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Chemtech: A Showcase for Common Law Partnership Doctrines

By Andy Howlett and Lisandra Ortiz

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Howlett and Ortiz examine *Chemtech* and the issues it raises for tax practitioners in forming partnership transactions. They analyze the lower court's broad decision, which disregarded the partnerships at issue using three separate common law doctrines, and they compare it with the Fifth Circuit's narrower opinion, which addressed only the sham partnership issue.

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On September 10, 2014, the Fifth Circuit announced its decision in *Chemtech*,[1] giving the government a win in its years-long battle against allegedly abusive tax shelters. The case is significant for the courts' use of common law doctrines to disregard two partnerships formed by Dow Chemical Co. The district court broadly invoked the sham partnership doctrine, the economic substance doctrine, and the bona fide partner doctrine, whereas the Fifth Circuit focused solely on the sham partnership issue.

This report examines *Chemtech* in depth, analyzing its implications for partnership arrangements. It concludes that in light of the district court and Fifth Circuit opinions, practitioners must consider the allocation of upside potential and downside risk when forming partnerships that involve priority returns, guarantees, and other protections against limited partners' risk of loss.

I. Facts

A. Chemtech I

Goldman Sachs, Dow's principal investment bank since the 1950s, proposed in 1992 that the company use a special limited investment partnership structure.[2] Dow implemented the transaction (Chemtech I) from 1993 until 1998 by forming Chemtech Royalty Associates LP (Chemtech), a Delaware limited partnership.

Several Dow entities were involved in the Chemtech I transaction. A foreign subsidiary, Dow Europe SA (DESA), contributed approximately $10 million to Chemtech and received a 1 percent interest as the general partner. Diamond Technology Partnership Co. (DTPC), another Dow subsidiary, initially became an 88 percent limited partner by contributing to Chemtech 73 patents created and

[1]*Chemtech Royalty Associates LP v. United States*, 766 F.3d 453 (5th Cir. 2014), *aff'g in part and rev'g and vacating in part*, No. 3:05-cv-00944 (M.D. La. 2013) (slip op.).

[2]*See* Plaintiff's Pretrial Brief at 11, *Chemtech Royalty Associates LP v. United States*, Nos. 05-944, 06-258, 07-405 (M.D. La. 2011). Throughout this report, uncontested facts are generally taken from the Fifth Circuit's opinion, the district court's opinion, Dow's briefs, or some combination thereof.

used by Dow in its business operations.[3] In another transaction, DESA and DTPC formed Chemtech Portfolio Inc. (CPI), a Texas corporation, and DTPC transferred all its CPI stock to Chemtech as a capital contribution.[4] Chemtech took an initial basis of approximately $2.5 million in the CPI stock, the same as DTPC's basis.

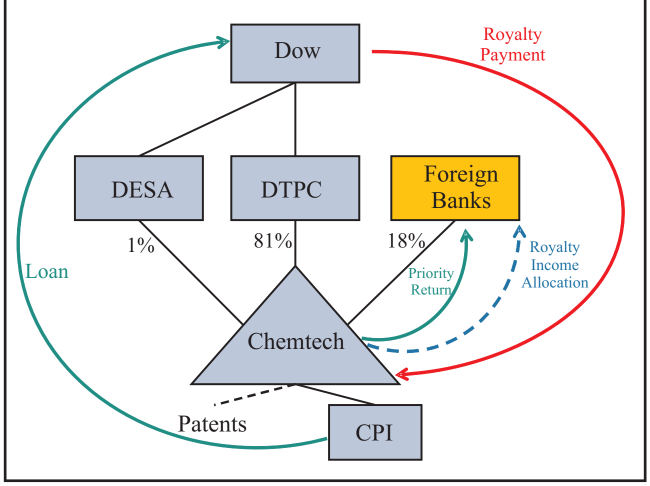
Next, five foreign banks contributed a combined $200 million to Chemtech for an aggregate 18 percent limited partnership interest. Thus, DESA (the general partner) had an ownership interest of approximately 1 percent, and DTPC and the foreign banks (the limited partners) had ownership interests of 81 percent and 18 percent, respectively. Chemtech owned all the CPI stock and the patents contributed by Dow through DTPC.

Under a licensing agreement, Dow paid royalties to Chemtech for use of the patents in its business operations. Chemtech had the right to license the patents to third parties if it gave Dow 90 days' notice. However, licensing to third parties was unlikely because Dow did not contribute to the partnership all the technology required for third parties to use the patents. They would therefore be useless to anyone other than a Dow entity.

The foreign banks were entitled to a priority return of approximately 7 percent on their limited partnership interests, which was paid primarily from the royalty income. Each year, after paying DESA a management fee and making a guaranteed payment to DTPC equal to 2.28 percent of the lesser of its original capital contribution or its average unrecovered capital, Chemtech contributed to CPI the excess cash the partnership received from royalties. CPI then lent that cash to Dow.[5]

From 1994 to 1997,[6] Dow paid an annual average of $131.5 million in royalties to Chemtech, and it received an annual average of $135.9 million back from Chemtech through the CPI loan, the difference being attributable to an increase in the value of CPI's portfolio.[7] The foreign banks received $13.9 million per year during that period through their priority return.

Figure 1. Operation of Chemtech I



Dow took federal income tax deductions for the royalty payments it made to Chemtech under the licensing agreement. From 1994 to 1997, Dow reported a $131.5 million annual average tax deduction for royalty expenses and $35.7 million of annual average taxable income from Chemtech. Each year, the foreign banks were specially allocated an average of $95.6 million (or approximately 80 percent) of Chemtech's taxable income.[8] Significantly, Chemtech was a hybrid entity treated as a partnership for U.S. tax purposes and as a corporation under the laws of the countries of the foreign banks. Thus, the foreign banks were able to claim treaty benefits that eliminated the 30 percent U.S. withholding tax on their allocated share of Chemtech's income.[9]

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[3]The patents were owned by Dow, which contributed them to DTPC. An appraisal firm valued the patents at roughly $867 million; Dow had a tax basis of approximately $54,000 in the patents.

[4]Other Dow subsidiaries also played a role in implementing Chemtech I through the contribution of patents to DTPC. For the sake of brevity, we describe only the final structure.

[5]The district court described the flow of money in Chemtech I as circular — "from Dow to Chemtech back to Dow, except the foreign banks were paid a fee equivalent to an interest payment." *Chemtech*, slip op. at 12. It can be assumed that this loan included interest so that it would be respected as debt, although neither the district court's opinion nor the Fifth Circuit's opinion so states. Interest would be imputed on any loan from CPI to Dow with below-market rates. *See generally* section 7872.

[6]Chemtech I operated from 1993 to 1998; however, the foreign banks were invested in the partnership for only part of the first and last years.

[7]During most of Chemtech I's operating years, more cash flowed back to Dow in the form of the CPI loan than Dow paid to Chemtech in royalties. That is because CPI received dividend and interest income from its portfolio, which mainly consisted of marketable securities.

[8]As explained by Dow in its brief to the Fifth Circuit, because "most of the partnership's profits were allocated to the [foreign] banks to satisfy their priority returns, governing tax rules at the time also allocated most of the partnership's taxable income to the banks." Brief of Appellants at 11, *Chemtech*, 766 F.3d 453 (5th Cir. 2014) (No. 13-30887). For instance, the partnership's profits for 1994 were approximately $14.7 million, and its taxable income was approximately $122.4 million (profits were much lower than taxable income because of patent amortization deductions taken when calculating profits but not recognized for tax purposes). The foreign banks received cash distributions of $13.9 million given their priority return (approximately 94 percent of the partnership's profits) and were accordingly also allocated approximately 94 percent of the partnership's taxable income.

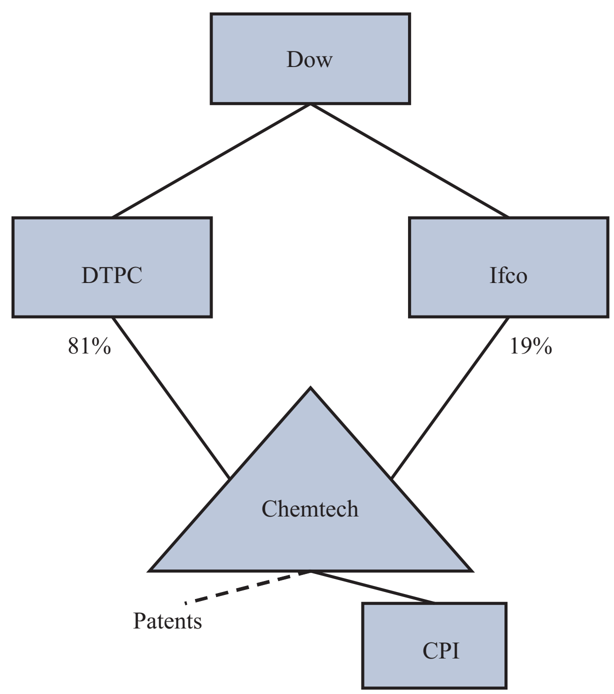
[9]*See* sections 881 and 1442.

The Chemtech partnership agreement and related agreements (including the patent license and indemnity agreements with the foreign banks) contained several provisions protecting the banks' investment. They were entitled to a priority return of approximately 7 percent on their contributions if Chemtech generated sufficient profits to make that payment.[10] They were also entitled to roughly 97 percent of that priority return even if there were no profits.[11] Thus, only the cessation of the partnership's business would prevent the foreign banks from receiving their priority return.

Further, Chemtech was required to maintain 3.5 times the banks' unrecovered capital contributions; it was precluded from spending more than $1 million per year without the banks' approval; and it was restricted in the types of assets it could hold.[12] The partnership agreement also gave the foreign banks a preference over the Dow entities in the event of liquidation, and it gave the banks the option to liquidate the partnership if any of several identified conditions were not satisfied.[13] On liquidation, the banks would receive their initial investment and 1 percent of any gain or loss attributable to a change in value of the assets (that is, the patents and the CPI stock) held by the partnership. Finally, Dow agreed to indemnify the foreign banks for any product liability claims concerning the patents and for any U.S. income tax liability that resulted from their participation in Chemtech I.

Regulations that became effective January 1, 1998, limited the foreign banks' ability to obtain treaty benefits through hybrid entities such as Chemtech.[14] Continued participation in the partnership would subject the banks to a 30 percent withholding tax on their share of Chemtech's taxable income.[15] In March 1998, Dow, through a subsidiary (Ifco Inc.), bought out the foreign banks' interests for a total of $210.4 million. Ownership of Chemtech thus changed, with Ifco owning approximately 19 percent as general partner and DTPC owning the remaining 81 percent as limited partner.[16]

Figure 2. Ownership of Chemtech After Chemtech I



During the foreign banks' exit from Chemtech I, a dispute arose over the increased value of the patents. A small portion of the $210.4 million payment to the banks was based on the mark-to-market gain in the value of the patents and the CPI stock. As provided in the partnership agreement, the banks were allocated 1 percent of that gain, or approximately $1.6 million.[17] Dow claimed that under the method provided in the partnership agreement for computing the mark-to-market gain,

[10]Under the patent license agreement between Dow and Chemtech, Dow's royalty payments consisted of a fixed minimum royalty (calculated on the basis of each patent's fair market value and economic life) plus a variable royalty tied to production. The Fifth Circuit agreed with the district court that the minimum royalty payments from Dow were sufficient to fund the foreign banks' priority return, making it "highly unlikely" that the banks would be paid less than the full priority return. *Chemtech*, 766 F.3d at 463, n.30; *Chemtech*, slip op. at 33.

[11]The foreign banks were also entitled to 1 percent of any residual partnership profits and 1 percent of capital gains.

[12]Chemtech was allowed to hold only the patents and CPI stock. CPI "was required to hold a minimum of $50 million and was permitted to own only cash equivalents, very low-risk securities, Dow loans, and Dow demand notes." 766 F.3d at 457, n.9.

[13]For example, the right to liquidate the partnership was triggered if Chemtech failed to earn profits of at least 98 percent of the foreign banks' priority return or if Dow or its affiliates failed to perform in accordance with the governing agreements. For each of its affiliates involved in Chemtech I, Dow guaranteed the performance of the affiliate's respective obligations under the relevant agreements.

[14]*See* T.D. 8722 and former reg. section 1.894-1T(d). Those temporary regulations were finalized by T.D. 8889. *See* reg. section 1.894-1(d).

[15]*See* sections 881 and 1442.

[16]Ifco also bought out DESA's 1 percent interest.

[17]The partnership's total mark-to-market gains were $166 million: $82 million corresponded to the patents and $84 million to the CPI stock. The remainder of the $210.4 million payment consisted of the return on the foreign banks' approximately $200 million capital contribution and unpaid priority return.

the patents had increased in value by $82 million. The foreign banks disagreed, contending that the patents' value had increased by approximately $180 million, which would have entitled them to an additional $1 million distribution. Dow held to its original valuation, refusing to pay the foreign banks any additional money.[18]

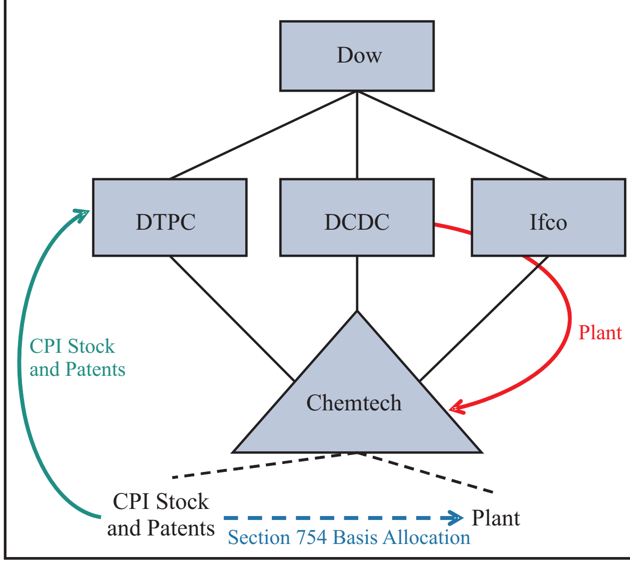
B. Chemtech II

As noted above, the regulatory change regarding hybrid entities meant that the Chemtech I structure was no longer attractive to the foreign banks. Their exit from Chemtech I gave Dow (through Chemtech) the opportunity to make a section 754 election. In the Chemtech II transaction, as in Chemtech I, Dow contributed to Chemtech an asset with a high value but a low tax basis. This time it was a chemical plant in Louisiana with a value of $715 million and a basis of $18.5 million. Under a lease agreement with Chemtech, Dow continued to use the plant as it had before — similar to Dow's arrangement in Chemtech I regarding the patents.

Dow contributed the plant to Chemtech through a subsidiary, Dow Chemical Delaware Corp. (DCDC), in exchange for a 73 percent ownership interest in the partnership. Chemtech initially took a carryover basis of $18.5 million in the plant under section 723.[19] Next, DTPC exchanged its interest in Chemtech for the patents and 70 percent of the CPI stock (in which Chemtech now had a high basis as a result of contributing cash that was lent back to Dow). This transaction was designed so that DTPC's exit from the partnership would be tax free under section 731 and so that Chemtech would receive a basis step-up in the plant through the operation of sections 734 and 754.

First, Chemtech distributed the patents and stock to DTPC in redemption of its partnership interest, which DTPC treated as a tax-free distribution under section 731.[20] Under section 732(c), DTPC had a basis in the distributed assets equal to its (low) basis in its partnership interest. Next, Chemtech made an election under section 754 that allowed the provisions of section 734 to apply. Under section 734(b)(1)(B), a partnership's basis in its property remaining after a distribution is increased by the excess of (1) the adjusted basis of the property distributed to the partnership immediately before the distribution (as adjusted by section 732(d)) over (2) the basis of the property in the hands of the partner that received the property in liquidation of its interest. Chemtech had a relatively high basis in the assets distributed to DTPC (approximately $463 million) compared with DTPC's much lower basis in its partnership interest (approximately $82 million), which allowed the roughly $381 million excess to be transferred to Chemtech's basis in its remaining assets. Of that excess, approximately $363 million was applied to Chemtech's basis in the chemical plant, increasing it from roughly $27 million to approximately $390 million.[21] That increased basis resulted in higher depreciation deductions for Chemtech.

Figure 3. Contributions and Exchanges in Chemtech II and the Section 754 Election



The last party to join Chemtech II was RBDC Inc., a U.S. affiliate of Rabo Merchant Bank NV, one of the foreign banks that participated in Chemtech I. RBDC purchased a 20 percent limited partnership interest for $200 million.[22] That interest entitled RBDC to a priority return of 6.37 percent, later

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[18]Dow rejected the foreign banks' valuation method as inconsistent with the method established in the partnership agreement. The foreign banks ultimately abandoned their remaining challenges.

[19]Under section 723, a partnership generally takes a transferred basis in contributed property equal to that of the contributing partner.

[20]Section 731 generally treats distributions of cash or other property by a partnership as tax free to all parties. Section 731(a) and (b). Section 731(c), however, provides special rules for distributions of marketable securities, which may lead to gain recognition. To ensure that the $700 million in Dow demand notes held by CPI would not be treated as marketable securities, CPI exchanged them for a deeply subordinated note payable in 33 years that had a face value of $781.6 million.

[21]It is unclear from the parties' briefs and the district court's opinion how the plant's pre-transaction basis of $18.5 million increased to $27 million at the time of Chemtech's section 754 election.

[22]Similar to the foreign banks that participated in Chemtech I, RBDC enjoyed several guarantees and protections that limited

(Footnote continued on next page.)

reduced to 4.21 percent under a renegotiated partnership agreement. DCDC was a limited partner with a 73 percent interest, and Ifco was the general partner with a 6 percent interest.[23]

The flow of cash and tax consequences in Chemtech II were similar to those in Chemtech I:

- Dow made lease payments to Chemtech for use of the chemical plant;
- Chemtech made annual payments to RBDC attributable to the priority return on RBDC's capital contribution;
- after paying a management fee to Ifco, Chemtech contributed the excess cash to CPI II (the successor to CPI, wholly owned by Chemtech); and
- CPI II in turn lent that cash back to Dow.[24]

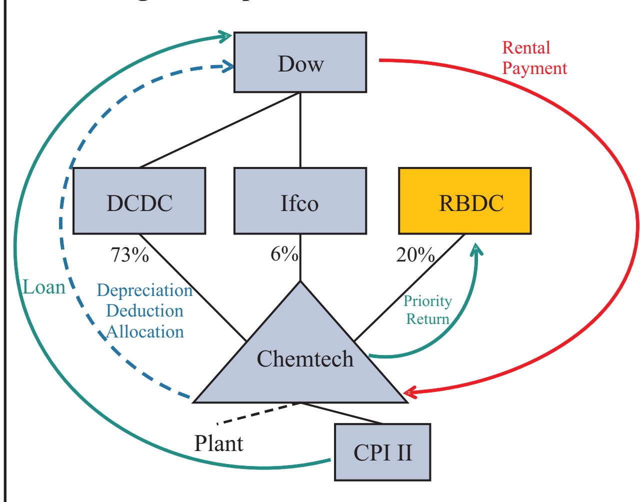
From 1999 to 2003, Dow made average annual lease payments of $75.8 million and received, through the CPI II loan, an annual average of $66.7 million. The remaining cash went to RBDC as payment for its priority return.

For federal income tax purposes, while Dow (through DCDC and Ifco) was allocated a significant portion of Chemtech's taxable income (on average, 81 percent from 1999 to 2003), it was also specially allocated 99 percent of the chemical plant's depreciation deductions.[25] Thus, although Dow received $66.7 million cash back through the CPI II loan (on average from 1999 to 2003), the net result of the income and depreciation deduction allocations was taxable income of $5.8 million (on average from 1999 to 2003). Those depreciation deductions were made possible by the section 754 election, which increased Chemtech's basis in the chemical plant.

II. District Court Decision

Following a five-day bench trial in June 2011, the U.S. District Court for the Middle District of Louisiana issued a lengthy memorandum decision on

Figure 4. Operation of Chemtech II



(Note that percentage interests do not add up to 100 because of rounding.)

February 26, 2013. The opinion sustained three arguments made by the government: (1) Dow's claimed tax benefits should be disallowed based on the economic substance doctrine; (2) even assuming that the transactions had economic substance, the Chemtech partnerships themselves were shams and should be disregarded; and (3) the foreign banks in Chemtech I were not bona fide partners because their interests in Chemtech were in the nature of debt, not equity.[26] The district court upheld 20 percent penalties under section 6662(b)(2) and 6662(c) for substantial understatement of tax and negligence, although it found that a 40 percent gross valuation misstatement penalty was inappropriate.[27]

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its risk in the transaction. For example, Dow agreed to indemnify RBDC for any liability arising from the chemical plant, and liquidation provisions protected RBDC in case the partnership terminated.

[23]Percentage interests do not add up to 100 because of rounding.

[24]For a breakdown of the cash and tax flows from 1999 to 2003, see *Chemtech*, slip op. at 23-28.

[25]Dow asserted that this allocation was appropriate because RBDC was a limited partner with a priority return and did not share in any of the risk of loss associated with the chemical plant.

[26]The district court did not reach several of the government's other arguments for disallowing the tax benefits sought by Dow. It reasoned that the theories discussed in its holding were sufficient to support disregarding the Chemtech transactions and partnerships for tax purposes. The other arguments raised by the government included (1) disallowing the post-1994 tax benefits under the partnership antiabuse regulation (reg. section 1.701-2(a)), (2) treating the liquidating distribution to DTPC as a taxable distribution of marketable securities under section 731, and (3) disallowing the allocations of royalty income to the foreign banks and depreciation deductions to the Dow entities on the grounds that they violated section 704(b).

[27]The gross valuation misstatement penalty decision was reconsidered by the district court on remand from the Fifth Circuit, as discussed *infra* in Section III.B. *See Chemtech Royalty Associates LP v. United States*, No. 05-00944-BAJ-SCR (M.D. La. 2015).

A. Economic Substance

Relying on *Frank Lyon*[28] and *Klamath*,[29] the district court stated that in the Fifth Circuit, a transaction is respected for tax purposes under the economic substance doctrine if it ''(1) has economic substance compelled by business or regulatory realities, (2) is imbued with tax-independent considerations, and (3) is not shaped totally by tax avoidance features.''[30] The district court also observed that in the Fifth Circuit, *Klamath* has been read as establishing a two-part economic substance test: an objective prong (the taxpayer must establish that the transaction had a reasonable possibility of profit) and a subjective prong (the taxpayer must establish that it was motivated to enter into the transaction for a legitimate nontax business purpose).[31] The district court found that the Chemtech transactions satisfied neither of those prongs.

On the objective prong, the district court said that there was in fact no income generated by forming Chemtech. The circular cash flows ultimately resulted in no economic advantage — a finding supported by the testimony of both sides' experts — according to the district court.[32] Thus, the district court concluded that the transaction in no way affected Dow's financial position.

Analyzing the subjective prong, the district court looked to Dow's asserted business purpose in entering the Chemtech transactions: its desire to obtain off-balance-sheet financing (OBSF). Dow argued that its primary business purpose in entering the transaction was to raise capital without issuing debt, which would hurt its balance sheet. It asserted that OBSF was a useful tool to maintain a high credit rating, which was significantly affected by the company's ratio of debt to total capital.

The district court rejected Dow's OBSF argument. It believed that the Chemtech transactions had no genuine business purpose and were motivated solely by tax avoidance considerations. The district court noted that when the purpose of the transaction is to make a profit, a ''reasonable possibility of profit that is substantial in relation to the tax benefits generated'' is required.[33] Dow did not assert that the purpose of the Chemtech transactions was to make a profit but rather said it was to obtain OBSF. For the district court, Dow's need for OBSF did not satisfy the requisite business purpose because there were cheaper and simpler alternatives that could have achieved the company's objective of raising capital while maintaining a strong credit rating. Accordingly, the district court concluded that whatever benefits OBSF would have provided paled in comparison with the expected tax benefits of the Chemtech transactions.

B. Sham Partnership

The district court applied the sham partnership doctrine to Chemtech I and Chemtech II and determined that the partnerships should be disregarded for federal tax purposes. At the core of the sham partnership doctrine is *Culbertson*, in which the Supreme Court in 1949 held that a partnership will be respected for federal tax purposes only if ''the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both.''[34] That assessment of the taxpayer's subjective intent is

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[28]*Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978) (When ''there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.'').

[29]*Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009).

[30]*Chemtech*, slip op. at 47 (quoting *Klamath*, 568 F.3d at 544).

[31]*Id.* (citing *Southgate Master Fund LLC v. United States*, 651 F. Supp.2d 596, 654 (N.D. Tex. 2009), *aff'd*, 659 F.3d 466 (5th Cir. 2011)). In *Southgate*, the taxpayer formed a partnership with a Chinese government bank. The bank contributed a high-basis, low-value package of nonperforming loans to the partnership. The taxpayer contributed marketable low-risk securities to the partnership and retained effective control over them. The partnership then sold a portion of the nonperforming loans, which generated a loss to the partnership because of its high basis in the loans. The Fifth Circuit held that the partnership's acquisition of the nonperforming loans had economic substance because (1) under the objective inquiry, the partnership and its members entered into the transaction ''with a reasonable possibility of making a profit''; and (2) subjectively, the loans were acquired for ''legitimate purposes,'' with the parties believing that they could earn a profit and some of the partners agreeing to the deal ''regardless of whether it had any tax benefits.'' *Southgate*, 659 F.3d at 480-483. The court determined, however, that the partnership was a sham because the partners and the bank did not intend to join together in the conduct of a business, did not intend to share the profits and losses of the venture, and did not have a valid business purpose. *Id.* at 483-491; *see infra* Section II.B (discussing the *Chemtech* district court's sham partnership holding).

[32]''Both Dr. Hubbard and Dow's economic expert, Andrew Carron, agree that 'the net present value of the financing transactions is at most zero.''' *Chemtech*, slip op. at 48.

[33]*Id.* at 51.

[34]*Commissioner v. Culbertson*, 337 U.S. 733, 741 (1949) (citation and internal quotation marks omitted). The sham partnership doctrine has also been the subject of several recent decisions, and its contours continue to evolve. *See, e.g.*, *Southgate*, 659 F.3d 466.

made in light of all relevant facts and circumstances.[35] The district court characterized the test as whether the formation of the partnership (as distinguished from its business operations) has economic substance.[36]

The district court determined that Dow had no intent to derive additional revenue through its use of the partnership form, a finding that contributed to the court's conclusion that Chemtech was not a true partnership.[37] Regarding the patents Dow contributed to the partnership in Chemtech I, the district court found it significant that Dow chose patents it would be able to continue to use after the transfer and that the company had no intention of licensing the patents to third parties. Moreover, in the district court's view, the circular flow of funds — with no real opportunity for anything resembling an economic profit — further suggested that the partnership was a sham.[38]

The final factor considered by the district court in its sham partnership analysis was the allocation of risks and losses between the partners. It found that the foreign banks in Chemtech I and RBDC in Chemtech II did not bear the risks of a true partner or entrepreneur but rather, as a result of the guarantees provided by Dow, essentially had secured loan interests. Moreover, it determined that because the partnership agreement in Chemtech I allocated 99 percent of any growth in the value of the patents to Dow, the foreign banks' potential upside was considerably limited as well. The district court also found the dispute concerning the banks' 1 percent interest in the growth of the patents significant, stating that Dow's success in preventing the foreign banks from collecting an additional $1 million of asserted appreciation in the patents underscored the limited nature of the banks' interest in the upside of the partnership's business. In light of those findings, the district court held that the Chemtech partnerships should be disregarded for tax purposes under the sham partnership doctrine.

C. Bona Fide Partners

Finally, the district court held that the foreign banks in Chemtech I were not true partners. In the opinion, this is phrased as a separate inquiry, although the ''true partner'' analysis was, in the district court's view, significant in reaching the conclusion that the partnership itself was a sham.[39] Regarding whether the foreign banks in Chemtech I were bona fide partners, the district court relied on the Second Circuit's opinion in *Castle Harbour II*,[40] stating that the inquiry of whether an interest is

[35]*Culbertson*, 337 U.S. at 742. The district court in *Chemtech* rejected Dow's argument that the test in *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), should apply. Under Dow's interpretation of the *Moline Properties* test, a partnership will be respected if it was formed for a business purpose *or* it actually carried on a business activity. The district court found that the test as formulated by Dow conflicted with Fifth Circuit precedent. It added that the *Moline Properties* test is ''a unitary test under which 'the existence of a formal business activity is a given but the inquiry turns on the existence of a nontax business motive.''' *Chemtech*, slip op. at 55 (quoting *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505, 512 (D.C. Cir. 2000)).

[36]*Chemtech*, slip op. at 54-55 (citing *Merryman v. Commissioner*, 873 F.2d 879, 881 (5th Cir. 1989)). In *Merryman*, the taxpayer had an interest in a partnership formed by an oil drilling company, along with the company's key officers and employees. The company sold the partnership an oil rig for installment payments over seven years, with the company managing all aspects of the rig's operation. Approximately six months after executing the sale agreement, in a purported section 351 exchange, the partners transferred their partnership interests into a corporation they owned. The partnership claimed depreciation deductions and an investment tax credit for the oil rig.

The Tax Court determined that although operation of the oil rig had economic substance and was entered into for profit, the formation and role of the partnership had no nontax purpose. The Fifth Circuit agreed that the partnership should be disregarded for tax purposes because its formation and function lacked economic purpose and profit motive. Some of the facts found significant by the court were the sale of the oil rig to the partnership on ''exceedingly favorable terms'' (no down payment required, and the partnership waived all warranties), the circular flow of funds among the parties without altering their economic positions, and the ''pattern of interconnected ownership of [the partnership] and related entities.'' *See Merryman*, 873 F.2d at 882-883.

[37]*Chemtech*, slip op. at 56. As the district court stated in its sham partnership analysis, ''selection of the partnership form must have been driven by a genuine business purpose.'' *Id.* at 54 (quoting *Southgate*, 659 F.3d at 484).

[38]*Chemtech*, slip op. at 56-57 (comparing the circular flow of funds in the Chemtech transactions to the cash flow in *Merryman*).

[39]*See Chemtech*, slip op. at 57 (''A partner whose risks are all insured at the expense of another partner 'hardly fits within the traditional notion of a partnership.' A valid partnership is not formed where, among other things, one partner receives a guaranteed, specific return'' (citations omitted).).

[40]*TIFD III-E Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006). In *Castle Harbour II*, two Dutch banks formed a partnership with the taxpayer, a U.S. corporation. The banks contributed cash to the partnership, entitling them to a guaranteed return and a preferred return in addition to an annual return of principal. The taxpayer contributed cash and aircraft that had been fully depreciated for tax purposes. The banks were allocated 98 percent of the partnership's taxable income or loss. However, the Second Circuit concluded that the banks realistically could (and did) receive only their fixed return because the amount they would receive depended on the partnership's book operating income, which was much lower than its taxable income, given depreciation deductions taken on the aircraft for book purposes only. The banks were protected against losses because their investment would not be at risk until the taxpayer's

(Footnote continued on next page.)

debt or equity is helpful in answering the bona fide partnership interest question.[41]

The district court determined that the foreign banks in Chemtech I, like the Dutch banks in the *Castle Harbour* transaction, had no meaningful risk of receiving less than their guaranteed return. It observed that ''the only risk to the banks that posed any real threat was the IRS, which could see through the Chemtech scheme and pursue the foreign banks for taxes.''[42] And that risk was effectively nullified, the district court reasoned, because Dow had agreed to indemnify the foreign banks if that situation arose.

Further, the district court determined that the foreign banks had no meaningful upside beyond their 7 percent priority return.[43] By cross-reference to the sham partnership portion of the opinion, the court again noted the steps taken by Dow to deny the foreign banks even their asserted 1 percent share of the increased value of the patents.[44]

III. Fifth Circuit Decision

A. Dow and the Government State Their Cases

Dow began its appellate brief as follows:

> Although the financial transactions underlying this case are complex, the legal questions presented here are not. This appeal boils down to the unremarkable proposition that the tax laws do not prevent companies from structuring transactions in a way that produces both tax and non-tax benefits.[45]

The thrust of Dow's appeal was that although tax consequences were relevant, there were legitimate nontax business justifications for creating the Chemtech partnerships. Dow thus maintained that the district court erred in all its holdings.[46]

Dow's central argument regarding the sham partnership issue was that the Chemtech transactions gave it a significant nontax financial benefit — OBSF — that allowed it to raise money without incurring debt. Because that nontax benefit required the use of a separate legal entity to hold Dow's assets, the company was entitled to use the partnership form, Dow argued. It contended that the district court ''fundamentally misunderstood'' Dow's business purpose for forming the Chemtech partnerships and how those partnerships operated.[47]

For instance, Dow argued that the business purpose in Chemtech I was not to maximize the revenue of the patents by licensing them to third parties but rather to monetize patents that would not otherwise make a positive contribution to Dow's balance sheet, while at the same time providing a ''steady, but not guaranteed,'' return to the foreign banks.[48] Dow also challenged the district court's characterization of the flow of money as circular, saying the 7 percent priority return to the foreign banks distinguished the situation from that in *Merryman* (which the district court cited in its circularity analysis) because in *Merryman* ''money flowed back and forth but the economic position of the parties was not altered.''[49]

Although Dow conceded that under the sham partnership doctrine, a taxpayer must be able to demonstrate that there was some nontax business purpose for its use of the partnership form,[50] it argued that the Chemtech I and Chemtech II partnerships met that standard because the financing Dow obtained through the transactions required a

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significant capital contribution was already lost. The government argued that the partnership was a sham and that the Dutch banks' interests were not bona fide equity interests.

The Second Circuit held that the Dutch banks were not bona fide partners. Unlike the district court (*Castle Harbour I*), it did not reach the sham partnership issue. The Second Circuit noted that a true partner must have meaningful participation in either the upside (profits) or downside (risk of loss of capital) of the partnership's business. It found that the banks did not meaningfully participate in the partnership's business because their interests were unaffected by the partnership's performance given the taxpayer's ability to limit the banks' participation in the profits to an insignificant amount.

[41]*See Chemtech*, slip op. at 58 (citing *Castle Harbour II*, 459 F.3d at 232).

[42]*Chemtech*, slip op. at 60.

[43]*Id.* (''Insofar as [there was] any 'equity-like' distribution, or the possibility thereof, such a distribution was not meaningful when compared to the [foreign banks'] guaranteed return on the investment.'').

[44]*See id.* at 28-36.

[45]Brief of Appellants, *supra* note 8, at 1.

[46]The Dow appeals brief also addressed the district court's economic substance holding and its determination that the foreign banks were not true partners. However, the Fifth Circuit declined to address those issues in its opinion, as discussed *infra* in Section III.B. On whether the foreign banks had a bona fide equity interest, Dow argued that the district court did not adequately perform a debt-equity analysis (which the Second Circuit in *Castle Harbour II* determined was ''helpful'' for the bona fide partner inquiry) that was in line with Fifth Circuit precedent in *United States v. South Georgia Railway*, 107 F.2d 3 (5th Cir. 1939). In that case, the Fifth Circuit stated that the sine qua non of debt is the existence of a fixed maturity of a principal sum with the right to enforce payment in the event of default. Dow asserted that because the banks could have lost their entire $200 million capital contribution if the patents had lost their value, the banks' interests were not debt interests. Brief of Appellants, *supra* note 8, at 49-62.

[47]Brief of Appellants, *supra* note 8, at 39.

[48]*Id.* at 40.

[49]*Id.* at 41-42 (quoting *Merryman*, 873 F.2d 879). For an overview of *Merryman*, see *supra* note 36.

[50]Citing *Southgate*, 659 F.3d at 479.

separate business entity.[51] Dow distinguished the Chemtech partnerships from the partnership in *Southgate*, partially on the grounds that the Chemtech partners strictly adhered to the terms of the partnership agreement, whereas in *Southgate* the foreign partner effectively reneged on its obligation to service a portfolio of loans owned by the partnership.[52] Dow noted that unlike in *Southgate*, all the parties in the Chemtech transactions respected the partnership form.

In its reply brief,[53] the government argued that the district court was correct in determining that the Chemtech partnerships were shams. The patents and the chemical plant that were nominally owned by the Chemtech partnerships were never really available for use in any partnership business, the government asserted, pointing to the fact that the partnerships' sole source of income was the Dow royalty payments (Chemtech I) and rental payments (Chemtech II). Accordingly, the government contended that the banks never saw themselves as managing the partnerships' underlying assets or as occupying a position from which they would profit from the partnerships' asserted business purpose, which reflected the limited upside, non-equity nature of the banks' interests. Similarly, the government maintained that the banks knew that they were effectively insulated from risk because they were protected from any tax or liability risk regarding the patents and they would receive their priority return unless the patents or the plant decreased significantly in value, an unlikely scenario.

The government asserted that Dow never answered the critical business purpose inquiry required under *Culbertson* and *Southgate*:

> Dow's brief does not even address the critical question of what business was being conducted by the Chemtech partnerships. The answer is supplied, however, by the record: *none*. Although Dow argues on appeal, as it did below, that *its* purpose for forming the Chemtech partnerships was to achieve [OBSF] (an assertion the court rejected), that alleged purpose still does not explain what business the *partnerships* were formed to conduct, and, in fact, actually conducted. Dow's assertion that its purpose was to obtain [OBSF] only bolsters the conclusion that the partnerships were not intended to conduct any business.[54]

Thus, the government argued that even if Dow had a business purpose for forming the partnerships as separate entities (OBSF), the partnerships themselves were required to have a business purpose as well because the relevant test required all the partners to act with a business purpose, not just one of them.[55] The government claimed that the Chemtech partnerships were merely vehicles through which Dow could obtain tax benefits and that the assets contributed to the partnerships "only mattered insofar as their value secured the banks' contributions and generated tax deductions."[56]

Further, the government maintained that even if the partnerships engaged in a legitimate business activity, there was no real intent for Dow and the banks to share in the profits and losses of the business. Although the partnership agreements on their face gave the banks a share of the profits and losses, their actual participation in the business was not meaningful, according to the government. It asserted that similar to the Dutch banks in *Castle Harbour*, the banks in the Chemtech partnerships were virtually guaranteed to receive a fixed return on their investment. Because of the structure of the agreements and Dow's active management and valuation of the patents, the government argued, the banks were unlikely to receive anything significantly more or less than the guaranteed return, given the unlikelihood that the patents and chemical plant would lose their value and given the indemnities and guarantees provided by Dow.[57]

B. Fifth Circuit Opinion

The Fifth Circuit released its opinion just over a month after hearing oral arguments. The court of appeals addressed only the sham partnership holding, which it affirmed. It did not consider whether the district court erred in determining that the transactions lacked economic substance or in classifying the transactions as debt.

[51]Dow acknowledged that the separate business entity could have been formed as a corporation rather than a partnership. It argued, however, that "the sham partnership doctrine does not require a taxpayer to justify why it elected to use a partnership entity as opposed to a corporate entity" and that "a business entity is free to choose its tax status for tax-motivated reasons." Brief of Appellants, *supra* note 8, at 44-45 (citation omitted).

[52]*See Southgate*, 659 F.3d at 475-476.

[53]Government's Combined Answering and Opening Brief, *Chemtech*, 766 F.3d 453 (5th Cir. 2014) (No. 13-30887) (government's brief).

[54]*Id.* at 44 (emphasis in original).

[55]*Id.* at 40 (quoting *Southgate*, 659 F.3d at 483-484) (citing *Culbertson*, 337 U.S. 733). The government further argued that tax benefits, not OBSF, were driving the Chemtech transactions and that this fact (with which the district court agreed) further supported characterizing the Chemtech partnerships as shams. *Id.* at 53-57.

[56]*Id.* at 44.

[57]The government argued that "Chemtech could only suffer a loss through a series of highly unlikely and catastrophic events: Dow declaring bankruptcy, and the patents and chemical plant losing all of their value." *Id.* at 51.

Relying on *Culbertson* and *Southgate*, the Fifth Circuit affirmed that a partnership is required to have ''(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.'''[58] Focusing on the second prong of that test, the Fifth Circuit concluded that the Chemtech partnership was a sham.

In its analysis, the Fifth Circuit referenced *Castle Harbour II* even though in identifying meaningful upside potential and downside risk in that case, the Second Circuit focused on whether the Dutch banks were bona fide partners, not on whether the partnership itself was a sham.[59] The Fifth Circuit tied the bona fide partner inquiry of *Castle Harbour II* to the sham partnership test of *Culbertson* by noting that a partnership requires, in addition to a business purpose, the partners' intent to share the profits and losses of the partnership's business.

Before applying the *Castle Harbour II* approach to examine the Chemtech transactions, the Fifth Circuit rejected Dow's argument that the banks' interests could not be classified as debt under debt-equity principles and that they were therefore bona fide equity interests in the partnership — which Dow argued necessarily led to the conclusion that the partnership itself was valid.[60] The Fifth Circuit held that a pure debt-equity analysis did not control the inquiry since *Castle Harbour II* had described that analysis as helpful but not necessary.[61] Such an approach, the Fifth Circuit stated, ran ''afoul of *Culbertson* and *Southgate*'' and would elevate form over substance.[62] In sum, the Fifth Circuit determined that simply finding that the foreign banks' interests were not debt would be insufficient to reach the conclusion that the partnership was not a sham.

The Fifth Circuit then listed three reasons supporting its holding that Dow and the foreign banks did not truly intend to share in the profits and losses of the Chemtech partnership. First, in the court's view, the banks' annual priority return on their investment, independent of the partnership's success, did not suggest an intent to share profits and losses. The Fifth Circuit characterized the chance of the banks receiving anything significantly more or less than their fixed return as highly unlikely because they would be compensated regardless of the partnership's profitability.

Second, the Fifth Circuit determined that any intent to share in the downside of the partnership's activities was negated by Dow bearing all significant risks arising from the Chemtech transactions. Here, the Fifth Circuit identified several ''ironclad assurances'' protecting the banks' investment, such as Dow's agreement to indemnify them for any liability arising from the patents and chemical plant and for any tax liability. Thus, the Fifth Circuit agreed with the district court that the banks faced effectively no risk that they would lose their initial investment or not get their priority return.

Third, the Fifth Circuit found that the absence of meaningful upside potential for the foreign banks was strong evidence that they did not intend to enter into a legitimate partnership with the Dow entities. Whether the foreign banks in Chemtech I would share in residual profits of the partnership and receive anything beyond their priority return depended on whether the patents increased in value. The Fifth Circuit noted that (1) neither Dow nor the banks contended that they expected the patents to increase in value; and (2) Dow did not argue that the Chemtech partnership was created for purposes of managing and profiting from the patents. The Fifth Circuit said there was no way the parties could have intended to share in the profits of Chemtech I if the business of the partnership (managing the patents) was not expected to be profitable.

The Fifth Circuit expressed no opinion on the district court's imposition of the 20 percent penalties for negligence and substantial understatement under section 6662(b)(1) and (2), but it instructed the lower court generally to consider whether imposing those penalties would be consistent with the appellate opinion. It also instructed the district court to consider both the substantial valuation (20 percent) and gross valuation (40 percent) misstatement penalties under section 6662(b)(3) and (h).[63]

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[58]*Chemtech*, 766 F.3d at 461.

[59]*See Castle Harbour II*, 459 F.3d at 231, n.11. The partnership in *Castle Harbour II* was formed by two Dutch banks and a U.S. corporation. Given the Second Circuit's holding that the Dutch banks were not true partners under a bona fide partner inquiry, there was no partnership left and it therefore may have been unnecessary for the court to reach a sham partnership inquiry.

[60]*Chemtech*, 766 F.3d at 462-463. Dow relied on *South Georgia Railway*, 107 F.2d 3, to argue that debt required (1) a fixed maturity date requiring payment of a fixed amount, and (2) the legal right of enforcement in case of default. *Chemtech*, 766 F.3d at 462. Dow reasoned that because the foreign banks' investment did not satisfy those requirements, their interests were equity and the banks were thus valid partners. *Id.*

[61]*See Castle Harbour II*, 459 F.3d at 232.

[62]*Chemtech*, 766 F.3d at 463.

[63]*Id.* at 465. Penalties under section 6662 are not stacked, even if more than one penalty applies. Thus, the significance of the Fifth Circuit's instruction was to allow the imposition of a 40 percent penalty as opposed to a 20 percent penalty. The Fifth Circuit noted that the Supreme Court recently held in *United States v. Woods*, 134 S. Ct. 557, 566 (2013), that the valuation penalty could apply even if the transaction were disallowed entirely.

The district court, relying on *Heasley*,[64] had concluded that it could not impose a valuation misstatement penalty in cases in which the entire transaction had been disregarded. The Fifth Circuit remanded the case on this point in light of the Supreme Court's intervening opinion in *Woods*,[65] which suggested that valuation misstatement penalties were potentially applicable.

On remand, the district court determined that it could impose the substantial and gross valuation penalties as a result of the Supreme Court decision in *Woods*.[66] The district court held that because the plant's basis was increased from approximately $27 million to more than $400 million in Chemtech II (exceeding the 400 percent threshold required under section 6662(h)(2)(A)(ii)(I)), the 40 percent gross valuation penalty applied.[67]

C. Petition for Rehearing *En Banc*

On October 27, 2014, Dow filed a petition for rehearing *en banc*, presenting the issue as whether a court may disregard a partnership as a sham for tax purposes ''based solely on the allocation of profits and losses among its equity investors.''[68] Dow argued that the appellate decision was inconsistent with *Culbertson*, Fifth Circuit precedent, and decisions by other courts of appeals because it required that ''a partner's return be risky or subject to significant variability'' to satisfy *Culbertson*'s requirement that the partners come together to share the profits and losses of the partnership. Dow also asserted that the Fifth Circuit's view of the ''sharing of profits and losses'' requirement would disrupt established financing arrangements. On November 17, 2014, the Fifth Circuit denied the petition.[69]

IV. *Chemtech*'s Significance

The district court struck down the Chemtech partnerships broadly, determining that they were void under the economic substance, sham partnership, and bona fide partner doctrines. On the sham partnership doctrine, the district court concluded that there was no genuine business purpose. The court did not respect Dow's asserted business purpose of obtaining OBSF, and it found that there was no intent to share the partnership's profits and losses.

By contrast, the Fifth Circuit accomplished with a scalpel what the district court did with a sledgehammer: It disregarded the Chemtech partnerships based solely on one prong of the sham partnership doctrine, concluding that Dow had no intent to share either the profits or the losses of Chemtech with the foreign banks.

The district court's decision is nonetheless relevant to practitioners as an example of how a judicial fact-finder may invoke the sham partnership, economic substance, and bona fide partner doctrines to disregard a partnership arrangement, particularly when it is a marketed transaction. Perhaps most significant to practitioners is the district court's application of its own judgment regarding whether the taxpayer's asserted business purpose in entering into the transaction could have been attained by ''cheaper and less complex alternatives.''[70] Practitioners therefore should be prepared to justify the profit potential of their partnership transactions while also being cognizant that a large difference between potential or actual profits and federal income tax benefits likely will invite greater judicial scrutiny, a concept reaffirmed by the district court's decision.[71]

The Fifth Circuit's decision lays out important principles regarding the sham partnership doctrine. *Chemtech* is particularly significant for future partnership arrangements given the Fifth Circuit's treatment of guarantees and preferred returns as important considerations when determining whether there are impermissible protections of a partner's investment that will prevent a partnership from being respected.

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[64]*Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990).

[65]*See supra* note 63.

[66]*See Chemtech Royalty Associates LP*, *supra* note 27.

[67]*Id.*

[68]Petition for Rehearing *En Banc* at 4, *Chemtech*, 766 F.3d 453 (5th Cir. 2014) (No. 13-30887) (Oct. 27, 2014).

[69]Denial of Petition for Rehearing *En Banc*, *Chemtech*, 766 F.3d 453 (5th Cir. 2014) (No. 13-30887) (Nov. 17, 2014).

[70]*Chemtech*, slip op. at 52. The district court scrutinized Dow's asserted business purpose of obtaining OBSF by engaging in a business-type analysis. Despite Dow's explanation of its business conditions at the time of the Chemtech transactions and of the company's need for a strong credit rating, the district court found that the evidence did not show that Dow had a critical need for cash at that time, and did not ''support the conclusion that Dow had a need for financial flexibility or capital expenditures.'' *Id.* at 39. Further, the district court noted that ''no evidence shows that Dow evaluated less costly alternatives to the Chemtech transaction when, in fact, other forms of financing existed that would have allowed Dow to achieve OBSF.'' *Id.* Critical to those findings, however, is the fact that Chemtech I was marketed by Goldman Sachs to Dow. *See, e.g.*, *id.* at 2-3, 40, and 51.

[71]In determining that under the subjective prong of the economic substance doctrine, Dow lacked a business purpose for entering into the Chemtech transactions, the district court found significant the difference between the transactions' potential nontax benefits and tax benefits, stating that ''if the purported purpose of a transaction is to make a profit, courts require that there be a reasonable possibility of profit that is substantial in relation to the tax benefits generated.'' *Id.* at 51 (citing *Nevada Partners Fund LLC v. United States*, 714 F. Supp.2d 598, 632 (S.D. Miss. 2010)); *see supra* Section II.A.

Like the district court, the Fifth Circuit focused on whether the upside and downside risk taken on by the foreign banks indicated an intent to share the profits and losses of the partnership, as required by the second prong of the sham partnership inquiry.[72] Even though the Fifth Circuit did not directly analyze the business purpose requirement of the sham partnership doctrine, which was discussed by the district court,[73] it implied that having a partnership business purpose (as opposed to the individual business purposes of the partners for using the partnership form, such as OBSF) was a prerequisite to meeting the meaningful participation requirement because the parties had to intend to share the profits of some joint enterprise.

In the Fifth Circuit's view, meaningful participation in the upside and downside of the partnership requires more than simple possession of an interest that was not debt.[74] The Fifth Circuit thus reaffirmed that the relevant inquiry into whether the partnership should be respected is controlled by *Culbertson* and its progeny, not by inquiries concerning whether an interest is bona fide debt for tax purposes, even though a true debt interest would always fail the *Culbertson* test in the Fifth Circuit's view because the holder would lack the intent to be a partner of the obligor.[75]

In assessing Dow's intent to be a partner with the foreign banks, the Fifth Circuit attached great significance to the guarantees offered by Dow, which the court had examined in determining whether the banks had any meaningful risk in entering into the transaction. Those guarantees, or ''ironclad assurances'' as the Fifth Circuit described them, included:

- the requirement that Chemtech maintain assets equivalent to 3.5 times the foreign banks' unrecovered capital contributions;
- the limitations on the types of assets Chemtech could hold;
- the preference given to the foreign banks in case of liquidation of the partnership, which permitted the banks to receive their full investment upon liquidation so long as the partnership had sufficient assets (which would be backed by Dow's guarantees); and
- Dow's guarantees that its subsidiaries would perform their obligations as required by the controlling agreements.[76]

Despite the lack of a sinking fund or other money set aside to actually guarantee payment of the foreign banks' priority return,[77] the Fifth Circuit found that Dow's guarantees had the same effect: protecting the banks' investments and insulating them from all the significant risks arising out of the transaction. Further, the Fifth Circuit found important that the banks were entitled to a priority return, which in its view was independent of the partnership's success because of the aforementioned protections. Even though Dow itself could have become insolvent, which would have rendered its guarantees meaningless, the Fifth Circuit did not consider that possibility and thus essentially concluded that the Dow guarantees fully protected the banks against any meaningful risk.

The Fifth Circuit's determination that the foreign banks had no meaningful upside was partially based on its view that Dow did not contend that the contributed patents would increase in value because, in the court's words, ''the parties could not have intended to share profits through a means no one expected or designed to be profitable.''[78] The Fifth Circuit was apparently unimpressed by the banks' attempt to get more money from the increase in the patents' value (that value did in fact increase).[79] It simply said that the district court was not in error on this point because the foreign banks collectively had only a 1 percent interest in the value increase, which was not enough to be meaningful. The Fifth Circuit found significant (1) the lack of assertion by Dow and the foreign banks that the patents were expected to increase in value, (2)

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[72]The district court's characterization of the transaction under the sham partnership doctrine is a question of law subject to *de novo* review, while ''the particular facts from which that characterization is made are reviewed for clear error.'' *Chemtech*, 766 F.3d at 460.

[73]The first prong under the sham partnership doctrine considers whether the parties had ''the intent to act in good faith for some genuine business purpose.'' *Id.* at 461. The Fifth Circuit did not evaluate that prong.

[74]As discussed *supra* in Section III.B, the Fifth Circuit rejected Dow's argument that before applying the sham partnership doctrine under *Culbertson*, the court had to first determine whether the banks' interests qualified as debt or equity. *See Chemtech*, 766 F.3d at 462-463. Instead, the Fifth Circuit believed that there was no precedent requiring it to ''find a valid partnership solely because the parties did not have a legal right to demand repayment of their principal investment on any fixed future date,'' which Dow argued was a feature of a debt interest. *Id.* at 462. And the court ultimately expressed no opinion on whether the banks' interests should be classified as debt.

[75]*Id.* at 463 (''We limit our inquiry to whether Dow possessed the intent to be partners with the foreign banks, focusing on whether Dow had the intent to share the profits and losses with the foreign banks.'').

[76]*See supra* Section I.A.

[77]In fact, ''Dow did not [guarantee] the return of the [foreign banks'] initial investment in Chemtech or the financial performance of the Partnership.'' Plaintiff's Pretrial Brief, *supra* note 2, Appendix I, at 4.

[78]*Chemtech*, 766 F.3d at 464.

[79]Over the duration of Chemtech I, the patents increased in value by $82 million (under Dow's calculations). *See supra* Section I.A.

Dow's ability to remove patents that were profitable, and (3) the foreign banks' limited (1 percent) participation in any increase in the value of the patents.

Accordingly, to the extent that a limited partner's return is subject to protections or guarantees, the parties should consider how they will establish that the limited partner has a real risk of not receiving the return. A court following *Chemtech* may not take into account the possibility that the guarantor could become insolvent. Similarly, the parties should consider the limited partner's share of any potential upside beyond its priority return and how it would prove meaningful participation in that potential upside. That analysis should take into account the other partners' ability to control profitability by, for example, removing the partnership assets they contributed. Unfortunately, the Fifth Circuit did not provide clear guidance on how much downside risk or upside participation is required to rise to the level of meaningful, although it identified the foreign banks' 1 percent participation in the increase in value of the patents as insufficient.

The Fifth Circuit's reliance on authority regarding the bona fide partner inquiry for its holding that Chemtech was a sham partnership is also noteworthy. Both *Castle Harbour II* and *Historic Boardwalk*[80] applied the meaningful upside/downside test to determine if an asserted interest in a partnership was in fact a partnership interest. The Fifth Circuit stated that ''in *Castle Harbour II*, in conducting the sham-partnership inquiry, the Second Circuit considered it *helpful* first to address whether an interest has 'the prevailing character of debt or equity.'''[81] However, in the section of the *Castle Harbour II* opinion cited by the Fifth Circuit, the Second Circuit was examining whether the Dutch banks' ''interest should be deemed a *bona fide equity participation in a partnership*,'' not whether the partnership itself was a sham.[82] Since the partnership in *Castle Harbour II* had only three partners (the two Dutch banks and the U.S. corporation), the Second Circuit's holding that the two Dutch banks were not legitimate partners effectively disregarded the partnership anyway (just as a sham partnership holding would have); however, the two doctrines are typically framed as separate analyses, as the district court's opinion in *Chemtech* demonstrates.

Following the Fifth Circuit's decision in *Chemtech*, the principles of *Castle Harbour II* are relevant to both inquiries. It is questionable how substantively distinct the bona fide partner inquiry is from the sham partnership inquiry when both determinations rely on an analysis of a partner's meaningful upside and downside regarding its partnership interest. One difference is that while *Castle Harbour II*[83] and *Historic Boardwalk*[84] provide that either meaningful upside potential or meaningful downside risk would be sufficient for an investor to be treated as a bona fide partner, *Chemtech* states that both are required to survive the sham partnership inquiry.[85] That is in line with the Fifth Circuit's sham partnership precedent in *Southgate*, which invoked the sham partnership doctrine based in part on ''the lack of intent to share profits *and* losses.''[86]

V. Conclusion

The Fifth Circuit's decision in *Chemtech* represents the latest development of the sham partnership doctrine. Case law will no doubt evolve in this area as the IRS continues to challenge partnerships it believes are motivated solely or primarily by federal tax benefits, regardless of whether those structures are the product of marketed transactions. Practitioners should carefully consider the concepts and framework of the *Chemtech* decisions in evaluating potential judicial challenges to partnership structures. The allocation of potential profits beyond a guaranteed or priority return (upside) and risks (downside) must be considered when forming partnerships that involve priority returns, guarantees, and other protections against limited partners' risk of loss. Although *Chemtech* does not provide specific benchmarks for that inquiry, it gives practitioners an indication of the factors that the Fifth Circuit considers significant, which should be taken into account when planning partnership transactions.

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[80]*Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012).

[81]*Chemtech*, 766 F.3d at 462 (emphasis in original) (citing *Castle Harbour II*, 459 F.3d at 232).

[82]*Castle Harbour II*, 459 F.3d at 232 (emphasis added).

[83]*Id.* at 224 (''While the government raises several arguments on appeal, we focus primarily on its contention that the Dutch banks should not be treated as equity partners in the Castle Harbour partnership because they had no meaningful stake in the success or failure of the partnership.''); *id.* at 241 (''We recognize that if the Dutch banks had a sufficiently sizable share in the profit potential of the partnership, they might appropriately be deemed equity participants for tax purposes, notwithstanding the guaranteed repayment of their initial investment at an agreed rate of return.'').

[84]*Historic Boardwalk*, 694 F.3d at 463 (''We conclude that because [the investor] lacked a meaningful stake in either the success or failure of [the partnership], it was not a bona fide partner.'').

[85]*See Chemtech*, 766 F.3d at 463 (''In assessing whether the district court erred in its sham-partnership holding . . . we limit our inquiry to whether Dow possessed the intent to be partners with the foreign banks, focusing on whether Dow had the intent to share the profits *and* losses with the foreign banks'' (emphasis added).).

[86]*Southgate*, 659 F.3d at 486 (emphasis added).