OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT: Substance v. Form

This Field Service Advice responds to your memorandum dated August 28, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =

Years 1 - 5 =

ISSUES:

1. Whether a subsidiary acquired its interest in certain custom-designed equipment from a third party by assignment-leaseback or from the parent by purchase. If the former, then the parent is required to recognize gain on the sale of the equipment to the third party. If the latter, the sale may qualify as a deferred intercompany transaction (within the meaning of Treas. Reg. § 1.1502-13). In

that case, the parent would not be required to recognize gain currently on the sale of the equipment.

2. Whether the Service may assert the Danielson rationale in response to petitioner's argument that the intent of the parties was different than that reflected in the transactional documents.

CONCLUSIONS:

1. The subsidiary acquired its interest in certain custom-designed equipment from a third party by assignment-leaseback and not from the parent by purchase. Accordingly, the parent is required to recognize gain on the sale of the equipment to the third party.

2. In support of its argument, the Service may assert the Danielson rationale in response to petitioner's argument that the intent of the parties was different than that reflected in the transactional documents. [redacted].

FACTS:

During Years 1 - 5, X entered into agreements with third-party customers for X to manufacture and sell certain custom-designed equipment to the customers. These transactions fell into three separate patterns:

1. X entered into a sales agreement with a third-party customer and received payment that was performed directly by the customer or its third-party finance company ("outside sale"). There, no intercompany deferral is claimed.

2. X entered into a sales agreement with a third-party customer, who subsequently entered into an assignment-leaseback agreement with X's finance subsidiary. There, X reports the transaction as a deferred intercompany sale in a Schedule M-1 adjustment, which the Commissioner disallowed. (This is the transaction in dispute)

3. X entered into a sales agreement directly with its finance subsidiary, agreeing to sell the custom-designed equipment desired by a customer-lessee directly to the finance subsidiary, which in turn agreed to lease it to the third-party customer ("inside sale"). Unlike situation 2 above, no purchase contract was executed between X and the third-party customer, because the customer did not elect to purchase the equipment or did not have sufficient credit to qualify as a purchaser.

The available information does not indicate how X or the finance subsidiary treats the above three categories of transactions for financial accounting purposes under GAAP.

In the transactions described under situation 2 above, the third-party purchaser made a partial payment on the purchase price when the agreement was signed and continued to make interim payments to fund X's manufacturing activities. During the executory phase of the contract, the customer would enter into an assignment-leaseback agreement with X's finance subsidiary. Under the assignment, the customer would transfer its contractual rights, obligations, equity interests, interim payment credits, and right to receive title to the finance subsidiary. Pursuant to the terms of that assignment, the finance subsidiary would simultaneously agree to perform the customer's obligations under the purchase contract, to accept title and lease the custom-manufactured equipment back to the third party. Although the customer's interim payments were sometimes refunded without interest to the customer or offset against the lease payments, the customer remained obligated as primary obligor under its purchase agreement with X. The customer's lease payments were calculated to reimburse the finance subsidiary for its out-of-pocket costs and give it an interest-like profit factor. You are attempting to determine the interest-factor formula used to calculate the lease payments.

For the situation 2 transactions, X contends that it and the finance subsidiary have a seller-purchaser relationship, on the grounds the assignment and alleged intent of the parties allow the subsidiary to stand in the shoes of the third-party purchaser. In support of this argument, X refers to several private letter rulings in which the issue involved determining the "purchaser," for Federal income tax purposes, of the property at issue.

In addition, X argues that any purported sale between itself and the third party did not occur before the assignment-leaseback occurred. For that reason, X argues that both legal and equitable ownership of the equipment was transferred directly from itself to the subsidiary and remained with the subsidiary until the equipment was accepted by the third party.

Alternatively, X argues that the agreement between itself and the third party was similar to an option that was assigned to the subsidiary pursuant to the assignment-leaseback. In that case, the question is whether the subsidiary's exercise of the purported option (to purchase the equipment from X) would make the third party the purchaser of the equipment.

If so, this exercise could constitute a sale of the equipment outside of the consolidated group prior to the subsidiary's acquisition of the equipment. In that case, the transaction would not qualify as a deferred intercompany sale. On the other hand, if the subsidiary's purchase of the equipment through the exercise of the option does not make the third party a purchaser of the equipment, then the sale of the equipment by X to the subsidiary may have constituted a deferred intercompany transaction.

Finally, you have asked us to consider whether an argument can be made in this case to hold the parties to the form set forth in the transactional documents based on Danielson v. Commissioner, 378 F.2d 771 (3d Cir. 1974), and subsequent cases.

1. Whether the Sale was Initially to the Third Party or Initially to the Subsidiary

LAW AND ANALYSIS

As noted above, X entered into agreements with third parties to sell them certain custom-designed equipment. These sales took three forms. In some cases, X sold the equipment directly to the third party, which financed the sale itself (“outside sale”). X recognized gain on this outside sale. In other cases, X sold the equipment directly to its finance subsidiary, which leased it to the purchaser (“inside sale”). X treated this inside sale as a deferred intercompany transaction, for which current gain recognition is not required. In the third category of cases (which are at issue here), X sold the equipment to the third party, which assigned it to the subsidiary, which leased it back to the third party. X also treated this type of transaction on its tax return as an inside sale and thus a deferred intercompany transaction. The question is whether this characterization of the transaction is correct.

In form, the transaction at issue is an outside sale. However, X contends that the substance of the transaction at issue is an inside sale. As noted above, X primarily relies on certain private letter rulings in which the issue involved determining the “purchaser,” for Federal income tax purposes, of the property at issue. In response, you note that in the transaction at issue the finance subsidiary is clearly the ultimate purchaser of the equipment.

As you point out, this argument might be important if the issue was whether the subsidiary became the owner of the equipment. However, the issue in the instant case is the identity of the seller, i.e., whether the finance subsidiary acquired its ownership interest in the equipment from the third-party customer or from X. In short, while the subsidiary may have stood in the shoes of a purchaser, it acquired that status from the initial third-party purchaser by assignment and not from X by purchase. Thus, we agree with your view that the private letter rulings cited by X are irrelevant.[1]

We concur with your contention that, in both form and substance, the transaction at issue is an outside sale. The "sale" was by executory contract from X to the third party,

[1] In any event, private rulings do not necessarily represent Service position and cannot be cited as precedent. I.R.C. § 6110(j)(3).

which subsequently assigned and transferred the benefits and burdens of ownership, as well as the right to title, to the finance subsidiary. In substance, the assignment is a sale between the third party and the finance subsidiary, i.e., the transfer of the benefits and burdens of ownership for a fixed price. In the assignment-leaseback transaction, the third-party customer promised (1) to remain the primary obligor for the fixed purchase price under the purchase agreement, (2) to transfer the benefits and burdens of ownership to the finance subsidiary, and (3) to make certain lease payments to the finance subsidiary. This was in consideration for the finance subsidiary's promise (1) to perform the third party's obligation to pay a fixed purchase price at a date certain to X and (2) to spread the third party's fixed purchase money obligation over a period of years in the form of lease payments calculated to reimburse the finance subsidiary and give it an interest-like factor.

The fact that there was at least one transaction in which X sold the system directly to the finance subsidiary suggests that X understands the difference between transferring property to a third party (an outside sale) and transferring it to its subsidiary (an inside sale). In the transaction at issue, X initially sold the equipment to the third party. As you point out, once the purchase agreement between X and the customer was executed, X was unconditionally obligated to sell the custom-designed system to the third party. Contract law would preclude X from selling the custom-designed equipment to anyone but the customer for whom it was designed and manufactured. X had no legal alternative or authority to do otherwise. Furthermore, the purchase contract between X and the customer was never rendered inoperative (1) by a novation between the parties, (2) by a rescission of the agreement, or (3) by an accord and satisfaction. X's obligations under the contract remained unchanged, and it placed the manufactured equipment in service at the customer's place of business as required by the contract. In short, we agree that the contract between X and the third party constituted a sale of the equipment outside the X group.

This characterization is not affected by the subsequent assignment of the equipment by the third party to the finance subsidiary followed by the subsidiary's lease of the equipment back to the third party. We recognize that X argues respondent's theory would require that title have been physically issued to the third party and endorsed by it over to the finance subsidiary. In our opinion, however, X merely transferred title in the telephone system directly to the finance subsidiary because the third-party customer directed it to do so. Thus, the finance subsidiary received title by exercise of contractual authority from the customer rather than by purchase from X.

We agree with your determination that the instant case is analogous to the situation in Chemetron Corporation v. Commissioner, T.C. Memo. 1960-269, 19 T.C.M. (CCH) 1497. There, the taxpayer held an option to acquire certain rights to pending patent applications owned by Klotz and subsequently agreed to assign its rights under that option to B.J. Company in settlement of a patent interference proceeding that involved one of the optioned patent applications. To satisfy a condition of the settlement, the taxpayer obtained an executed transfer of title from Klotz to B.J. Company. The Tax Court held that the taxpayer informally exercised the option and then sold the patents to B.J. Company, even though the taxpayer never held legal title. In finding that the taxpayer's lack of legal title had no effect on this holding, the Tax Court discussed a similar situation in Butler v. Commissioner, 43 B.T.A. 1005 (1941), in which A sold an option on mineral rights to B for $5,000, who then sold an option to the same mineral rights to C for $36,000. When C exercised his option and gave B $36,000, B gave $5,000 to A and instructed A to convey title to C. Taxpayer B argued that he did not sell mineral rights to C because he never took title to the property. The Chemetron court quoted (19 T.C.M. at 1506) the following passage from Butler, 43 B.T.A. at 1008:

> It is true that there were not two deeds, one from [A to B] and one from [B to C], but in view of the fact that [B] apparently exercised the option he had by giving his check for $5,000 to [A], and that [C] did not pay anything to [A], it appears that all parties concerned eliminated one step in an economy of effort and that the deed from [A to C] was in reality a deed on behalf of [B], conveying title which he had acquired under exercise of his option, to [C], who exercised the option he obtained from [B]. In our opinion, the substance rather than the form of the transaction is controlling.[2]

Under the rationale of Chemetron and Butler, X's transfer of title directly to the finance subsidiary does not alter the substance of the sale to the third-party customer followed by the sale-leaseback between the customer and the finance subsidiary. The fact that the finance subsidiary paid X on behalf of the customer is immaterial. In Butler, "C" could have paid $5,000 to A on behalf of B without changing the result. "A" would have received the payment in constructive trust for B. Here, instead of having the subsidiary transfer its purchase payment to the customer, who in turn would transfer the money to X, the subsidiary's payment was made directly to X to discharge the customer's purchase payment obligation to X. As discussed above, the customer remained primarily liable to X under the original purchase contract. Similarly, even under X's alternative position based on treating the agreement between X and the third party as an option, the continuing obligation of the third party to X would make the instant case analogous to the situations in Chemetron and Butler. Accordingly, we do not believe X would obtain a different result by treating X's agreement with the third party as an option.

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[2] The fact that C paid B and the fact that the subsidiary paid X on behalf of the customer is immaterial. "C" could have paid $5,000 to A on behalf of B without changing the result. "A" would have received the payment in constructive trust for B. Here, instead of having the subsidiary transfer its purchase payment to the customer, who in turn would transfer the money to X, the subsidiary's payment was made directly to X to discharge the customer's purchase payment obligation to X.

Generally, a taxpayer may not argue that the substance of a transaction is different from its form. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974), discussed below. Therefore, under this analysis, X may not argue that the series of steps comprising the transaction at issue represent, in substance, an inside sale when the form represents an outside sale.

Taxpayers "are entitled to attack the form of their transactions only where their tax reporting and other actions have shown an honest and consistent respect for what they argue is the substance of the transactions". Federal Nat'l Mortgage Ass'n v. Commissioner ("FNMA"), 90 T.C. 405, 426 (1988) (citing Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986)), aff'd, 896 F.2d 580 (D.C. Cir. 1990), cert. denied, 499 U.S. 974 (1991). [redacted]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

2. Procedural Issues

LAW AND ANALYSIS

In determining income tax liabilities, respondent may look through the form of a transaction to its substance. Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Further, as noted above, respondent, as a general rule, may bind a taxpayer to the form in which the taxpayer has cast a transaction. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974); Bradley v. United States, 730 F.2d 718, 720 (11th Cir. 1984); Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954), aff'g 19 T.C. 718 (1953). In National Alfalfa the Court stated:

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so must accept the tax consequences of this choice . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not.

National Alfalfa, 417 U.S. at 149.

Courts have allowed taxpayers to disavow the form they chose for a transaction under two fairly restrictive rules: the Danielson rule and the "strong proof" rule. The Danielson rule allows a taxpayer to disavow the form of its transaction only if it adduces proof that "in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir.), cert. denied 389 U.S. 858 (1967). The strong proof rule allows a taxpayer to disavow the form of its transaction if it adduces "strong proof" that the agreement lacks economic reality and was entered into under economic duress. Sonnleitner v. Commissioner, 598 F.2d 464, 467 (5th Cir. 1979).

Nevertheless, the Danielson rule does not apply if the agreement in question is ambiguous. Smith v. Commissioner, 82 T.C. 705, 713 (1984).

As mentioned above, the issue in this case is whether X's subsidiary acquired the equipment via an assignment from the third party, or whether the subsidiary acquired it by purchase from X. The terms of the agreement reflect that the parties agreed to an assignment from the third party to X's subsidiary. Under the Danielson rationale, the petitioner must show fraud, undue influence or mistake in order to reverse the agreement.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

If you have any further questions, please call (202) 622-7930.

Deborah A. Butler
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By: __________________________
STEVEN J. HANKIN
Chief, Corporate Branch

cc: