction) involving transfers of distressed foreign trade receivables through several purported domestic partnerships. Three parties were centrally involved in the transaction: (1) BDO Seidman, LLP (BDO), a professional services firm providing accounting, tax, financial, and consulting services, that marketed the transaction; (2) Mr. Howard, who invested in the transaction; and (3) Gramercy Advisors, LLC (Gramercy Advisors), an investment advisory firm, that implemented the transaction on Mr. Howard's behalf.

The receivables involved in the transaction originated with Santa Bárbara Indústria e Comércio de Ferro Ltda. (Santa Barbara), a metal products supplier organized under the laws of Brazil. The receivables consisted of *duplicatas*,<sup>2</sup> i.e., orders for payments, issued by Santa Barbara in 1996 to Encol S/A Engenharia Comércio e Indústria (Encol), a real estate development and construction company organized under the laws of Brazil. Encol purchased products from Santa Barbara on credit. Santa Barbara billed the trade receivables to Encol when it purportedly delivered goods to Encol in the ordinary course of business.

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2. Under Brazilian law, *duplicatas* are orders for payments issued by the creditor against the debtor related to the sales of goods or services that are evidenced by an invoice.

*Appendix B*

In 1997 Encol filed for bankruptcy protection. A Brazilian bankruptcy court granted Encol's petition, preventing adjudication of bankruptcy so long as Encol satisfied certain conditions concerning repayment of its creditors, and appointed a trustee to oversee the process. After Encol failed to meet the court's stated conditions by the end of 1998, the trustee recommended that the court declare Encol bankrupt. The court did so in 1999 and directed the liquidation of its assets.

On August 1, 2002, Santa Barbara contributed the Encol receivables using a tiered partnership structure. First, Gramercy Advisors and Santa Barbara formed XBOXT, LLC (XBOXT).<sup>3</sup> Santa Barbara contributed the Encol receivables in exchange for a 99% interest in XBOXT. Gramercy Advisors owned the remaining 1% membership interest. Second, XBOXT and Tall Ships, a limited liability company affiliated with Gramercy Advisors, formed PIMLICO. XBOXT contributed the majority of its Encol receivables to PIMLICO in exchange for a 99% membership interest, and Tall Ships acquired the remaining 1% interest.

Next, Mr. Howard became involved. He had significant investment experience including investments in distressed assets. In 2002 BDO approached Mr. Howard to pitch the distressed debt structure. BDO discussed with him tax benefits—including specific tax losses—that could be obtained through the transaction.

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3. XBOXT was a limited liability company (LLC) formed under Delaware law.

*Appendix B*

On December 10, 2002, Mr. Howard entered into a consulting agreement with BDO with respect to the transaction. Mr. Howard agreed to pay BDO a consulting fee of \$865,000, while BDO agreed to provide Mr. Howard with an opinion letter concerning the federal income tax consequences of the transaction. BDO issued the opinion letter, dated October 15, 2003, to Mr. Howard.

Through BDO, Mr. Howard was introduced to Gramercy Advisors. On December 3, 2002, Mr. Howard entered into an investment management agreement with Gramercy Investment Management, LLC, an affiliate of Gramercy Advisors, with respect to an investment of \$360,000.

On December 11, 2002, Mr. Howard transferred \$360,000 to an account at Boston Safe Deposit & Trust Co. (Boston Trust) managed by Gramercy Advisors for the benefit of Mr. Howard. On that same day, Mr. Howard acquired an 89.10% membership interest in PIMLICO from XBOXT in exchange for \$300,164. An interest-bearing account for XBOXT at Boston Trust was opened on December 20, 2002. On December 23, 2002, an internal transfer (i.e., from another Boston Trust account) of \$300,164 was made into the XBOXT account. After Mr. Howard's acquisition of his interest, PIMLICO's three members were Mr. Howard with an 89.10% interest, XBOXT with a 9.9% membership interest, and Tall Ships with a 1% interest.

PIMLICO and Tall Ships formed PICCIRC, a limited liability company under Delaware law. On December 11,

*Appendix B*

2002, PIMLICO contributed 104 of the Encol receivables valued at Brazilian real 23,585,000 to PICCIRC for a 99% ownership interest. Tall Ships contributed 0.1871% participation interests in two promissory notes for \$900 each in exchange for 1% interest in PICCIRC. RSK Investments, LLC, and Wester Gailes Capital Management, LLC, issued the notes. The PICCIRC operating agreement valued the PIMLICO capital contribution at \$333,335 and Tall Ships' contribution at \$3,376.

On December 13, 2002, Mr. Howard entered into an Investment Advisory Services Fee Agreement with Mead Point Capital Management LLC (Mead Point), an affiliate of Gramercy Advisors that collects fees with respect to its separately managed accounts. Under the terms of the agreement, Mr. Howard agreed to pay Mead Point a one-time fee of \$59,836 with respect to the transaction. (This figure represented the balance of the \$360,000 Mr. Howard initially transferred to his account at Boston Trust after his payment to XBOXT of \$300,164 for his PIMLICO interest.)

On December 26, 2002, PICCIRC sold all its Encol receivables to an affiliate of Gramercy Advisors, Gramercy Financial Services, LLC, for \$357,144. Mr. Howard was not aware of the sale by PICCIRC of its Encol receivables to Gramercy Financial Services, LLC.

On January 16, 2003, Gramercy Advisors received a facsimile copy of a letter, dated December 16, 2002, from Santa Barbara requesting a withdrawal of \$300,164 of its

*Appendix B*

membership interest in XBOXT and its payment to an account at Hudson United Bank for Kiesser Investments, SA.<sup>4</sup> XBOXT's account at Boston Trust, which had received a transfer of \$300,164 on December 23, 2002, had a closing balance of \$79 on January 30, 2003.

On January 21, 2003, Tojal Renault Advogados Associados issued a legal opinion related to the validity and enforceability of the assignment of the Encol receivables by Santa Barbara to XBOXT. This document represented that Santa Barbara had the necessary authority to perform its obligations.

On February 27, 2003, Proskauer Rose, LLP, sent a representation letter to Mr. Howard confirming that the firm would represent him in reviewing the tax consequences of the transaction. Pursuant to the representation agreement, Mr. Howard agreed to pay a fixed fee of \$100,000.<sup>5</sup> On June 13, 2003, Mr. Howard executed a copy of the representation letter, agreeing to and accepting the terms set forth therein. Proskauer Rose issued a tax opinion letter, dated October 13, 2003, to Mr. Howard with respect to the transaction. The opinion letter represented that the transaction had the requisite

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4. This letter was identical to a sample draft letter that Gramercy Advisors had sent to Santa Barbara, except with respect to the designation of the account to which the withdrawn funds were to be sent.

5. On June 20, 2003, Mr. Howard paid \$75,000 of this fee. On October 13, 2003, Proskauer Rose invoiced Mr. Howard for the remaining \$25,000, which he paid on October 15, 2003.

*Appendix B*

economic substance and business purposes to be respected under the authorities discussed in the opinion letter.

On October 15, 2003, BDO issued a tax opinion letter to Mr. Howard. The opinion letter represented that no penalty should apply to the transaction pursuant to section 6662(b)(2) or (3).

On its Form 1065 for taxable year 2002, PICCIRC reported an ordinary loss of \$22,718,351 from the transaction. This purported ordinary loss from the transaction was allocated to PIMLICO. Mr. Howard's share of the purported loss from the transaction was \$20,446,516. He claimed flow-through ordinary loss deductions of \$14,506,070 and \$6,118,531 from PIMLICO for the taxable years 2002 and 2004, respectively.

**OPINION****I. Burden of Proof**

Generally, the Commissioner's determinations set forth in an FPAA are presumed correct, and taxpayers bear the burden of showing the determinations are erroneous. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Republic Plaza Props. P'ship v. Commissioner*, 107 T.C. 94, 104 (1996). Petitioner did not contend that the burden of proof should shift to respondent under section 7491(a).

*Appendix B***II. Disguised Sale**

In general, partners may contribute capital to a partnership tax free and may receive a tax-free return of previously taxed profits through distributions to the extent that a distribution does not exceed adjusted basis. *See* §§ 721, 731. These nonrecognition rules do not apply, however, where the transaction is found in substance to be a disguised sale of property. *See Jacobson v. Commissioner*, 96 T.C. 577 (1991), *aff'd per curiam*, 963 F.2d 218 (8th Cir. 1992).

A disguised sale occurs where a partner contributes property to a partnership and receives a related distribution that is, in effect, consideration for the contributed property. *See* § 707(a)(2)(B); *Canal Corp. & Subs. v. Commissioner*, 135 T.C. 199, 210–11 (2010); Treas. Reg. § 1.707-3. A transaction may be deemed a disguised sale if, on the basis of all the facts and circumstances, (1) the partnership's transfer of money or other consideration to the partner would not have been made but for the partner's transfer of property and (2) if the transfers were not made simultaneously, the subsequent transfer was not dependent on the entrepreneurial risks of partnership operations. Treas. Reg. § 1.707-3(b)(1); *see also Route 231, LLC v. Commissioner*, 810 F.3d 247, 253 (4th Cir. 2016), *aff'g* T.C. Memo. 2014-30. The regulations provide that transfers between a partnership and a partner within a two-year period are presumed to be a sale of property to the partnership unless the facts and circumstances “clearly establish” otherwise. Treas. Reg. § 1.707-3(c)(1);

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*see Superior Trading, LLC v. Commissioner*, 728 F.3d 676, 681 (7th Cir. 2013) (finding the presumption triggered where the partner received a substantial distribution 10 months after contributing distressed receivables), *aff’g* 137 T.C. 70 (2011), *supplemented by* T.C. Memo. 2012-110. “This presumption places a high burden on the partnership to establish the validity of any suspect partnership transfers.” *Va. Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129, 139 (4th Cir. 2011), *rev’g* T.C. Memo. 2009-295.

Petitioner contends that the transaction is not a disguised sale. In particular, petitioner argues that the record contains no evidence of a distribution to Santa Barbara within two years of its contribution of the Encol receivables. We disagree.

The timeline for the transaction is far less than two years. On August 1, 2002, Santa Barbara contributed the receivables to XBOXT. On December 16, 2002, Santa Barbara requested a withdrawal from XBOXT of \$300,164. The withdrawal Santa Barbara requested is the same amount Mr. Howard paid to acquire an 89.10% interest in PIMLICO from XBOXT on December 11, 2002. Given that XBOXT had received a transfer of \$300,164 into an interest-bearing account on December 23, 2002, but had a balance in that account of only \$79 on January 30, 2003, we are satisfied that the \$300,164 requested by Santa Barbara on December 16, 2002, was in fact paid from the XBOXT account sometime between December 23, 2002, and January 30, 2003.

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The above facts do not appear to be coincidental. The facts and circumstances existing on the date of the earliest transfer are generally the relevant ones to be considered. Treas. Reg. § 1.707-3(b)(2). Petitioner has the burden of proving that there was no premeditated agreement that Santa Barbara would receive any distributions. The circumstances surrounding Santa Barbara's partial redemption of its XBOXT interest suggest that it was a preconceived step to shift basis to Mr. Howard.

The payment to Santa Barbara was not paid out of operational profits but rather from the proceeds of Mr. Howard's subsequent acquisition of an interest in PIMLICO from XBOXT. The redemption and acquisition are for the same amount. Mr. Howard's acquisition was made five days before the date on the Santa Barbara redemption letter. The purpose of the redemption was to trigger the section 704(c) loss allocation rule for the benefit of Mr. Howard. The dates and account activity of the partnerships match to such an extent that it becomes clear that XBOXT was formed solely as a conduit to execute a disguised sale of the Encol receivables.

Petitioner has offered no alternate explanation for this account activity or posited where more than \$300,000 in funds went between December 23, 2002, and January 30, 2003. Petitioner has failed to counter these facts and has failed to meet its burden of proof. Therefore, the transaction is a disguised sale. Accordingly, we sustain respondent's disallowance of PICCIRC's claimed loss deduction to the extent that the claimed loss exceeds the

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transferred basis from XBOXT (via PIMLICO) in the Encol receivables.

**III. Basis in Encol Receivables**

Pursuant to section 723, the basis of property contributed to a partnership by a partner shall be the partner's adjusted basis at the time of the contribution. In other words, the basis equals the basis the asset had in the hands of the contributing partner. Santa Barbara purportedly transferred the Encol receivables to XBOXT as the first step in the transaction.

The only evidence related to basis are the 125 *duplicatas* and a spreadsheet prepared by Gramercy Advisors listing the *duplicatas*. These documents do not provide enough information to determine the value of the *duplicatas* immediately before Santa Barbara's contribution of them to XBOXT. Therefore, we cannot determine the basis in the Encol receivables.

**IV. Validity of Partnerships**

A partnership exists for federal income tax purposes when parties intend to join together in the conduct of a trade or business and to share in the profits or losses of that trade or business. *Commissioner v. Tower*, 327 U.S. 280, 286 (1946). Whether a partnership is respected for federal tax purposes depends upon whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

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To form a bona fide partnership, the parties “must have two intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, demonstrated by an intent to share ‘the profits and losses.’” *Chemtech Royalty Assocs., LP v. United States*, 766 F.3d 453, 461 (5th Cir. 2014); *see also Commissioner v. Culbertson*, 337 U.S. at 741–43; *Commissioner v. Tower*, 327 U.S. at 286–87; *Southgate Master Fund, L.L.C. ex rel. Montgomery Cap. Advisors, LLC v. United States*, 659 F.3d 466, 483–84 (5th Cir. 2011). In determining whether a bona fide partnership has been formed, we must consider all relevant facts and circumstances, including “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.” *Commissioner v. Culbertson*, 337 U.S. at 742.

All the partnerships involved in this transaction were LLCs created under Delaware law. Pursuant to the check-the-box regulations under Treasury Regulation § 301.7701-3(b)(1), an LLC is classified as a partnership by default unless it elects to be classified as a corporation. This regulation does not entitle a partnership to the benefits provided by the Code to partnerships. *Superior Trading, LLC v. Commissioner*, 728 F.3d at 681.

There is no evidence that Santa Barbara and Gramercy Advisors, partners of XBOXT, endeavored to join in a common enterprise with a community of interest in profits

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and losses. The purported partners were accomplices to the transaction. The same is also true for PICCIRC. There is no evidence that PICCIRC, PIMLICO, and Tall Ships were engaged in business together.

The abundance of “abusive tax-avoidance schemes . . . designed to exploit the Code’s partnership provisions” requires that “our scrutiny of the taxpayer’s choice to use the partnership form [be] especially stringent.” *Southgate Master Fund*, 659 F.3d at 483–84. A partnership need not be respected “merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective.” *TIFD III-E, Inc. v. United States (Castle Harbour)*, 459 F.3d 220, 232 (2d Cir. 2006). Rather, the parties’ reasons for choosing the partnership form “must, on balance, display good ‘common sense from an economic standpoint.’” *Southgate Master Fund*, 659 F.3d at 484 (quoting *Boca Investerings P’ship v. United States*, 314 F.3d 625, 631 (D.C. Cir. 2003)). Even where a partnership engages in transactions having economic substance, the parties’ choice to operate as a partnership must be for “a legitimate, profit-motivated reason,” *id.*, and “the absence of a nontax business purpose is fatal,” *ASA Investerings P’ship v. Commissioner*, 201 F.3d 505, 512 (D.C. Cir. 2000), *aff’g* T.C. Memo. 1998-305; *see also Castle Harbour*, 459 F.3d at 231–32; *Andantech L.L.C. v. Commissioner*, 331 F.3d 972, 980 (D.C. Cir. 2003), *aff’g in part and remanding* T.C. Memo. 2002-97; *Merryman v. Commissioner*, 873 F.2d 879, 881 (5th Cir. 1989), *aff’g* T.C. Memo. 1988-72.

The partnership antiabuse rules provide that the provisions of subchapter K and the regulations thereunder

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must be applied in a manner that is consistent with the intent of subchapter K. Treas. Reg. § 1.701-2. Pursuant to these rules, a partnership satisfies the general antiabuse rule if it meets three conditions: (1) the partnership is bona fide and each partnership transaction or series of transactions is entered into for a substantial business purpose; (2) each partnership transaction is respected under substance over form principles; and (3) the tax consequences to each partner must accurately reflect the partners' economic agreement unless deviation therefrom is clearly contemplated by subchapter K. *Id.* para. (a). Where a partnership is formed to facilitate a transaction a principal purpose of which is to produce tax consequences inconsistent with the intent of subchapter K, the Commissioner may recast partnership transactions to achieve tax results intended by subchapter K. *Id.* para. (b). The Commissioner has broad authority to disregard the partnership to justify or modify the claimed tax treatment.

Whether a partnership satisfies the antiabuse regulation is determined on the basis of all of the facts and circumstances. *Id.* para. (c). The regulation provides a list of illustrative factors that may indicate a disregard for the intent of subchapter K. *Id.* para. (c). The factors relevant to this case include the following: (1) the present value of the aggregate federal tax liability of the partners is substantially less than if the partners had owned the partnership's assets and conducted the partnership's activities directly; (2) the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions designed to achieve a particular end result were integrated

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and treated as steps in a single transaction; and (3) one or more partners who are necessary to achieve the claimed tax results have a nominal interest in the partnership and are substantially protected from any risk of loss from the partnership's activities. *Id.*

Relevant to the first two factors listed above is that if Mr. Howard had purchased the assets directly from Santa Barbara, PICCIRC's basis in the receivables at the time of the sale that produced the losses would have been significantly lower than what was claimed. If, as our disguised sale analysis concludes, (1) Santa Barbara's contribution of the Encol receivables to XBOXT, (2) XBOXT's contribution of the receivables to PIMLICO, and (3) XBOXT's sale of its 89.1% interest in PIMLICO to Mr. Howard were integrated into a single transaction, the result would effectively be a direct sale of the receivables from Santa Barbara to Mr. Howard. The tax consequence of such a sale would be that Mr. Howard would have received a cost basis in the receivables under section 1012, as opposed to the significantly larger basis claimed to be transferred from Santa Barbara through XBOXT and then to PIMLICO under section 721. The subsequent contribution of the receivables to PICCIRC would be deemed made by Mr. Howard himself, and PICCIRC's basis would be equal to Mr. Howard's cost basis. *See* § 721. The subsequent sale of the receivables by PICCIRC would, in turn, produce significantly lesser losses. The parties' aggregate federal tax liability would, consequently, be substantially higher.

Further, Santa Barbara had no risk of loss because XBOXT and PICCIRC had no activities besides the sale

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of tax shelters. Santa Barbara had a nominal interest in XBOXT and no real participation. Upon our consideration of the facts and circumstances, we conclude that the partnerships should be disregarded for violation of the partnership antiabuse rules.

**V. Other Issues Petitioner Raises**

Petitioner contends that it was in compliance with the Code and that the Court should not address judicial antiabuse doctrines such as economic substance, sham transaction, business purpose, and step transaction. Respondent disagrees with this argument. We do not need to address the arguments associated with these doctrines because we have concluded that the transaction was a disguised sale and the partnerships were shams. An analysis similar to that discussed above would be used for an analysis under these doctrines. A discussion of these doctrines would not change our conclusion that respondent's determination is correct.

**VI. Accuracy-Related Penalties**

Section 6662 provides that a taxpayer may be liable for a 20% accuracy-related penalty on the portion of an underpayment of income tax attributable to, among other things, negligence or disregard of rules or regulations, a substantial understatement of income tax, or a substantial valuation misstatement. Section 6662(h)(1) increases the penalty rate from 20% to 40% to the extent that the underpayment is attributable to a gross valuation misstatement. A gross valuation misstatement exists

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where the value or adjusted basis of the property claimed on a return is 400% or more of the amount determined to be correct.<sup>6</sup> If the value or adjusted basis of the property is determined to be zero, the gross valuation misstatement penalty is applicable. Treas. Reg. § 1.6662-5(g).

Section 7491(c) generally places the burden of production of evidence on the Commissioner with respect to a taxpayer's liability for any penalty imposed by the Code. § 7491(c). In cases involving partnerships to which the TEFRA provisions apply, as is the case here, section 7491(c) does not apply. *See Dynamo Holdings Ltd. P'ship v. Commissioner*, 150 T.C. 224, 235–36 (2018). Petitioner therefore carries the burden of showing that respondent's determination to impose the penalty is erroneous. *See* Rule 142(a); *Welch v. Helvering*, 290 U.S. at 115.

Under our disguised sale analysis, PICCIRC's basis is, at the most, \$300,164. PICCIRC's reported basis of \$23,075,495 on the 2002 partnership return is well in excess of 400% of the correct basis. Petitioner produced no evidence to refute respondent's determination concerning the penalty. Further, petitioner's posttrial briefs fail to address the accuracy-related penalty. We deem petitioner

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6. The Pension Protection Act of 2006 (PPA), Pub. L. No. 109-280, 120 Stat. 780, effected certain amendments to the gross valuation misstatement penalty regime. Before the enactment of the PPA, the penalty applied when taxpayers misstated the value of property by 400% or more; PPA § 1219(a)(2), 120 Stat. at 1083, lowered the threshold to 200%. *See* § 6662(h). This case involves a return filed before the effective date of the PPA (August 17, 2006), and therefore we apply the higher threshold.

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to have conceded the issue, and we sustain respondent's penalty determination at the heightened rate. *See Rule 151(e)(4) and (5); Mendes v. Commissioner*, 121 T.C. 308, 312–13 (2003) (first citing *Clajon Gas Co. v. Commissioner*, 119 T.C. 197, 213 n.17 (2002), *rev'd*, 354 F.3d 786 (8th Cir. 2004); then citing *Davis v. Commissioner*, 119 T.C. 1, 1 n.1 (2002); then citing *Nicklaus v. Commissioner*, 117 T.C. 117, 120 n.4 (2001); and then citing *Rybak v. Commissioner*, 91 T.C. 524, 566 n.19 (1988)).

To reflect the foregoing,

*Decision will be entered for respondent.*

**APPENDIX C — DENIAL OF REHEARING OF THE  
UNITED STATES COURT OF APPEALS FOR THE  
SECOND CIRCUIT, FILED NOVEMBER 4, 2025**

UNITED STATES COURT OF APPEALS  
FOR THE  
SECOND CIRCUIT

Docket No: 24-1982

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Thurgood Marshall United States Courthouse, 40 Foley Square, in the City of New York, on the 4th day of November, two thousand twenty-five.

PIMLICO, LLC,

*Petitioner-Appellant,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent-Appellee.*

**ORDER**

Appellant, Pimlico, LLC, filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*. The panel that determined the appeal has considered the request for panel rehearing, and the active members of the Court have considered the request for rehearing *en banc*.

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IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:

/s/ Catherine O'Hagan Wolfe  
Catherine O'Hagan Wolfe, Clerk

## APPENDIX D — RELEVANT STATUTORY PROVISIONS

### 26 U.S.C.A. § 704, I.R.C. § 704

#### § 704. Partner's distributive share

**Effective: August 5, 1997 to October 22, 2004**

\* \* \*

##### (c) Contributed property--

(1) In general.--Under regulations prescribed by the Secretary--

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, and

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed--

(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason

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of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

- (ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and
- (iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph.

\* \* \* \*

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**26 U.S.C.A. § 704, I.R.C. § 704**

**§ 704. Partner's distributive share**

**Effective: October 23, 2004 to November 1, 2015**

\* \* \*

**(c) Contributed property.--**

**(1) In general.--**Under regulations prescribed by the Secretary--

**(A)** income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution,

**(B)** if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed--

**(i)** the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

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(ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and

(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph, and

(C) if any property so contributed has a built-in loss--

(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C), the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution.

\* \* \* \*

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**26 U.S.C.A. § 707, I.R.C. § 707**

**§ 707. Transactions between partner and partnership**

**Effective: [See Text Amendments] to July 3, 2025**

**(a) 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

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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.

\* \* \* \*

*Appendix D***26 C.F.R. § 1.701–2, Treas. Reg. § 1.701–2****§ 1.701–2 Anti-abuse rule.**

**(a) Intent of subchapter K.** Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements—

- (1)** The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the 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)** Except as otherwise provided in this paragraph (a)(3), the 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, the proper reflection of

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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. See, for example, paragraph (d) Example 6 of this section (relating to the value-equals-basis rule in § 1.704-1(b)(2)(iii)(c)), paragraph (d) Example 9 of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) Examples 10 and 11 of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§ 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

**(b) Application of subchapter K rules.** The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (intent of subchapter K). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may

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fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—

- (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
- (2) One or more of the purported partners of the partnership should not be treated as a partner;
- (3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;
- (4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or
- (5) The claimed tax treatment should otherwise be adjusted or modified.

(c) **Facts and circumstances analysis; factors.** Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the

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transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

- (1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;
- (2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;
- (3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any

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risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704–1 and 1.704–2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

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**(d) Examples.** The following examples illustrate the principles of paragraphs (a), (b), and (c) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

**Example 1.** Choice of entity; avoidance of entity-level tax; use of partnership consistent with the intent of subchapter K. (i) A and B form limited partnership PRS to conduct a bona fide business. A, the corporate general partner, has a 1% partnership interest. B, the individual limited partner, has a 99% interest. PRS is properly classified as a partnership under §§ 301.7701-2 and 301.7701-3. A and B chose limited partnership form as a means to provide B with limited liability without subjecting the income from the business operations to an entity-level tax.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. Although B has retained, indirectly, substantially all of the benefits and burdens of ownership of the money or property B contributed to PRS (see paragraph (c)(6) of this section), the decision to organize and conduct business through PRS under these circumstances is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and

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(3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 2.** Choice of entity; avoidance of subchapter S shareholder requirements; use of partnership consistent with the intent of subchapter K. (i) A and B form partnership PRS to conduct a bona fide business. A is a corporation that has elected to be treated as an S corporation under subchapter S. B is a nonresident alien. PRS is properly classified as a partnership under §§ 301.7701-2 and 301.7701-3. Because section 1361(b) prohibits B from being a shareholder in A, A and B chose partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of subchapter S treatment for A and its shareholders.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the partnership transaction should not be respected because it does not reflect its substance (inasmuch as application of the substance over form doctrine arguably could result in B being treated as a shareholder of A, thereby invalidating A's subchapter S election), the facts indicate otherwise. The shareholders of A are subject to tax on their pro rata shares of A's income (see section 1361

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et seq.), and B is subject to tax on B's distributive share of partnership income (see sections 871 and 875). Thus, the form in which this arrangement is cast accurately reflects its substance as a separate partnership and S corporation. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 3.** Choice of entity; avoidance of more restrictive foreign tax credit limitation; use of partnership consistent with the intent of subchapter K. (i) X, a domestic corporation, and Y, a foreign corporation, form partnership PRS under the laws of foreign Country A to conduct a bona fide joint business. X and Y each owns a 50% interest in PRS. PRS is properly classified as a partnership under §§ 301.7701-2 and 301.7701-3. PRS pays income taxes to Country A. X and Y chose partnership form to enable X to qualify for a direct foreign tax credit under section 901, with look-through treatment under § 1.904-5(h)(1). Conversely, if PRS were a foreign corporation for U.S. tax purposes, X would be entitled only to indirect foreign tax credits under section 902 with respect to dividend distributions from PRS. The look-through rules, however, would not apply, and pursuant to section 904(d)(1)(E) and § 1.904-4(g), the dividends and associated taxes would be subject to a separate foreign tax credit limitation for dividends from PRS, a noncontrolled section 902 corporation.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and

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conduct business through PRS in order to take advantage of the look-through rules for foreign tax credit purposes, thereby maximizing X's use of its proper share of foreign taxes paid by PRS, is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 4.** Choice of entity; avoidance of gain recognition under sections 351(e) and 357(c); use of partnership consistent with the intent of subchapter K. (i) X, ABC, and DEF form limited partnership PRS to conduct a bona fide real estate management business. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. X, the general partner, is a newly formed corporation that elects to be treated as a real estate investment trust as defined in section 856. X offers its stock to the public and contributes substantially all of the proceeds from the public offering to PRS. ABC and DEF, the limited partners, are existing partnerships with substantial real estate holdings. ABC and DEF contribute all of their real property assets to PRS, subject to liabilities that exceed their respective aggregate bases in the real property contributed, and terminate under section 708(b)(1)(A). In addition, some of the former partners of ABC and DEF each have the right, beginning two years after the formation of PRS, to require the redemption of their limited partnership interests in PRS in exchange for cash or X stock (at X's option) equal to the fair market value of their respective interests in PRS at the time of the redemption. These partners are not

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compelled, as a legal or practical matter, to exercise their exchange rights at any time. X, ABC, and DEF chose to form a partnership rather than have ABC and DEF invest directly in X to allow ABC and DEF to avoid recognition of gain under sections 351(e) and 357(c). Because PRS would not be treated as an investment company within the meaning of section 351(e) if PRS were incorporated (so long as it did not elect under section 856), section 721(a) applies to the contribution of the real property to PRS. See section 721(b).

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS, thereby avoiding the tax consequences that would have resulted from contributing the existing partnerships' real estate assets to X (by applying the rules of sections 721, 731, and 752 in lieu of the rules of sections 351(e) and 357(c)), is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the transaction should not be respected because it does not reflect its substance (inasmuch as the present value of the partners' aggregate federal tax liability is substantially less than would be the case if the transaction were integrated and treated as a contribution of the encumbered assets by ABC and DEF directly to X, see paragraph (c)(2) of this section), the facts indicate otherwise. For example, the right of some of the former ABC and DEF partners after two years to exchange their

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PRS interests for cash or X stock (at X's option) equal to the fair market value of their PRS interest at that time would not require that right to be considered as exercised prior to its actual exercise. Moreover, X may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes. Thus, although it may be likely that some or all of the partners with the right to do so will, at some point, exercise their exchange rights, and thereby receive either cash or X stock, the form of the transaction as a separate partnership and real estate investment trust is respected under substance over form principles (see paragraph (a)(2) of this section). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 5.** Special allocations; dividends received deductions; use of partnership consistent with the intent of subchapter K. (i) Corporations X and Y contribute equal amounts to PRS, a bona fide partnership formed to make joint investments. PRS pays \$100x for a share of common stock of Z, an unrelated corporation, which has historically paid an annual dividend of \$6x. PRS specially allocates the dividend income on the Z stock to X to the extent of the London Inter-Bank Offered Rate (LIBOR) on the record date, applied to X's contribution of \$50x, and allocates the remainder of the dividend income to Y. All other items of partnership income and loss are allocated equally between X and Y. The allocations under the partnership agreement have substantial economic effect within the meaning of § 1.704-1(b)(2). In addition to avoiding an entity-level tax, a principal purpose for the formation of the partnership was to invest in the Z common

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stock and to allocate the dividend income from the stock to provide X with a floating-rate return based on LIBOR, while permitting X and Y to claim the dividends received deduction under section 243 on the dividends allocated to each of them.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Section 704(b) and § 1.704–1(b)(2) permit income realized by the partnership to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Section 704(e)(2) is not applicable to the facts of this example (otherwise, the allocations would be required to be proportionate to the partners' ownership of contributed capital). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 6.** Special allocations; nonrecourse financing; low-income housing credit; use of partnership consistent with the intent of subchapter K. (i) A and B, high-bracket taxpayers, and X, a corporation with net operating loss carryforwards, form general partnership PRS to own and operate a building that qualifies for the low-income housing

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credit provided by section 42. The project is financed with both cash contributions from the partners and nonrecourse indebtedness. The partnership agreement provides for special allocations of income and deductions, including the allocation of all depreciation deductions attributable to the building to A and B equally in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the building. The section 42 credits are allocated to A and B in accordance with the allocation of depreciation deductions. PRS's allocations comply with all applicable regulations, including the requirements of §§ 1.704-1(b)(2)(ii) (pertaining to economic effect) and 1.704-2(e) (requirements for allocations of nonrecourse deductions). The nonrecourse indebtedness is validly allocated to the partners under the rules of § 1.752-3, thereby increasing the basis of the partners' respective partnership interests. The basis increase created by the nonrecourse indebtedness enables A and B to deduct their distributive share of losses from the partnership (subject to all other applicable limitations under the Internal Revenue Code) against their nonpartnership income and to apply the credits against their tax liability.

(ii) At a time when the depreciation deductions attributable to the building are not treated as nonrecourse deductions under § 1.704-2(c) (because there is no net increase in partnership minimum gain during the year), the special allocation of depreciation deductions to A and B has substantial economic effect because of the value-equals-basis safe harbor contained in § 1.704-1(b)(2)(iii)(c) and the fact that A and B would bear the economic

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burden of any decline in the value of the building (to the extent of the partnership's investment in the building), notwithstanding that A and B believe it is unlikely that the building will decline in value (and, accordingly, they anticipate significant timing benefits through the special allocation). Moreover, in later years, when the depreciation deductions attributable to the building are treated as nonrecourse deductions under § 1.704–2(c), the special allocation of depreciation deductions to A and B is considered to be consistent with the partners' interests in the partnership under § 1.704–2(e).

(iii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Section 704(b), § 1.704–1(b)(2), and § 1.704–2(e) allow partnership items of income, gain, loss, deduction, and credit to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Moreover, the application of the value-equals-basis safe harbor and the provisions of § 1.704–2(e) with respect to the allocations to A and B, and the tax results of the application of those provisions, taking into account all the facts and circumstances, are clearly contemplated. Accordingly, even if the allocations

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would not otherwise be considered to satisfy the proper reflection of income standard in paragraph (a)(3) of this section, that requirement will be treated as satisfied under these facts. Thus, even though the partners' aggregate federal tax liability may be substantially less than had the partners owned the partnership's assets directly (due to X's inability to use its allocable share of the partnership's losses and credits) (see paragraph (c)(1) of this section), the transaction is not inconsistent with the intent of subchapter K. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 7.** Partner with nominal interest; temporary partner; use of partnership not consistent with the intent of subchapter K. (i) Pursuant to a plan a principal purpose of which is to generate artificial losses and thereby shelter from federal taxation a substantial amount of income, X (a foreign corporation), Y (a domestic corporation), and Z (a promoter) form partnership PRS by contributing \$9,000x, \$990x, and \$10x, respectively, for proportionate interests (90.0%, 9.9%, and 0.1%, respectively) in the capital and profits of PRS. PRS purchases offshore equipment for \$10,000x and validly leases the equipment offshore for a term representing most of its projected useful life. Shortly thereafter, PRS sells its rights to receive income under the lease to a third party for \$9,000x, and allocates the resulting \$9,000x of income \$8,100x to X, \$891x to Y, and \$9x to Z. PRS thereafter makes a distribution of \$9,000x to X in complete liquidation of its interest. Under § 1.704-1(b)(2)(iv)(f), PRS restates the partners' capital accounts immediately before making the liquidating distribution to X to reflect its assets consisting of the

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offshore equipment worth \$1,000x and \$9,000x in cash. Thus, because the capital accounts immediately before the distribution reflect assets of \$19,000x (that is, the initial capital contributions of \$10,000x plus the \$9,000x of income realized from the sale of the lease), PRS allocates a \$9,000x book loss among the partners (for capital account purposes only), resulting in restated capital accounts for X, Y, and Z of \$9,000x, \$990x, and \$10x, respectively. Thereafter, PRS purchases real property by borrowing the \$8,000x purchase price on a recourse basis, which increases Y's and Z's bases in their respective partnership interests from \$1,881x and \$19x, to \$9,801x and \$99x, respectively (reflecting Y's and Z's adjusted interests in the partnership of 99% and 1%, respectively). PRS subsequently sells the offshore equipment, subject to the lease, for \$1,000x and allocates the \$9,000x tax loss \$8,910x to Y and \$90x to Z. Y's and Z's bases in their partnership interests are therefore reduced to \$891x and \$9x, respectively.

(ii) On these facts, 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 (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), (3), and (5) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph

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(a)(2) of this section) and does not properly reflect the income of Y (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or the validity of the allocations under § 1.704–1(b)(2) (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

**Example 8.** Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K. (i) A owns land with a basis of \$100x and a fair market value of \$60x. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. To effect this plan, A, C (A's brother), and W (C's wife) form partnership PRS, to which A contributes the land, and C and W each contribute \$30x. All partnership items are shared in proportion to the partners' respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership's

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assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset held by PRS. Under section 732(b), A's basis in the asset distributed equals \$100x, A's basis in A's partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a \$40x loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains \$100x. At the end of year 3, pursuant to the lease option, PRS sells the land to B for \$60x (its fair market value). Thus, PRS recognizes a \$40x loss on the sale, which is allocated equally between C and W. C's and W's bases in their partnership interests are reduced to \$10x each pursuant to section 705. Their respective interests are worth \$30x each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize \$20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A's built-in loss in the land prior to its contribution to PRS.

(iii) On these facts, 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 (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal

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purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

**Example 9.** Absence of section 754 election; use of partnership consistent with the intent of subchapter K. (i) PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of \$100x, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually agreed to by A

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and the managing general partner, P. P and A agree to distribute to A \$100x worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of \$20x. Upon distribution, A's aggregate basis in the securities is \$100x under section 732(b). PRS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the \$80x of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied.

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The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly

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recognized that if the section 754 election were not made, basis distortions may result. Taking into account all the facts and circumstances of the transaction, the electivity of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 10.** Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K. (i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of \$100x, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of \$60x and a basis to PRS of \$40x, and related equipment with two years of cost recovery remaining and a value and basis to PRS of \$40x. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732(b) and (c), A's \$100x basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or \$50x to the nondepreciable asset and \$50x to the equipment. Thus, A will have a \$10x built-in gain in the nondepreciable asset (\$60x value less \$50x basis)

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and a \$10x built-in loss in the equipment (\$50x basis less \$40x value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements

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of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732 (b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

**Example 11.** Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K. (i) Partnership PRS has for several years been engaged in the development and management of

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commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS, which has a value of  $\$95x$  and a basis of  $\$5x$ . X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes  $\$100x$  to PRS for an interest therein. Subsequently (at a time when the value of the partnership's assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of  $\$5x$ . The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732(b) and (c), X's  $\$100x$  basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or  $\$50x$  each. Thereafter, X plans to sell the second asset for its value of  $\$5x$ , recognizing a loss of  $\$45x$ . In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732(b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.

(ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax

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results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

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**(e) Abuse of entity treatment—(1) General rule.** The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.

**(2) Clearly contemplated entity treatment.** Paragraph (e)(1) of this section does not apply to the extent that—

**(i)** A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and

**(ii)** That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

**(f) Examples.** The following examples illustrate the principles of paragraph (e) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

**Example 1.** Aggregate treatment of partnership appropriate to carry out purpose of section 163(e)(5).

(i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial

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bona fide business activities. As part of these business activities, PRS issues certain high yield discount obligations to an unrelated third party. Section 163(e)(5) defers (and in certain circumstances disallows) the interest deductions on this type of obligation if issued by a corporation. PRS, X, and Y take the position that, because PRS is a partnership and not a corporation, section 163 (e)(5) is not applicable.

(ii) Section 163(e)(5) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 163(e)(5) is to limit corporate-level interest deductions on certain obligations. The treatment of PRS as an entity could result in a partnership with corporate partners issuing those obligations and thereby circumventing the purpose of section 163(e)(5), because the corporate partner would deduct its distributive share of the interest on obligations that would have been deferred until paid or disallowed had the corporation issued its share of the obligation directly. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 163(e)(5) (regardless of whether any party had a tax avoidance purpose in having PRS issue the obligation). Each partner of PRS will therefore be treated as issuing its share of the obligations for purposes of determining the deductibility of its distributive share of any interest on the obligations. See also section 163(i)(5)(B).

**Example 2.** Aggregate treatment of partnership appropriate to carry out purpose of section 1059.  
(i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial

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bona fide business activities. As part of these business activities, PRS purchases 50 shares of Corporation Z common stock. Six months later, Corporation Z announces an extraordinary dividend (within the meaning of section 1059). Section 1059(a) generally provides that if any corporation receives an extraordinary dividend with respect to any share of stock and the corporation has not held the stock for more than two years before the dividend announcement date, the basis in the stock held by the corporation is reduced by the nontaxed portion of the dividend. PRS, X, and Y take the position that section 1059(a) is not applicable because PRS is a partnership and not a corporation.

(ii) Section 1059(a) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 1059(a) is to limit the benefits of the dividends received deduction with respect to extraordinary dividends. The treatment of PRS as an entity could result in corporate partners in the partnership receiving dividends through partnerships in circumvention of the intent of section 1059. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 1059 (regardless of whether any party had a tax avoidance purpose in acquiring the Z stock through PRS). Each partner of PRS will therefore be treated as owning its share of the stock. Accordingly, PRS must make appropriate adjustments to the basis of the Corporation Z stock, and the partners must also make adjustments to the basis in their respective interests in PRS under section 705(a)(2)(B). See also section 1059(g)(1).

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**Example 3.** Prescribed entity treatment of partnership; determination of CFC status clearly contemplated. (i) X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign Country A. They form PRS, a bona fide domestic general partnership in which X owns a 40% interest and Y owns a 60% interest. PRS is properly classified as a partnership under §§ 301.7701–2 and 301.7701–3. PRS holds 100% of the voting stock of Z, a Country A entity that is classified as an association taxable as a corporation for federal tax purposes under § 301.7701–2. Z conducts its business operations in Country A. By investing in Z through a domestic partnership, X seeks to obtain the benefit of the look-through rules of section 904(d)(3) and, as a result, maximize its ability to claim credits for its proper share of Country A taxes expected to be incurred by Z.

(ii) Pursuant to sections 957(c) and 7701(a)(30), PRS is a United States person. Therefore, because it owns 10% or more of the voting stock of Z, PRS satisfies the definition of a U.S. shareholder under section 951(b). Under section 957(a), Z is a controlled foreign corporation (CFC) because more than 50% of the voting power or value of its stock is owned by PRS. Consequently, under section 904(d)(3), X qualifies for look-through treatment in computing its credit for foreign taxes paid or accrued by Z. In contrast, if X and Y owned their interests in Z directly, Z would not be a CFC because only 40% of its stock would be owned by U.S. shareholders. X's credit for foreign taxes paid or accrued by Z in that case would be subject to a separate foreign tax credit limitation for dividends from Z, a noncontrolled section 902 corporation. See section 904(d)(1)(E) and § 1.904–4(g).

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(iii) Sections 957(c) and 7701(a)(30) prescribe the treatment of a domestic partnership as an entity for purposes of defining a U.S. shareholder, and thus, for purposes of determining whether a foreign corporation is a CFC. The CFC rules prevent the deferral by U.S. shareholders of U.S. taxation of certain earnings of the CFC and reduce disparities that otherwise might occur between the amount of income subject to a particular foreign tax credit limitation when a taxpayer earns income abroad directly rather than indirectly through a CFC. The application of the look-through rules for foreign tax credit purposes is appropriately tied to CFC status. See sections 904(d)(2)(E) and 904(d)(3). This analysis confirms that Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, under paragraph (e) of this section, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of determining X's foreign tax credit limitation.

**(g) Effective date.** Paragraphs (a), (b), (c), and (d) of this section are effective for all transactions involving a partnership that occur on or after May 12, 1994. Paragraphs (e) and (f) of this section are effective for all transactions involving a partnership that occur on or after December 29, 1994.

**(h) Scope and application.** This section applies solely with respect to taxes under subtitle A of the Internal Revenue Code, and for purposes of this section, any reference to a federal tax is limited to any tax imposed under subtitle A of the Internal Revenue Code.

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**(i) Application of nonstatutory principles and other statutory authorities.** The Commissioner can continue to assert and to rely upon applicable nonstatutory principles and other statutory and regulatory authorities to challenge transactions. This section does not limit the applicability of those principles and authorities.

*Appendix D***26 C.F.R. § 1.707–3, Treas. Reg. § 1.707–3****§ 1.707–3 Disguised sales of property to partnership; general rules.**

**(a) Treatment of transfers as a sale—(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) this section is treated as a sale for all purposes of the Internal Revenue 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

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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.

**(3) Application of disguised sale rules.** If a person purports to transfer property to a partnership in a capacity as a partner, the rules of this section apply for purposes of determining whether the property was transferred in a disguised sale, even if it is determined after the application of the rules of this section that such person is not a partner. If after the application of the rules of this section to a purported transfer of property to a partnership, it is determined that no partnership exists because the property was actually sold, or it is otherwise determined that the contributed property is not owned by the partnership for tax purposes, the transferor of the property is treated as having sold the property to the person (or persons) that acquired ownership of the property for tax purposes.

**(4) Deemed terminations under section 708.** In applying the rules of this section, transfers resulting from a termination of a partnership under section 708(b)(1)(B) are disregarded.

**(b) Transfers treated as a sale—(1) In general.** A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances—

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(i) The transfer of money or other consideration would not have been made but for the transfer of property; and

(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

(2) **Facts and circumstances.** The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section. Among the facts and circumstances that may tend to prove the existence of a sale under paragraph (b)(1) of this section are the following:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner's right to receive the transfer of money or other consideration is secured in any

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manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(vi) That a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

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**(ix)** That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

**(x)** That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

**(c) Transfers made within two years presumed to be a sale—**(1) **In general.** For purposes of this section, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

**(2) Disclosure of transfers made within two years.** Disclosure to the Internal Revenue Service in accordance with § 1.707–8 is required if—

**(i)** A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner with a two-year period (without regard to the order of the transfers);

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(ii) The partner treats the transfers other than as a sale for tax purposes; and

(iii) The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under § 1.707-4(a)(1)(ii), is not a reasonable preferred return within the meaning of § 1.707-4(a)(3), and is not an operating cash flow distribution within the meaning of § 1.707-4(b)(2).

(d) **Transfers made more than two years apart presumed not to be a sale.** For purposes of this section, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

(e) **Scope.** This section and §§ 1.707-4 through 1.707-9 apply to contributions and distributions of property described in section 707(a)(2)(A) and transfers described in section 707(a)(2)(B) of the Internal Revenue Code.

(f) **Examples.** The following examples illustrate the application of this section.

**Example 1.** Treatment of simultaneous transfers as a sale. A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market

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value of \$4,000,000 and an adjusted tax basis of \$1,200,000. Immediately after the transfer, the partnership transfers \$3,000,000 in cash to A. Assume that, under this section, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered to have sold a portion of property X with a value of \$3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize \$2,100,000 of gain (\$3,000,000 amount realized less \$900,000 adjusted tax basis (\$1,200,000 multiplied by \$3,000,000/\$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, \$1,000,000 of the fair market value of the property with an adjusted tax basis of \$300,000.

**Example 2.** Treatment of transfers at different times as a sale. (i) The facts are the same as in Example 1, except that the \$3,000,000 is transferred to A one year after A's transfer of property X to the partnership. Assume that under this section the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Assume also that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

(ii) Under paragraph (a)(2) of this section, A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer \$3,000,000 to A one year later. Section 1274 applies to this obligation because it does not

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bear interest and is payable more than six months after the date of the sale. As a result, A's amount realized from the receipt of the partnership's obligation will be the imputed principal amount of the partnership's obligation to transfer \$3,000,000 to A, which equals \$2,721,088 (the present value on April 9, 1992, of a \$3,000,000 payment due one year later, determined using a discount rate of 10 percent, compounded semiannually). Therefore, A's amount realized from the receipt of the partnership's obligation is \$2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only \$2,721,088 of the fair market value of property X. The remainder of the \$3,000,000 payment (\$278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize \$1,904,761 of gain (\$2,721,088 amount realized less \$816,327 adjusted tax basis (\$1,200,000 multiplied by \$2,721,088/\$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, \$1,278,912 of the fair market value of property X with an adjusted tax basis of \$383,673.

**Example 3.** Operation of presumption for transfers within two years. (i) C transfers undeveloped land to the CD partnership in exchange for an interest in the partnership. The partnership intends to construct a building on the land. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted

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tax basis of \$500,000 and a fair market value of \$1,000,000. The partnership agreement provides that upon completing construction of the building the partnership will distribute \$900,000 to C.

(ii) If, within two years of C's transfer of land to the partnership, a transfer is made to C pursuant to the provision requiring a distribution upon completion of the building, the transfer is presumed to be, under paragraph (c) of this section, part of a sale of the land to the partnership. C may rebut the presumption that the transfer is part of a sale if the facts and circumstances clearly establish that—

(A) The transfer to C would have been made without regard to C's transfer of land to the partnership; or

(B) The partnership's obligation or ability to make this transfer to C depends, at the time of the transfer to the partnership, on the entrepreneurial risks of partnership operations.

(iii) For example, if the partnership will be able to fund the transfer of cash to C only to the extent that permanent loan proceeds exceed the cost of constructing the building, the fact that excess permanent loan proceeds will be available only if the cost to complete the building is significantly less than the amount projected by a reasonable budget would be evidence that the transfer to C is not part of a sale. Similarly, a condition that limits the amount of the permanent loan to the cost of constructing the building (and thereby limits the partnership's ability to

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make a transfer to C) unless all or a substantial portion of the building is leased would be evidence that the transfer to C is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. Another factor that may prove that the transfer of cash to C is not part of a sale would be that, at the time the land is transferred to the partnership, no lender has committed to make a permanent loan to fund the transfer of cash to C.

(iv) Facts indicating that the transfer of cash to C is not part of a sale, however, may be offset by other factors. An offsetting factor to restrictions on the permanent loan proceeds may be that the permanent loan is to be a recourse loan and certain conditions to the loan are likely to be waived by the lender because of the creditworthiness of the partners or the value of the partnership's other assets. Similarly, the factor that no lender has committed to fund the transfer of cash to C may be offset by facts establishing that the partnership is obligated to attempt to obtain such a loan and that its ability to obtain such a loan is not significantly dependent on the value that will be added by successful completion of the building, or that the partnership reasonably anticipates that it will have (and will utilize) an alternative source to fund the transfer of cash to C if the permanent loan proceeds are inadequate.

**Example 4.** Operation of presumption for transfers within two years. E is a partner in the equal EF partnership. The partnership owns two parcels of unimproved real property (parcels 1 and 2). Parcels 1 and 2 are unencumbered. Parcel 1 has a fair market value of

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\$500,000, and parcel 2 has a fair market value of \$1,500,000. E transfers additional unencumbered, unimproved real property (parcel 3) with a fair market value of \$1,000,000 to the partnership in exchange for an increased interest in partnership profits of  $66 \frac{2}{3}$  percent. Immediately after this transfer, the partnership sells parcel 1 for \$500,000 in a transaction not in the ordinary course of business. The partnership transfers the proceeds of the sale \$333,333 to E and \$166,667 to F in accordance with their respective partnership interests. The transfer of \$333,333 to E is presumed to be, in accordance with paragraph (c) of this section, a sale, in part, of parcel 3 to the partnership. However, the facts of this example clearly establish that \$250,000 of the transfer to E is not part of a sale of parcel 3 to the partnership because E would have been distributed \$250,000 from the sale of parcel 1 whether or not E had transferred parcel 3 to the partnership. The transfer to E exceeds by \$83,333 (\$333,333 minus \$250,000) the amount of the distribution that would have been made to E if E had not transferred parcel 3 to the partnership. Therefore, \$83,333 of the transfer is presumed to be part of a sale of a portion of parcel 3 to the partnership by E.

**Example 5.** Operation of presumption for transfers more than two years apart. (i) G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of \$500,000 and a fair market value of \$1,000,000. H contributes \$1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on

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the land. The projected construction cost is \$5,000,000, which the partnership plans to fund with its \$1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.

(ii) Shortly before G's transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of \$5,000,000. The partnership is not obligated to reimburse or indemnify H if H must make payment on the completion guarantee. The permanent loan will be funded upon completion of the building, which is expected to occur two years after G's transfer of the land. The amount of the permanent loan is to equal the lesser of \$5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G's transfer of the land to the partnership. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed \$5,000,000 only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected cost of \$5,000,000 approximately two years after G's transfer of the land. Shortly thereafter, the permanent loan is funded in the amount of \$5,000,000. At the time

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of funding the land and building have an appraised value of \$7,000,000. The partnership transfers the \$1,000,000 excess permanent loan proceeds to G 25 months after G's transfer of the land to the partnership.

(iii) G's transfer of the land to the partnership and the partnership's transfer of \$1,000,000 to G occurred more than two years apart. In accordance with paragraph (d) of this section, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale of the property, in whole or part, to the partnership. The transfer of \$1,000,000 to G would not have been made but for G's transfer of the land to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time an amount that equals the excess of the permanent loan proceeds over \$4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of \$4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of \$1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G's transfer of the land to the partnership is not treated as part of a sale.

**Example 6.** Rebuttal of presumption for transfers more than two years apart. The facts are the same as in Example 5, except that the partnership is able to

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secure a commitment for a permanent loan in the amount of \$5,000,000 without regard to the appraised value of the improved property at the time the permanent loan is funded. Under these facts, at the time that G transferred the land to the partnership the subsequent transfer of \$1,000,000 to G was not dependent on the entrepreneurial risks of partnership operations, because during the period before the permanent loan is funded, the permanent lender's obligation to make a loan in the amount necessary to fund the transfer is not subject to the contingencies related to the risks of partnership operations, and after the permanent loan is funded, the partnership holds liquid assets sufficient to make the transfer. Therefore, the facts and circumstances clearly establish that G's transfer of the land to the partnership is part of a sale.

**Example 7.** Operation of presumption for transfers more than two years apart. The facts are the same as in Example 6, except that H does not guarantee either that the improvements will be completed or that the cost to the partnership of completing the improvements will not exceed \$5,000,000. Under these facts, if there is a significant risk that the improvements will not be completed, G's transfer of the land to the partnership will not be treated as part of a sale because the lender is required to make the permanent loan if the improvements are not completed. Similarly, the transfers will not be treated as a sale to the extent that there is a significant risk that the cost of constructing the improvements will exceed \$5,000,000, because, in the absence of a guarantee of the cost of the improvements by H, the \$5,000,000 proceeds of the permanent loan might not be sufficient to retire the construction loan and fund the transfer to G. In

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either case, the transfer of cash to G would be dependent on the entrepreneurial risks of partnership operations.

**Example 8.** Rebuttal of presumption for transfers more than two years apart. (i) On February 1, 1992, I, J, and K form partnership IJK. On formation of the partnership, I transfers an unencumbered office building with a fair market value of \$50,000,000 and an adjusted tax basis of \$20,000,000 to the partnership, and J and K each transfer United States government securities with a fair market value and an adjusted tax basis of \$25,000,000 to the partnership. Substantially all of the rentable space in the office building is leased on a long-term basis. The partnership agreement provides that all items of income, gain, loss, and deduction from the office building are to be allocated 45 percent to J, 45 percent to K, and 10 percent to I. The partnership agreement also provides that all items of income, gain, loss, and deduction from the government securities are to be allocated 90 percent to I, 5 percent to J, and 5 percent to K. The partnership agreement requires that cash flow from the office building and government securities be allocated between partners in the same manner as the items of income, gain, loss, and deduction from those properties are allocated between them. The partnership agreement complies with the requirements of § 1.704-1(b)(2)(ii) (b). It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the office building. At the time the partnership is formed, I, J, and K contemplated that I's interest in the partnership would be liquidated sometime after January 31, 1994, in exchange for a transfer of the government securities and cash (if necessary). On March 1, 1995, the partnership transfers

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cash and the government securities to I in liquidation of I's interest in the partnership. The cash transferred to I represents the excess of I's share of the appreciation in the office building since the formation of the partnership over J's and K's share of the appreciation in the government securities since they are acquired by the partnership.

(ii) I's transfer of the office building to the partnership and the partnership's transfer of the government securities and cash to I occurred more than two years apart. Therefore, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale. Absent I's transfer of the office building to the (partnership, I would not have received the government securities from the partnership. The facts including the amount and nature of partnership assets) indicate that, at the time that I transferred the office building to the partnership, the timing of the transfer of the government securities to I was anticipated and was not dependent on the entrepreneurial risks of partnership operations. Moreover, the facts indicate that the partnership allocations were designed to effect an exchange of the burdens and benefits of ownership of the government securities in anticipation of the transfer of those securities to I and those burdens and benefits were effectively shifted to I on formation of the partnership. Accordingly, the facts and circumstances clearly establish that I sold the office building to the partnership on February 1, 1992, in exchange for the partnership's obligation to transfer the government securities to I and to make certain other cash transfers to I.