OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Counsel) CC:DOM:FS:P&SI

SUBJECT:

This Field Service Advice assistance responds to your memorandum dated December 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:

| | |
|---|---|
| Taxpayer | = |
| B | = |
| C | = |
| D | = |
| E | = |
| F | = |
| G | = |
| H | = |
| L | = |
| Accounting Firm | = |
| Period 1 | = |

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|---|---|
| Date 1 | = |
| Date 2 | = |
| Date 3 | = |
| Date 4 | = |
| Date 5 | = |
| Date 6 | = |
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| Amount 1 | = |
| Amount 2 | = |
| Amount 3 | = |
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| Amount 24 | = |
| Amount 25 | = |
| Amount 26 | = |
| Amount 27 | = |
| Amount 28 | = |

| | |
|---|---|
| Year W | = |
| Year X | = |
| Year Y | = |
| Year Z | = |

Percentage 1 =

Shares X =
Shares Y =
Shares Z =

Number =

Form =

FACTS:

This case involves a lease-stripping transaction, where one p realizes rental income from property and another party or parties to the transaction claim deductions for rental expenses and/or depreciation on the equipment. In Notice 95-53, 1995-2 C.B. 334, the Service defined and described forms of lease-stripping transactions and the I.R.C. sections and doctrines that are applicable to such transactions. Notice 95-53 states that, depending upon the facts of the case, the Service may apply the following authorities to the transaction: sections 269, 382, 446(b), 482, 701 or 704, 7701(l), and the regulations of each section, and authorities that recharacterize certain assignments or accelerations of future payments as financings; assignment-of-income principles; the business-purpose doctrine; or the substance-over-form doctrines (including the step transaction and sham doctrines.

ISSUES:

(1)(a) Whether the lease stripping transactions at issue are sham transactions lacking business purpose and economic substance.

(1)(b) Whether the “Sham the Partner and/or Partnership” argument applies to the lease stripping transactions at issue and would support disallowance of the taxpayer's claimed deductions for rental expenses.

(2) Whether the step transaction doctrine applies to the series of lease stripping transactions described below.

(3) Whether I.R.C. § 269 applies to disallow the deductions claimed by B as a result of the series of lease stripping transactions described below.

(4) Whether the business purpose requirement of I.R.C. § 351 is not satisfied, in the case of the series of lease stripping transactions described below, so that the transferee corporation, B, is required to take a fair market value basis in the property received, and is not entitled to take a carryover basis in such property.

(5) Whether the purported sale of the rights to the lease receivables (the “Lessor Rights”) by C to D. should be recharacterized as a financing?

(6) Whether I.R.C. § 482 applies to B and the other parties to the lease stripping transactions described below, and, if so, what are the consequences of applying I.R.C. § 482.

CONCLUSIONS:

(1)(a) The Service may apply the sham transaction theory to support the disallowance of the taxpayer’s claimed deductions for rental expenses in the years at issue on the grounds that the lease-stripping transactions lack business purpose and economic substance, if additional fact development supports this theory.

(1)(b) The Service may apply the “Sham the Partner and/or Partnership” argument to the lease stripping transactions to support the disallowance of the taxpayer's claimed deductions for rental expenses, if additional fact development supports this theory.

(2) Additional factual development is necessary before we can determine whether the step transaction doctrine applies.

(3) Additional factual development is necessary before we can determine whether I.R.C. § 269 applies.

(4) Additional factual development is necessary before we can determine whether lack of a business purpose should be asserted to disqualify the transfer of property of B under I.R.C. § 351. Please coordinate this issue with the National Office after the facts have been further developed.

(5) Additional factual development is required in order to recharacterize the sale of the Lessor Rights as a financing.

(6) Section 482 may apply to the lease-stripping transaction described below (the “Transaction”) because the parties to the Transaction acted pursuant to a common plan to shift income and deductions artificially and to assist Taxpayer in the evasion of taxes.

FACTS:

For the years at issue, Taxpayer was the common parent of an affiliated group of corporations filing a consolidated return. Prior to the lease stripping transactions described below, as well as during the years at issue, C was a member of the Taxpayer consolidated group.

C is a general partnership. During the years at issue, C had three partners. Two individuals each had a Percentage 3 interest in all items of income, gain, loss, deduction, and credit of C. E had a Percentage 1 interest in C. E is a limited partnership of which, during the years at issue, F was a Percentage 1 limited partner. Thus, E is effectively exempt from Federal income tax.

Prior to Date 1, G acquired ownership interests in a number of mainframe computer systems and associated peripherals. All of this equipment was leased to unrelated parties (the “user leases”).

On Date 1 , C purchased G’s ownership and leasehold interests in six computer systems, subject to the user leases and subject to the liens securing the senior debt and junior debt. As of that date, the aggregate outstanding balance of the senior and junior debt was $Amount 1 . However, the rent due on the remaining term of the user leases was only $Amount 2 .

The total consideration paid by C to G was $Amount 3 . No cash changed hand at closing. Instead, C assumed the senior debt and issued three notes (the “C notes”), payable to G, in the aggregate amount of $Amount 4.

Also on Date 1, C sold the ownership and leasehold interests it acquired from G to H, subject to the user leases and subject to the liens securing the senior debt, the junior debt and the C notes, for $Amount 5 . As with the transaction described in the previous paragraph, no cash changed hands at closing. H issued a recourse note and six nonrecourse notes. H immediately leased the ownership and leasehold interests back to C pursuant to the Agreement of Lease (”Master Lease”). C’s lease payments to H exactly match H’s payments to C on the nonrecourse notes.

In an agreement dated Date 2, C sold its right to receive payments, under any extension or renewal of the user leases, or under any lease entered into with another party after the termination of a user lease, for a period of Period 1 after the end of the initial terms of the user leases, to L. The consideration paid by L was a combination of cash and notes.

Pursuant to the terms of the residual Purchase Agreement, C’s rights included the following:

(i) collect and receive all proceeds from the rental of the

> Equipment allocable to and accruing during the period . . . including the right to receive and collect all rents accrued and payable by a third party . . . pursuant to a lease of the Equipment, only as permitted by the Master Lease, during [L's] Residual period . . .;
> (ii) consent or refuse to consent to the remarketing of the Equipment and approve or disapprove of the terms of a Subsequent Sublease, to the extent permitted by the Master Lease and the Remarketing Agreement, . . . ; and
> (iii) receive and collect the portion set forth... of any sums payable by any party to [C] upon the termination of the Subsequent Sublease or the sale of the Equipment before or during [L's] Residual Period or upon the loss, damage or destruction of the Equipment . . . (being collectively referred to as the "Sold Residuals").

Residual Purchase Agreement, at 2.

On Date 3, C purportedly sold to D, a Delaware corporation, certain rights ("Lessor Rights") for a total amount of $Amount 6 pursuant to the terms of the Lease Purchase Agreement ("Lease Purchase Agreement"). The rights that D purchased included the right to Number payments of rent in the amount of $Amount 7 each, for a total amount of $Amount 8 , pursuant to the preexisting user leases. The rights in the Lease Purchase Agreement, at 1-2, included the following:

> (1) all rights of any lessor under the Existing User Lease or any Replacement Lease, including all prepayment of rent . . . rents accrued but unpaid . . . and all payments of last charges, damages and other amounts payable . . .
> (2) the "Buyer's Portion" and "Seller's Portion" of (a) any casualty or stipulated loss payment and (b) all proceeds resulting from or arising out of the disposition of the Existing User Lease,
> (3) all of the lessor's rights and remedies . . ., and
> (4) the rights to enforce the "Nonexclusive Rights". . . .

In the Lease Purchase Agreement, at 3, C, the seller, agreed to convey to D, the buyer, "the 'Sold Lessor Rights' . . . free and clear of all liens, security interests and encumbrances." D acquired the right to enforce the users' obligations, including the right to enforce payment of rents, payment of insurance on the equipment, and payment of taxes. Lease Purchase Agreement, at 3. D has the right to re-lease the equipment, and also had the right to sell, assign, transfer and encumber the Lessor Rights, but these rights would not affect D's obligations to C. Lease Purchase Agreement, at 12-13.

C agreed that it would pay most of the related taxes. Lease Purchase Agreement, at 11. Additionally, in the event of the loss, damage, or destruction of the equipment, or the early termination of the leases, C agreed that it would forward to the equipment user a notice "directing User to remit to Buyer [D] any payment due from User pursuant to the Existing User Lease as a result of such event." Lease Purchase Agreement, at 11.

In a series of substantially similar agreements, dated Date 3 and Date 9, C sold its right to receive future rental payments under the user leases to a number of parties,
including D, Inc.

On Date 4 , C contributed assets and liabilities to B, a California corporation, in exchange for newly issued preferred stock in B pursuant to an exchange under I.R.C. § 351. Prior to the exchange, B's sole shareholder was Taxpayer, the taxpayer. In disclosure statements relating to the section 351 exchange, C reported that it had an adjusted basis in its assets of $Amount 9 , and in its liabilities of $Amount 10 . C received Shares X of Series A preferred stock of B. Taxpayer contributed $Amount 11 in cash to B, and received Shares Y of no par value common stock and Shares Z of Series A preferred stock of B with fair market values of $Amount 12 and $Amount 13 . B acquired the rights to receive payments of principal and interest from H, and also the obligation to pay rent to H under the leaseback. These two were equal in amount and timing.

For C's taxable year ending Date 5 , C reported on its Form that it transferred to B assets with a tax basis of $Amount 9, with liabilities in the amount of $Amount 10, in exchange for Series A preferred stock with a fair market value of $Amount 14.

B received interest income in the tax year ending Date 7, and in tax year ending Date 8 . B took interest and depreciation deductions in excess of the income for Year W and Year X. The depreciation deduction for Year W was $Amount 15 and for Year X was $Amount 16. B amortized its start-up costs in Year W and Year X. B also paid rent to H in Year W and Year X. The exact amount of the rents and depreciation allocable to the computer equipment is unknown. B and Taxpayer reported income and deductions on Taxpayer's consolidated returns for the Year W and Year X tax years.

In a Yearly Profit and Loss statement detailing B's taxable income, taxes saved and total benefits, from Year W through Year Y, B projected that it would have a total (economic) loss of $Amount 17, $Amount 18 in taxes saved, and $Amount 19 in total benefits.

In a somewhat different transaction, on Date 6 , G sold certain computer equipment to C, subject to a user lease and subject to the liens securing the senior debt, for

$Amount 20 (in the form of two notes, a secured recourse note and a non-recourse installment note). No cash changed hands at closing. Immediately after the sale, C leased the equipment back to G. The periodic rental payments due from G to C under the lease exactly offset, in amount and timing, the payments due from C to G under the installment note.

The field proposes to disallow most of the claimed deductions on the ground that: (1) the transactions which caused those expenses lack economic substance, and (2) the taxpayer has not established that its claimed basis in the equipment is not demonstrably in excess of the fair market value of the equipment (with respect to certain depreciation deductions).

The field has asked for any alternative theories which could be asserted and any additional factual development that would be advisable. Below, we discuss separately several theories that the Service has asserted in various lease stripping transactions: (1(a) sham transaction (1)(b) step transaction, (2) I.R.C. § 269, (3) the business purpose requirement of I.R.C. § 351, (4) sale vs. financing, and (5) I.R.C. § 482.

Issue One - Sham Transaction and Sham Partnership

(1)(a) Whether the lease stripping transactions at issue are sham transactions lacking business purpose and economic substance?

CONCLUSION

(1)(a) The Service may apply the sham transaction theory to support the disallowance of the taxpayer's claimed deductions for rental expenses in the years at issue on the grounds that the lease-stripping transactions lack business purpose and economic substance, if additional fact development supports this theory.

LAW AND ANALYSIS

District Counsel has indicated it believes that the sham transaction theory is the strongest argument for challenging the transactions. If the Service prevails on this ground, the taxpayer's claimed depreciation deductions will be entirely disallowed.

In Notice 95-53, 1995-2 C.B. 334, the Service discusses “lease strips” or “stripping transactions” and the tax consequences of these transactions. In this Notice, the Service announced that it may apply the substance-over-form-doctrines, including the sham transaction theory and the step transaction theory.

As to the sham transaction theory, generally, where 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 transaction is not a sham and the Service should honor the allocation of rights and duties effectuated by the parties. To provide guidance in determining whether a transaction is a sham for tax purposes, courts have looked to: (1) whether the taxpayer had a business purposes for engaging in the transaction other than tax avoidance; and (2) whether the transaction had economic substance beyond the creation of tax benefits. Thus, both the taxpayer's subjective business motivation and the objective economic substance of the transactions are examined.

Here, District Counsel asserts that the facts developed to date support a finding that the transactions are sham transactions in that: (1) A transaction which could reasonably be expected to be tax-neutral over its normal life expectancy was artificially divided into an income leg and a loss leg; (2) Recognition of income was accelerated by an entity which was effectively exempt from United State taxation; (3) The tax-exempt entity effectively exits from the transaction leaving the loss to be recognized by a US taxpayer in need of a tax shelter; (4) At no time is the US taxpayer exposed to any significant risk of economic loss as a result of the transaction, by the same token, at no time did the US taxpayer have a significant opportunity to earn an economic profit as a result of the transaction; and (5) the US taxpayer does not provide any detailed explanation of its tax -independent motivation for entering into the transaction, here, an electric and gas utility entering into a handful of computer leasing transactions.

From the facts presented by District Counsel, we concur that the Service has a viable argument that the transactions are sham transactions. While it is impossible to have a simple test or checklist for determining whether a particular transaction is a sham, we see no reason not to assert the sham transaction theory in this case. This theory is the Service's primary weapon in virtually all sale/leaseback cases.

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752(1975); Rice's Toyota World v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978). When a transaction is treated as a sham, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction.

The Service must show that the taxpayer was motivated by no substantial business purpose other than obtaining tax benefits and that the transaction did not have any economic substance. All of the facts and circumstances surrounding the transactions must be considered. No single factor will be determinative. Courts will respect the taxpayer's characterization of the transactions if there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped solely by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990).

Recently, the Service was successful in showing that a series of prearranged transactions involving the purchase and sale of debt instruments in an attempt to shift accelerated installment sale gain to a tax-neutral partner and manufacture a loss for another partner was a sham. ACM Partnership v. Commissioner, T.C. Memo. 1997-115, 73 T.C.M. (CCH) 2189 (1997), aff'd in relevant part, rev'd in part, remanded, 157 F.3d 231 (3d Cir. 1998) cert denied, 1999 U.S. LEXIS 1899 (U.S. Mar. 22, 1999). In ACM Partnership, the Service argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance and lacking in economic reality.

In its opinion, the Tax Court said that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The Tax Court also stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transaction lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts when viewed as a whole have no economic substance. Similarly, in Rev. Rul 99-4, 1999-3 I.R.B. 1, the Service concluded that lease-in / lease-out ("LILO") transactions have no economic substance and therefore, determined that a U. S. taxpayer could not take deductions for rent or interest paid or incurred in connection with the transaction.

Even if the entire transaction is not a sham, that is, if the debts created were genuine, the transaction could still be rejected by the court. In Goldstein v. Commissioner, 364 F.2d 734, 742 (2d Cir. 1966), the court disallowed petitioner's deductions for interest paid in connection with a loan on the grounds that the transaction lacked any expectation of profit and was entered into by petitioner without any purpose except to obtain an interest deduction. See also, United States v. Wexler , 31 F. 3d 117, 125 (3d Cir. 1994) ; cert. denied, 513 U.S. 1190(1995); Lee v. Commissioner, 31 F. 3d 117, (3d. Cir.1998) 1998 WL 640281, 82 A.F.T.R.2d 98-6110 (2nd Cir., August 25, 1998)(No. 97-4308).

The sham transaction theory should be applied in this case to disallow income expenses and deductions from the sale-leaseback. The transaction at issue in this case involves a series of sale-leasebacks each of which may have some business purpose, but when taken as a whole have no business purpose independent of tax considerations. As in ACM Partnership, the Taxpayer entered into the transaction for the sole purposes of avoiding taxes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

While there is no case on point that involves a lease-stripping transaction of the nature in this case, there are many cases involving transactions in which courts have applied the Sham Transaction Doctrine. Resolution of the issue will depend on the facts in the case. [redacted]

(1)(b) Whether the “Sham the Partner and/or Partnership” argument would support the disallowance of the taxpayer's claimed deductions for rental expenses?.

CONCLUSION

(1)(b) The Service may apply the “Sham the Partner and/or Partnership” argument to this lease stripping transaction to support the disallowance of the taxpayer's claimed deductions for rental expenses if additional fact development supports this theory.

LAW AND ANALYSIS:

In order for a federal tax law partnership to exist, the parties must, in good faith and with a business purpose, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise. The entity’s status under state law is not determinative for federal income tax purposes. Commissioner v. Tower, 327 U.S. 280, 287 (1946); Luna v. Commissioner, 42 T.C. 1067, 1077 (1964). The existence of a valid partnership depends on whether: considering all of the facts—the agreement of the parties, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent–the parties in good faith and action with a business purpose intended to join together for the present conduct of an undertaking or enterprise. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); ASA Investering Partnership v. Commissioner, T.C. Memo. 1998-305; Rev. Rul. 82-61, 1982-1 C.B. 13.

Recently, the Service was successful in making this argument in ASA Investering Partnership v. Commissioner, T.C. Memo. 1998-305, appeal docketed, No. 98-1583 (D.C. Cir. Dec.11, 1998). In that case, the primary issue considered by the Tax Court was whether Allied Signal, Allied Signal Investment Corporation, Barber Corporation N.V., and Dominguito Corporation, N.V. formed a valid partnership for Federal income tax purposes. The Tax Court held that the corporations did not. In ASA Investering, the court disregarded the existence of Barber and Dominguito because the facts demonstrated that those entities were agents for ABN, the lender. Commissioner v. Bollinger, 485 U.S. 340 (1988). The court pointed out several relevant facts. First, both Barber and Dominguito were thinly capitalized shell corporations established for the sole purpose of engaging in the venture. Second, the parties treated ABN as the real participant in the venture and disregarded Barber's and Dominguito's respective corporate forms. As an example, AllliedSignal paid ABN directly for Barber's and Dominguito's participation in the venture. Third, Barber and Dominguito were mere conduits. ABN lent Barber and Dominguito the funds for their respective "capital contributions" and retained options that allowed ABN to purchase Barber's and Dominguito's shares for a de minimis amount. All of Barber's and Dominguito's profit from the transactions came back to ABN.

The court also concluded that because ASIC is AlliedSignal's wholly-owned subsidiary, AlliedSignal, not ASIC, is the relevant party. So for purposes of deciding the issue, the court also ignored the existence of ASIC. The court then considered whether AlliedSignal and ABN intended to join together in the present conduct of an enterprise.

The court pointed out the following facts as relevant to reaching its conclusion that AlliedSignal and ABN did not intend to join together in the present conduct of an enterprise. First, AlliedSignal and ABN had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses to shelter an anticipated capital gain. In pursuing this goal, AlliedSignal chose to ignore transaction Lts, profit potential, and other fundamental business considerations. AlliedSignal focused solely on the potential tax benefits. In contrast, ABN entered into the venture for the sole purpose of receiving its specified return. This return was independent of the performance of ASA's investments (e.g., the profitability of the LIBOR Notes) and the success of the venture (i.e., whether AlliedSignal succeeded in generating capital losses). Further, ABN did not have any profit potential beyond its specified return and did not have any intention of being AlliedSignal's partner. In essence, the arrangement did not put all of the parties "in the same business boat," therefore, "they cannot get into the same boat merely to seek * * * [tax] benefits." Commissioner v. Culbertson, at 754.

In ASA Investerings, petitioner argued that ASA should be respected as a bona fide partnership because the purported partners carefully followed partnership formalities. The court stated that such formalities may have created a partnership facade, but the conduct of AlliedSignal and ABN demonstrates that the side agreement , not the partnership agreement, governed their affairs.

The court concluded that the characteristics of AlliedSignal and ABN's relationship are contrary to the characteristics of a bona fide partnership. AlliedSignal and ABN had divergent, rather than common, interests. Moreover, they did not share in the venture's profit and losses and did not comply with their partnership agreement when it conflicted with the side agreement. In conclusion, the court stated that AlliedSignal, ASIC, and ABN's agents, Barber and Dominguito, did not have the requisite intent to join together for the purpose of carrying on a partnership and sharing in the profits and losses therefrom. Instead, further analysis revealed that AlliedSignal and ABN had a debtor-creditor relationship. Having concluded that ABN is in substance a lender, the court held that Barber and Dominguito were not partners in ASA and that the appropriate amount of gain relating to the sale of the PPNs and loss relating to the sale of the LIBOR notes should be allocated between AlliedSignal and ASIC.

We believe the Sham Transaction theory with its economic substance underpinning is the stronger argument in this case. We also believe the Sham Partnership theory applies based on an analysis similar to that in ASA Investerings. In this case, we would argue that the existence of C and its partners should be ignored because C is acting as a mere agent of G, H and Taxpayer. Support for this position comes from Commissioner v. Bollinger, 485 U.S. 340 (1988). Once you ignore C and the transactions C was a party to, you are left with a basic sale/leaseback transaction between G, H and Taxpayer.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Issue Two - Step Transaction

LAW AND ANALYSIS

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

The step transaction doctrine, as described above, allows the Service to argue that certain economically meaningless steps of a transaction can be collapsed or ignored. Thus, the issue is whether the step transaction doctrine can be applied in this case to eliminate economically meaningless steps.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Issue Three - I.R.C. § 269

LAW AND ANALYSIS

Section 269(a) authorizes the Service to disallow any deduction or other allowance if (1) any person or persons directly or indirectly acquire control of a corporation or (2) any corporation acquires property from an unrelated corporation in a transaction in which the basis of the property carries over, and, in either case, the principal purpose for the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction or other allowance that such person or corporation would not otherwise enjoy.

In this case, it does not appear that the parties acquired control of B in the transaction because it appears that Taxpayer already controlled B.  In that case, I.R.C. § 269(a)(1) would not apply.  However, we do not have any information when Taxpayer first acquired B.

If Taxpayer formed B shortly before the transaction and B conducted no business until this transaction, the Service may be able to argue that the formation of, and the transfer of the property to, B should be integrated.  In that case, Taxpayer and C would be treated as having acquired B (by formation) as part of the transaction.  We note that the acquisition requirement of I.R.C. § 269(a)(1) may be met even if the target corporation was newly incorporated by the taxpayer in a tax-free exchange under I.R.C. § 351.  See Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968).

In addition, B acquired property from a partnership, C, not a corporation.  Therefore, I.R.C. § 269(a)(2) does not apply to this case.

## Issue Four - I.R.C. § 351

### LAW AND ANALYSIS

Generally, I.R.C. § 351 provides that investors do not recognize gain or loss if they transfer property to a corporation solely in exchange for its stock and if the transferors, as a group, are in control of the transferee corporation immediately after the exchange.  For purposes of I.R.C. § 351, control is defined as ownership of 80 percent of the total combined voting power of all classes entitled to vote and 80 percent of the total number of shares of all other classes of stock of the transferee corporation (I.R.C. §§ 351(a) and 368(c)).  The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met.  Subject to certain limitations, to determine control, a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction.

If I.R.C. § 351 applies to an exchange, under I.R.C. § 362(a)(1) the transferee corporation takes the same basis in the assets it received from the transferor as the transferor had in such assets increased by the amount of gain, if any, recognized to the transferor.  The facts as stated indicate that C's basis in the transferred assets exceeded the liabilities assumed (see I.R.C. § 357(c)).  Thus, if I.R.C. § 351 applies to the transfer of the ownership and leasehold interests to B, it appears B will take the same basis in such interest as the transferors had.[1] Consequently, I.R.C. § 351 will not prevent B from deducting the amounts claimed as depreciation.

On the other hand, if I.R.C. § 351 does not apply, the transfer of the ownership and leasehold interests to B is a taxable exchange under I.R.C. § 1001. B still recognizes no gain or loss on the transaction under I.R.C. § 1032. However, B determines the basis of the property it receives under § 1012. Under Treas. Reg. § 1.1012-1(a), B takes a basis in the ownership and leasehold interests equal to the fair market value of the stock B distributes in the exchange. As noted above, B received property with an aggregate adjusted basis of $Amount 9 , subject to liabilities of $Amount 10 , in exchange for newly issued preferred stock of B, valued at $Amount 14. Consequently, if I.R.C. § 351 does not apply, B would take an aggregate basis in the ownership and lease interests of $Amount 14. In that case, B would not be able to deduct much of the amounts claimed as depreciation.

The Service could argue that the transfer of the ownership and leasehold interests to B does not qualify under I.R.C. § 351 because such transfer lacks a business purpose. Courts have hinted at the concept of a business purpose requirement in I.R.C. § 351 repeatedly. Opinions discussing other I.R.C. § 351 issues often indicate that the taxpayer had a valid business purpose for the transaction in question. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in I.R.C. § 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). In Caruth, the court explains that I.R.C. § 351 is tied very closely to the reorganization provisions and reasons that the doctrines applicable there are equally valid for capital contributions. Under Caruth, the business purpose requirement for I.R.C. § 351 transactions appears to be the same as the business purpose requirement for acquisitive reorganizations. Generally, I.R.C. § 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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[1] B will have a basis in the cash received from Taxpayer equal to the face amount of such cash whether or not the transaction qualifies under I.R.C. § 351.

[redacted]

[redacted].

Please notify the National Office after the facts have been developed for further consideration of whether the lack of a business purpose should be asserted to disqualify the transfer of the  to B under I.R.C. § 351.

Issue Five -  Sale of Lease Receivables

Whether the purported sale of the rights to the lease receivables (the "Lessor Rights") by C  to D should be recharacterized as a financing?

CONCLUSION:

Additional factual development is required in order to recharacterize the sale of the Lessor Rights as a financing.

LAW AND ANALYSIS:

One approach to this transaction is to examine whether the purported sale of the Lessor Rights (the rental "strip") by C, the seller, to D, the buyer, should be recharacterized as a financing or a secured financing.  If this transaction is properly characterized as a sale of the Lessor Rights then C and ultimately its indirect majority partner, the Indian Nation, must recognize any gain or loss from the sale of the Lessor Rights for federal income tax purposes under section 1001, if subject to federal taxation. In this case, most of the gain or loss to C would pass through the C and partnerships to the Indian Nation untaxed.

Alternatively, if the transaction is a financing or a secured financing, then C and subsequently the Indian Nation do not include the borrowed or financed amounts in gross income. United States v. Centennial Savings Bank FSB, 499 U.S. 573, 582 (1991), 1991-2 C.B. 30. If this transaction is properly characterized as a financing, then the $Amount 6 that C received from D would represent a financing of the Lessor Rights. C, remaining as the owner of the leases and the Lessor Rights, would continue to realize income from the rental payment stream on the leases, either when paid or accrued, instead of accelerating the income in Year W.

In general, federal income tax consequences are governed by the substance of a transaction. Gregory v. Helvering, 293 U.S. 465, 470 (1935), XIV-1 C.B. 193. A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996). Generally, courts examine a number of factors to determine whether a transaction is a sale or something else, such as a financing or a lease. E.g., Levy v. Commissioner, 91 T.C. 838, 859-62 (1988); Larsen v. Commissioner, 89 T.C. 1229, 1266-68 (1987), aff'd in part and rev'd in part, Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

The Tax Court in Grodt & McKay, in considering whether the purported sale of cattle was a bona fide sale or a sham, determined that the purported sale was not a sale, and the taxpayers' only real expectation of profit rested on their expected tax benefits. The court enumerated eight factors to consider when making the determination of whether the transaction is a sale or a financing:

(1) whether legal title has passed;
(2) how the parties treated the transaction;
(3) whether an equity interest was acquired in the property;
(4) whether the seller was obligated to execute and deliver a deed and the buyer was obligated to make payments;
(5) whether the purchaser had a vested right to possession;
(6) which party paid property taxes;
(7) which party bore the risk of loss or damage; and
(8) which party received profits from the operation and sale.

Grodt & McKay, 77 T.C. at 1237-38.

The courts have generally focused on the risk of loss and treated a transaction as a sale when the assignee bears the risk that the anticipated income will not be paid, where the assignment involves the right to receive future income in exchange for consideration. Estate of Stranahan v. Commissioner, 472 F.2d 867, 870-71 (6th Cir. 1973). Conversely, when the assignee is certain that it will be fully repaid, that certainty is characteristic of a loan. Mapco Inc. v United States, 556 F.2d 1107, 1110 (Ct.Cl. 1977) (concluding that certificates of deposits issued by a bank and held by the taxpayer were indirect guarantees intended to protect the bank against default even though the taxpayer was not personally liable to the bank for the borrower's loan).

To establish that an assignment is a secured financing, it is necessary to show that: (1) the assignee received a security interest in the leased equipment; (2) the assignor expressly guaranteed the payment of the future income; or (3) the assignor implicitly guaranteed the payment of the future income. Watts Copy Systems Inc. v. Commissioner, T.C. Memo. 1994-124 (concluding that assignment was a loan). An implicit guarantee can be found where the assignor agrees to repurchase a lease in default or where the assignor provided the assignee with indirect collateral. See, e.g., Mapco, 556 F.2d at 1111.

In this case, certain facts that are known to us do not support a recharacterization of the transaction as a financing. It appears that C and D treated this as a sale of the Lessor Rights because the Lease Purchase Agreement discusses the transaction as a sale. This fact fails to support a recharacterization. However, it is not clear how C and D treated the transaction for accounting purposes. Pursuant to the terms of the Lease Purchase Agreement, C was to pay the state sales and use taxes, a fact which fails to support a recharacterization, but whether C actually paid is unclear. It appears that D bore the risk of loss because D had the right and the obligation to enforce the terms of the underlying User Leases, a fact which fails to support a recharacterization. C, however, was obligated to notify the users of the equipment that the users were to pay D directly upon loss, damage or destruction of the equipment or early termination of the leases.

Additional factual development is required to recharacterize this as a financing. It is not clear whether legal title to the Lessor Rights has passed from C to D. It is not clear whether an equity interest in the Lessor Rights was acquired by D. D was obligated to pay C $Amount 6 to purchase the Lessor Rights, but whether D actually paid, and whether this represents the fair market value of the Lessor Rights is unclear. It is not clear whether D had a vested right to possession of the leases; however, it does not appear that D filed a security interest under the UCC Article 9 for the rights that it acquired. Although D was obligated to enforce its own rights under the end user leases, C was obligated to notify the users to remit payment to D upon the loss of the equipments, and C could have taken an active part in enforcing D's rights under the Lease Purchase Agreement. Whether C actually assisted D in enforcing its rights or whether C expressly or implicitly guaranteed payment of rent (and minimized D's risk of loss) by the end users is not known.

D was locked into a certain profit from its purported purchase; however, this is not dispositive of whether a sale of the Lessor Rights occurred because D appears to have borne the risk of loss.

It appears that this transaction was not a secured financing. It appears that D did not have a security interest in the Lessor Rights. There are no facts present that indicate that C expressly or implicitly guaranteed D's right to future rental payments beyond the fact that C was obligated to notify the end users of the equipment of their obligations to D, in the event of the loss, destruction, or termination of the equipment or termination of the user leases.

The sale or financing argument should be used as an alternative to the substance-over-form arguments (including the sham / lack of economic substance), denial of the rental expense deductions taken by B and Taxpayer under section 162, and a denial of the depreciation deductions under section 167, which we conclude are the better arguments in this case. A successful application of the substance-over-form arguments will accomplish the goal of matching the income with the deductions.

The rental expense deductions could be denied because B had no intent to earn an economic profit from the leasing transaction. Portland Golf Club v. Commissioner, 497 U.S. 154, 169 (1990). For example, the fact that the rental payments from the end users had been accelerated and passed through to the Indian Nation prior to B's involvement is an indication that B never intended to profit. Additionally, if the residual interests in the equipment were overvalued and unrealistic, this may be an indication that B never intended to profit from the leases or the equipment.

The depreciation deductions on the computer equipment, if any, taken by B could be denied if the computer equipment or leases were neither used in B's trade or business nor held for the production of income, as is required under section 167.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

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[redacted]

Issue Six - I.R.C. § 482

LAW AND ANALYSIS

Generally, in order for section 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. I.R.C. § 482. To the extent that it can be shown that a transaction was carried out pursuant to a common design intended to effect an arbitrary shifting of income and deductions, the participants in the common design may be treated for purposes of the transaction as "controlled by the same interests" for the purposes of section 482. Accordingly, in the lease-stripping context, section 482 may be applied to prevent the arbitrary separation of deductions (steered to the entity subject to the U.S.'s taxing jurisdiction, e.g., B) from the income associated with those deductions (steered to an entity exempt from the U.S.'s taxing jurisdiction, e.g., C).

A. Section 482 -- Generally

Section 482 provides the following:

> In any case of two or more organizations, trades, or businesses owned or ***controlled*** directly or indirectly by the ***same interests***, the Secretary may distribute apportion, or allocate gross income, deductions... between or among such organizations...if he determines that such distribution, apportionment, or allocation is necessary in order to

> prevent evasion of taxes or clearly to reflect the income of any of such organizations. [Emphasis added].

Thus, in order for I.R.C. § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. As there is no common ownership among the participants to the Transaction (other than Taxpayer's ownership of B), the primary question under I.R.C. § 482 becomes whether any of the participants, particularly C, are controlled by the same interests.

B. Legal Standard for Control

The section 482 regulations define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(a)(3), 1968-1 C.B. 218; Treas. Reg. § 1.482-1T(g)(4), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4), 1994-2 C.B. 93.[2] See also Appeal of Isse Koch & Company, Inc., 1 B.T.A. 624, 627 (1925), acq., 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument."). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. Id. Accord Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert denied, 385 U.S. 899 (1966); Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223, 224; Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967).

Moreover, the 1968 regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3) (1968). See Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on Treas. Reg. § 1.482-1(a)(3) (1968), the Service properly argued that proof of income

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[2] At issue are the taxable years ending Date 7 , and Date 8 . Accordingly, there are three sets of I.R.C. § 482 regulations that potentially apply to the years at issue: the 1968 regulations apply to taxable years beginning on or before April 21, 1993; the 1993 regulations apply to taxable years beginning after April 21, 1993; and the 1994 regulations apply to taxable years beginning after October 6, 1994, unless an election is made to apply them to all prior open years. Treas. Reg. § 1.482-1(j)(2) (1994). We are uncertain whether Taxpayer made an election to apply the 1994 regulations retroactively, and uncertain whether Taxpayer is a calendar year taxpayer. Consequently, we will distinguish between the regulations by referring to their year of promulgation (in parenthesis) when each set of regulations is referred to.

shifting between two corporations establishes a presumption of common control). Accord Hall v. Commissioner, 294 F.2d 82 (5th Cir. 1961), aff'g, 32 T.C. 390 (1959), acq., 1959-2 C.B. 4 (referring to Reg. 111 § 29.45-1). The 1993 and 1994 regulations also contain this presumption, and add that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-1T(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). Accord DHL Corp. v. Commissioner, T.C. Memo. 1998-461 ("[W]hen the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled [in determining whether the control requirement under the 1968 regulations is satisfied]."). Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of I.R.C. § 482 if income or deduction shifting is present, or if there is common goal to shift income or deductions. But see Lake Erie & Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq., 1945 C.B. 5, acq. withdrawn and substituted for nonacq., Rev. Rul. 65-142, 1965-1 C.B. 223; B. Forman v. Commissioner, 54 T.C. 912 (1970), rev'd in relevant part, 453 F.2d 1144 (2d Cir. 1972), cert denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq, 1975-2 C.B. 3 (nonacquiescence relates to the Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 section 482 regulations).

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of I.R.C. § 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., at 1390. We believe that this burden is met by the "stripping" of income from the leases to C, an entity whose Percentage 1 general partner is itself Percentage 1 owned by an entity E that is exempt from U.S. tax, and the reporting of the deductions relating to that income by B. *See* Notice 95-53, 1995-2 C.B. 334 ("[T]he parties to a stripping transaction are controlled by the same interests, because, among other factors, they act in concert with a common goal of arbitrarily shifting income and deductions between a transferor and a transferee.").

C. Legal Standard for "Same Interests"

If control is found to exist, the Service may allocate income and deductions among members of the "controlled group." Treas. Reg. § 1.482-1(b)(1) (1968); Treas. Reg. § 1.482-1T(a)(2) (1993); Treas. Reg. § 1.482-1(a)(2) (1994). A controlled group or controlled taxpayer is defined to mean the entities owned or controlled by the "same interests," and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. § 1.482-1(a)(5) (1968); Treas. Reg. §§ 1.482-1T(4), (5) (1993); Treas. Reg. §§ 1.482-1(i)(5), (6) (1994). Unlike the term "control," the phrase "same interests" is not defined in the section 482 regulations. Case law as well as the legislative history of section 482 provide guidance, however.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, *i.e.,* placing deductions in one entity and income related to those deductions in another entity. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing, H. Rep. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rep. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also H. Rep. No. 350 and S. Rep. No. 275, 67th Cong., 1st Sess. (1921). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, 598 F.2d at 1379; South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), aff'g, 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967); Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233 (1925). *See also* LXI-Part 6 CONG. REC. 5827 (1921) (statement of Sen. King referring to the "same forces" controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. South Texas Rice Warehouse, 366 F.2d at 894-95. See also Brittingham, 598 F.2d at 1378-79, *citing Ach,* 42 T.C. at 125-26 (The phrase, "same interests," should not be narrowly construed to frustrate the intent of I.R.C. § 482); Rishell Phonograph, 2 B.T.A. at 233 ("If `the same interests' was intended to mean only `the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). Accord Grenada Indus., supra.

Thus, it is not necessary that the same person or persons own or control each controlled business before I.R.C. § 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interests is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Consequently, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met.

D. Control by the Same Interests in the Transaction

1. Common Plan Theory

Based on the facts as presented, we believe the parties to the Transaction likely acted pursuant to a common plan to shift income and deductions in a manner that was beneficial to each participant in the Transaction. According to the request for Field Service Advice, Taxpayer (through its consolidated return with B) stood to receive $Amount 22 of deductions for its $Amount 23 investment in the Transaction, which at a Percentage 2% Federal tax rate resulted in $Amount 24 of tax benefits.[3]

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[3] [redacted]

These significant tax benefits were to be realized only if each party to the Transaction performed their pre-designed role, for which they may have received other forms of compensation. We ask that the District obtain more information on the manner in which each participant expected to be compensated for participating in the Transaction. To date, we only have information on C's owner's receipt of preferred stock.

Further, based on: (1) the close proximity in time between (a) the C - G sale (Date 1 ), (b) the C - H sale-leaseback (also Date 1 ), (c) the C - L sale of residual rental payments after the expiration of the User Leases (Date 2 ), (d) the C - D sale of future rental payments under the User Leases (December 21 and 22, Year W), and (e) the C - Taxpayer I.R.C. § 351 transaction (Date 4 ), and (2) the peculiarly circular cash flows between the parties to the Transaction, we believe it is likely that each of the parties to the Transaction acted pursuant to a common plan to effect the lease strip. Below, in the last section of this memorandum, we suggest types of information that should be developed in order to bolster the application of the common-plan theory.

2. <u>Alternative Control Theory -- Ability to Direct the Actions</u>

The District may wish to establish control among the participants under an alternative theory that does not rely on evidence of a common plan. [redacted]

E. <u>Section 482's Application to the Transaction -- In General</u>

Generally, we have considered applying section 482 to lease-stripping transactions under three alternative analyses. The application of these three analyses to a lease-stripping transaction, however, does not preclude the application of other theories, such as the sham and step-transaction doctrines, to the Transaction. The

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[redacted]

section 482 analyses should be applied in conjunction with these other theories, because section 482 applies whether or not a transaction is a sham or otherwise colorable where a transaction is merely a device to shift income or deductions. Treas. Reg. § 1.482-1(c) (1968); Treas. Reg. § 1.482-1T(d)(1)(i) (1993); Treas. Reg. § 1.482-1(f)(1)(i) (1994); G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 367 (1987).

1. Economic Substance

Section 482 overlaps with the case law relating to economic substance and sham doctrines by allowing the Service, in certain instances, to disregard contractual terms and agreements and to recharacterize a transaction. *See* Treas. Reg. §§ 1.482-2T(a)(1)(ii)(B), -2T(a)(3) (1993); Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1), -1(d)(3)(ii)(C) ex. 3, -1(f)(2)(ii), -2(a)(1)(ii)(B), -2(a)(3), -4(f)(3)(ii)(A) (1994). See also B. Forman, supra, 453 F.2d at 1160-1, and Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455 (RIA) 3277, 3322 (applying the 1968 section 482 regulations to analyze the economic substance of intercompany contracts). However, the section 482 regulations expand upon case law principles and provide additional guidance in specific areas. Specifically, the regulations provide the following:

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties.... If the contractual terms are inconsistent with economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994); Treas. Reg. § 1.482-1T(d)(1) (1993). Thus, section 482 provides an alternative approach to challenging the Transaction by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions. See G.D. Searle, 88 T.C. at 367. We note that in the context of the Transaction (and similar tax-shelter transactions), this allocation authority would exist only where there is a common tax avoidance scheme among the participants to arbitrarily shift income and/or deductions. [Emphasis Added.] [Note, the prior sentence does not apply to the alternative theory discussed above for establishing control ( the ability to direct the actions of certain participants).]

Under the first I.R.C. § 482 analysis, the economic substance of a transaction subject to I.R.C. § 482 is analyzed by focusing on the parties' actual conduct; the economic risks purportedly transferred; and whether, from a business perspective, the transaction makes objective business sense, or under the language of some cases, would have been entered into by a "hard-headed business [person].[4]" *See* Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-1T(d)(1) (1993); Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This treatment may result in a denial of deductions arising from the transaction at issue. See, e.g., B. Forman, supra, 453 F.2d at 1160-1; Medieval Attractions, supra, at 3322 (royalty payments lacked economic substance under section 482, because the foreign payee was not the creator or developer of, nor in substance had the ability to, transfer intangibles.).

Considering whether the participants' conduct was consistent with the Transaction's putative substance, relevant factors include, inter alia, (1) whether any gain realized by C was actually paid to the E with respect to (a) H - C sale, (b) the sale to D of the future rental stream from the User Leases, and (c) the sale to L of the future residual rental stream after expiration of the User Leases; (2) whether for state law purposes, the registrations of the security interests of the third-party creditors were changed to reflect the sale-lease back transactions; (3) whether C and other entities claimed deductions (*e.g.*, for interest or depreciation expenses) for the period they held title to the equipment; (4) whether C claimed rent deductions for the period it was a lessee of the equipment; (5) whether the third-party leases permitted the sale of the equipment without the prior consent of the lessees and whether such consent was obtained; and (6) whether dividends on preferred stock issued to C by B were ever paid (assuming the subscription agreement provided for such dividends). We suggest other items of factual development in the last section of this Memorandum in comparing the consistency of the parties' conduct to their characterization of the Transaction.

As stated above, the allocation of risks under the Transaction must also be considered in analyzing its economic substance. From the facts provided, it appears that a consequence of the G - C sale of equipment and interest in the User Leases was that G effectively substituted the credit risk of the third-party lessees for that of C. This is because prior to the Date 1 equipment sale, G was subject to the risk that the third-party lessees would default on their rental obligations. After this sale, G was subject to the risk that C would default on its notes to G. If the third-party

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[4] B. Forman, supra, 453 F.2d at 1160-61 (section 482 may overlap with section 162 and result in the denial of deductions where a lack of arm's length dealings results in payments between parties with a "close relationship" in an attempt to avoid taxes).

lessees were relatively more creditworthy than C (e.g. because the lessees generally had higher credit ratings than C, or because C was undercapitalized), we question whether G's decision to substitute the third-party lessees' credit risk for that of C's made economic sense. If the substance reveals that the Transaction would not have been entered into by persons acting at arm's length, or by "hard-headed business [persons]," then the Service may disregard the Transaction and disallow the deductions arising therefrom. See Medieval Attractions, supra; B. Forman, supra.

Similarly, the substitution of the credit risk of C for that of the third-party lessees must be analyzed under the risk allocation test of the 1993 and 1994 section 482 regulations. Both sets of regulations contain a non-exclusive, three-prong test that may be used in determining whether an allocation of risk has economic substance and should therefore be respected. *See* Treas. Reg. § 1.482-1T(c)(3)(ii)(B) (1993) and Treas. Reg. § 1.482-1(d)(3)(iii)(B) (1994). Two prongs of these test are particularly relevant to the Transaction.

The first prong concerns whether the controlled taxpayer has the financial capacity to bear potential losses that might be expected to occur due to the allocation of risk. *See* Treas. Reg. § 1.482-1T(c)(3)(ii)(B)(2) (1993); Treas. Reg. § 1.482-1(d)(3)(iii)(B)(2) (1994). If C was undercapitalized, the C - G equipment sale may fail to satisfy this prong. This is because as a result of the $Amount 25 purchase of equipment from G, C assumed the credit risk of the third-party lessees, a $Amount 26 senior debt obligation, and a $Amount 27 obligation to pay G. Given the possibility of default by the third-party lessees and because the senior and junior debt exceeded the rent due under the existing leases by approximately $Amount 28,[5] if C was undercapitalized, it may not have had the financial capacity to bear potential losses arising from default. Accord Malone & Hyde, Inc. v. Commissioner, 62 F.3d 835 (6th Cir. 1995).

The second prong in the risk allocation test that is particularly relevant to the Transaction considers whether the controlled taxpayer is engaged in the active conduct of a trade or business to which the risk at issue relates, and whether the controlled taxpayer exercises substantial managerial and operational control over the business activities that directly influence the amount of income or loss to be realized. *See* Treas. Reg. § 1.482-1T(c)(3)(ii)(B)(3) (1993); Treas. Reg. § 1.482-1(d)(3)(iii)(B)(3) (1994). C may not satisfy this factor if it is not engaged in the business of computer leasing or sales and has no employees or officers that influenced whether a profit or loss would be made on the sale or leasing of the computers to the third parties. The fact that C may have "hired" a third party to

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perform C's duties should not affect this analysis, as the managerial activities must be (largely) carried out by C, rather than "independent contractors." *See* Treas. Reg. § 1.482-1T(c)(3)(ii)(B)(3) (1993), referring to Treas. Reg. § 1.367(a)-2T(b)(2), (3). [The 1994 regulations do not contain the reference to the section 367 regulations.]

Accordingly, if the C - G equipment sale is found to be devoid of economic substance -- either because the Transaction would not have been entered into by "hard-headed business [persons]," or because the allocation of risk fails the risk test under the section 482 regulations, the chain of transactions that gave rise to B's deductions would be broken. Accordingly, B's deductions would have to be denied. See Treas. Reg. § 1.482-1T(c)(3)(ii)(E) ex. 2 (1993); Treas. Reg. § 1.482-1T(d)(3)(iii)(C) ex. 2 (1994) (contracts seeking to allocate risk to an entity lacking financial capacity to bear the putative risk allocation may be disregarded for tax purposes).

2. Section 482's Role in Nonrecognition Transactions

The second section 482 analysis that may be applied to the Transaction relates to its role in nonrecognition transactions, such as section 351 transactions. Specifically, section 482 may apply in nonrecognition transactions to prevent the avoidance of taxes or clearly reflect income. For example, section 482 may allocate income and deductions attributable to an entity's disposition of built-in-loss (and gain) property, which it acquired in a nonrecognition transaction, to the contributing shareholder (or partner). *See* Treas. Reg. § 1.482-1(d)(5) (1968); Treas. Reg. § 1.482-1T(d)(1)(iii) (1993); Treas. Reg. § 1.482-1(f)(1)(iii) (1994); National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943); Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff'd without opinion, 732 F.2d 168 (Fed. Cir. 1984); Northwestern Nat. Bank of Minneapolis v. United States, 556 F.2d 889, 892 (8th Cir. 1977), aff'g, 37 A.F.T.R.2d ¶76-1400 (D. Minn. 1976); Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987), aff'g, 82 T.C. 830 (1984); Foster v. Commissioner, 80 T.C. 34, 160, 172-77 (1983), aff'd in relevant part, 756 F.2d 1430, 1433-4 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986). See also Eli Lily & Co. v. Commissioner, 84 T.C. 996, 1119 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988) (restricting I.R.C. § 482's application to nonrecognition transactions in cases of tax avoidance).

The above analysis, relating to the re-allocation to the contributing shareholder of the deduction attributable to an entity's disposition of built-in-loss property, may also be applied to re-allocate to the contributing shareholder the entity's depreciation deductions on built-in loss property, to the extent those deductions are attributable to the portion of the property's basis in excess of the property's fair market value at the time of the contribution. (By analogy, see the flush language of I.R.C. §

382(h)(2)(B), concerning the treatment of depreciation deductions attributable to built-in losses). Because there appears to have been a tax-avoidance purpose underlying the Transaction, including the I.R.C. § 351 transaction between Taxpayer, C, and B, the depreciation deductions, to the extent attributable to built-in losses, may be allocated to C, a pass-through entity substantially all of whose interests are owned by an entity not subject to the U.S. tax.

Furthermore, in the lease-stripping context, this analysis applies by likening the contribution (in a nonrecognition transaction) of the obligation to pay rent after the income has been stripped-off to a contribution of built-in-loss property. This is because the stripping off of income, combined with the continuing obligation to pay rent, creates continuing tax deductions (losses). This is in spite of the fact that the transferee (in the nonrecognition transaction) will pay little, if any, out-of-pocket cash. This is attributable to the fact that the cash inflows, consisting largely of (tax-free) principal (payable by H to B), will offset the deductible outflows for rent (payable by B to H). Accordingly, if a tax avoidance motive is present, which is often the case in lease-stripping transactions, it is appropriate to allocate the built-in loss to the tax-exempt, contributing shareholder and prevent the evasion of taxes by the "investor."

Based on the facts provided, the net effect of C's transfer to B of equipment that was subject to pre-existing debt and from which the right to future (taxable) streams of rental income had been sold is akin to a contribution of built-in loss property by C to B. This is due to B's ability to take substantial tax deductions (e.g., for the deemed rental payments to H and possibly other expenses related to the equipment) without making actual cash disbursements, as the payment streams on H's nonrecourse notes and the lease offset. Because there appears to have been a tax-avoidance purpose underlying the Transaction, including the I.R.C. § 351 transaction between Taxpayer, C, and B, the deductions may be allocated to C, a pass-through entity substantially all of whose interests are owned by an entity not subject to the U.S. tax.

3. Clear Reflection of Income & Prevent the Evasion of Taxes

The third theory under which a lease-stripping transaction may be analyzed under section 482 relates to the Service's ability to allocate income and deductions in order to clearly reflect income and/or prevent the evasion of taxes. I.R.C. § 482; Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-1T(a)(1) (1993); Treas. Reg. § 1.482-1(a)(1)(1994). This analysis, and the case law affirming the Service's exercise of this allocation authority, is not based upon an economic-substance analysis. Rather, it focuses on the distortions in taxable income caused by the separation of income from deductions. See Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1951), rev'g, 16 T.C. 882, cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962).

As stated in Notice 95-53, the separation of income from deductions in lease-stripping transactions does not clearly reflect income, particularly where they are achieved through a transaction structured to evade taxes. Lease-stripping transactions are often effected by (a) creating an artificial separation of the rental income from the associated deductions by accelerating the rental income in the hands of an entity not subject to the U.S.'s taxing jurisdiction, and (b) by placing the deductions associated with the rental income in an entity subject to U.S. tax. *See* Notice 95-53. In such an instance, the Service may prevent this artificial shifting of income and deductions by (1) allocating the rental deductions from the U.S. taxpayer to the tax-exempt entity, or (2) allocating the rental income from tax-exempt entity to the U.S. taxpayer. See, e.g., Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967); J.R. Land Co. v. Commissioner, 361 F.2d 607, 609-10 (4th Cir. 1966), aff'g sub nom, Brentwood Homes, Inc. v. United States, 240 F. Supp. 378 (E.D.N.C. 1965); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), rev'g, 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Advance Machinery Exchange, Inc. v. Commissioner, 196 F.2d 1006 (2nd Cir. 1952), cert. denied, 344 U.S. 835 (1952).

Accordingly, it may be appropriate to either (1) allocate B's deductions to C during the period C owned stock of B, or (2) allocate income (i.e. a portion of the gain from the multiple sales of C's interest in the equipment and leases) to B in proportion to the period B owned the interest in the equipment and leases. Such an allocation would match the income and the deductions associated with the income, and thereby constitute a clearer reflection of income than that which is represented by the Transaction. Concomitantly, the evasion of taxes would be prevented.

## CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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If you have any questions, please contact (202) 622-2830.

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