Canal Corporation and Subsidiaries, formerly Chesapeake Corporation and Subsidiaries v. Commissioner of Internal Revenue, 135 T. C. 199 (2010)

In Canal Corp. v. Comm'r, the U. S. Tax Court ruled that a transaction structured as a partnership contribution and distribution was a disguised sale, requiring immediate tax recognition. Chesapeake Corporation, through its subsidiary WISCO, transferred assets to a joint venture with Georgia-Pacific, receiving a large cash distribution. The court found that Chesapeake's attempt to defer tax on the transaction failed due to WISCO's lack of economic risk, impacting how businesses structure tax deferral strategies and the reliance on professional tax opinions.

Parties

Canal Corporation and Subsidiaries (formerly Chesapeake Corporation and Subsidiaries), Petitioner, v. Commissioner of Internal Revenue, Respondent. The case proceeded through trial before the U. S. Tax Court.

Facts

Chesapeake Corporation sought to restructure its business and divest its tissue business operated by its subsidiary, Wisconsin Tissue Mills, Inc. (WISCO). Chesapeake engaged Salomon Smith Barney and PricewaterhouseCoopers (PWC) to advise on strategic alternatives. PWC suggested a leveraged partnership structure with Georgia-Pacific Corporation (GP), where WISCO would transfer its tissue business assets to a newly formed LLC in exchange for a 5% interest and a special cash distribution. GP would contribute its tissue assets to the LLC in exchange for a 95% interest. The LLC obtained a bank loan, with GP as guarantor, and WISCO indemnified GP against the principal of the loan. The transaction closed on the same day PWC issued a "should" opinion that the transaction would be tax-free. Chesapeake treated the transaction as a sale for accounting purposes but not for tax purposes, deferring the recognition of a $524 million gain. The partnership ended in 2001 when GP sold its interest to comply with antitrust regulations, and Chesapeake reported the gain in 2001.

Procedural History

The Commissioner of Internal Revenue issued a deficiency notice to Chesapeake for 1999, asserting that the transaction should have been treated as a disguised sale in 1999, triggering a $524 million gain. Chesapeake filed a petition with the U. S. Tax Court. The Commissioner amended the answer to assert an additional accuracy-related penalty for a substantial understatement of income tax. The Tax Court applied a de novo standard of review and found for the Commissioner.

Issue(s)

Whether WISCO's transfer of its tissue business assets to the LLC and the simultaneous receipt of a cash distribution should be characterized as a disguised

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sale under Section 707(a)(2)(B) of the Internal Revenue Code, requiring Chesapeake to recognize a $524 million gain in 1999?

Whether Chesapeake is liable for an accuracy-related penalty for a substantial understatement of income tax under Section 6662(a) of the Internal Revenue Code?

Rule(s) of Law

A transaction where a partner contributes property to a partnership and soon thereafter receives a distribution of money or other consideration may be deemed a disguised sale if, based on all the facts and circumstances, the distribution would not have been made but for the partner's transfer of property. See *26 C. F. R. § 1. 707-3(b)(1)*. The regulations provide a two-year presumption that such transactions are sales unless the facts and circumstances clearly establish otherwise. See *26 C. F. R. § 1. 707-3(c)(1)*. The debt-financed transfer exception applies if the distribution does not exceed the distributee partner's allocable share of the partnership liability. See *26 C. F. R. § 1. 707-5(b)(1)*. A partner's share of a recourse liability is determined by the portion for which the partner bears the economic risk of loss. See *26 C. F. R. § 1. 752-1(a)(1)*. The anti-abuse rule may disregard a partner's obligation if it creates a facade of economic risk of loss. See *26 C. F. R. § 1. 752-2(j)(1)*. An accuracy-related penalty applies for substantial understatement of income tax unless the taxpayer shows reasonable cause and good faith. See *26 U. S. C. § 6662(a), (d)(1); 26 C. F. R. § 1. 6664-4(a)*.

Holding

The U. S. Tax Court held that WISCO's transfer of assets to the LLC and the simultaneous receipt of a cash distribution constituted a disguised sale under Section 707(a)(2)(B) of the Internal Revenue Code, requiring Chesapeake to recognize a $524 million gain in 1999. The court also held that Chesapeake is liable for an accuracy-related penalty for a substantial understatement of income tax under Section 6662(a) of the Internal Revenue Code.

Reasoning

The court applied the disguised sale rules, finding that WISCO's transfer of assets and the simultaneous receipt of a cash distribution triggered the two-year presumption. Chesapeake failed to rebut this presumption as WISCO did not bear the economic risk of loss for the LLC's debt. The court disregarded WISCO's indemnity obligation under the anti-abuse rule because it lacked substance and economic reality. WISCO's assets post-transaction were insufficient to cover the indemnity, and Chesapeake could cancel WISCO's main asset at its discretion. The court found that Chesapeake's reliance on PWC's tax opinion was unreasonable due to PWC's inherent conflict of interest in structuring the transaction and issuing the opinion. The opinion was based on dubious legal assumptions and lacked thorough analysis. The court concluded that Chesapeake did not act with reasonable cause or

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in good faith in relying on the opinion, thus sustaining the accuracy-related penalty.

Disposition

The U. S. Tax Court entered a decision for the Commissioner, requiring Chesapeake to recognize the $524 million gain in 1999 and imposing an accuracy-related penalty for a substantial understatement of income tax.

Significance/Impact

Canal Corp. v. Comm’r is significant for its application of the disguised sale rules and the anti-abuse rule in partnership transactions. The case highlights the importance of economic substance in structuring tax deferral strategies and the scrutiny applied to indemnity obligations. It also underscores the limitations of relying on professional tax opinions when the adviser has a conflict of interest. Subsequent cases have cited Canal Corp. for its analysis of disguised sales and the standards for reasonable reliance on tax advice. The decision impacts how businesses structure transactions to achieve tax deferral and the importance of maintaining economic substance in such arrangements.

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