OFFICE OF
CHIEF COUNSEL

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

CC:DOM:FS:FI&P

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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MEMORANDUM FOR: DISTRICT COUNSEL

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

SUBJECT:

This Field Service Advice ("FSA") is a supplement to an earlier FSA dated DATE 11. 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 =

DATE 1 =
DATE 2 =
DATE 3 =
DATE 4 =
DATE 5 =
DATE 6 =
DATE 7 =
DATE 8 =
DATE 9 =
DATE 10 =

DATE 11	=
AMOUNT 1	=
AMOUNT 2	=
AMOUNT 3	=
AMOUNT 4	=

ISSUE:

Whether the facts in this transaction should be characterized to better reflect the proper Federal income tax consequences?

CONCLUSION:

There are three alternative ways to characterize this transaction for Federal income tax purposes.

FACTS:

The Field Service Advice that was issued on DATE 11, presented a comprehensive set of facts. Only a brief recital of the facts is necessary here.

On DATE 1, C, a U.S. corporation, sold computer equipment to B, a Belgian national and individual, for AMOUNT 1. B financed this purchase by obtaining loans from E.

On DATE 1, B leased the same equipment to C.

On DATE 2, B sold his rights to the lease receivables (i.e., the rents) to D, a U.S. bank. B sold his rights to receive rental income for 28 months, until DATE 8. Upon his sale of the rights to rental income, B accelerated his income, and realized income from the sale in DATE 3 instead of from DATE 3 through DATE 10. B was not subject to U.S. federal taxation.

On DATE 4, B and the taxpayer, which owned all of the stock of F engaged in a purported I.R.C. § 351 transaction. The taxpayer contributed cash to F in exchange for common stock in F. B contributed his interest in the equipment and lease in exchange for preferred stock in F.

F claimed depreciation expenses and a section 1231 loss for the DATE 5 through DATE 9 tax years. F did not recognize gain from B’s sale of the rents because F was not yet the owner of the equipment. Accordingly, a foreign individual not subject to U.S. federal taxation received the income from the rental stream, but a U.S. corporation took the depreciation deductions.

LAW AND ANALYSIS:

a. Overview

In our earlier Field Service Advice ("FSA") we stated that the strongest argument against the parties' tax treatment of the lease-stripping transaction is that it is a sham and, thus, its form should be disregarded in determining the proper tax treatment. In this supplemental FSA, we propose a number of possible characterizations of the transaction for you to consider in determining the economic substance of the transaction.[1] While the characterizations in this supplemental FSA are similar to the characterizations described in the section 482 discussion of the earlier FSA, we view these characterizations as alternatives to the section 482 characterizations.

As we stated in the prior FSA, as part of the section 482 analysis, the sale-leaseback between C and B, coupled with the sale by B to D of the right to receive rents from C, appears to be a loan of AMOUNT 3 from D to C. We shall not repeat the earlier analysis concerning section 482. We revisit the conclusion because it is the starting point in this FSA for determining the substance of the purported transfer of the equipment to F.

[redacted]

In addition to the characterizations present in the prior FSA, we offer three possible characterizations for you to consider as you evaluate the facts and circumstances of this case.[2] The purported section 351 transfer of the equipment to F may be characterized as (1) a sale in which C sold to F the equipment including the right to receive rent, (2) a sale in which C sold a residual interest in the equipment to F, or (3) a financing in which F loaned money to C. [redacted]

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[1] In pursuing an economic substance argument in this case, we also suggest considering recently published Rev. Rul. 99-14, 1999-13 I.R.B. 1, where the Service concluded that "lease-in, lease-out" transactions do not produce the desired tax result of deductible lease and interest payments because they have no economic substance according to case law.

[2] It is also possible that, in disregarding B's role, C could be treated as having transferred the property to F in a section 351 transaction. This possibility was discussed in the earlier FSA under Issue 2. [redacted]

[redacted]

[redacted]

b. [redacted].

[redacted][3][redacted]

[redacted] the term of the C lease. This is similar to the approach taken by the Tax Court in Alstores Realty Corporation v. Commissioner, 46 T.C. 363 (1966), acq., 1967-2 C.B. 1, and Steinway & Sons v. Commissioner, 46 T.C. 375 (1966), acq., 1967-2 C.B. 3.

In Alstores, the taxpayer purchased a building for $1 million, paying $750,000 cash and granting the seller a right to 2½ years' rent-free occupancy under a leaseback agreement. The taxpayer argued that the transaction, in substance, was a

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[3] In form, the following amounts were paid by the parties in the various transfers:

[redacted]

conveyance of a future interest with the seller reserving to itself a term of 2½ years in the property. The Tax Court disagreed and concluded that the transaction was, in both form and substance, a sale and leaseback. In doing so, the court relied, in part, on certain features of the legal documents that resembled a lessor-lessee relationship. The court then determined that the taxpayer's cost basis in the property was equal to the cash paid, plus the fair market value of the lease received, and that the taxpayer had taxable rental income in the year of sale in the amount of $253,090.75. Alstores, 46 T.C. at 374.

In the companion case, Steinway & Sons, 46 T.C. 375, the Tax Court determined that the seller in turn had an amount realized that included the fair market value of the lease, and had an amortizable basis in the lease equal to its fair market value. Steinway, 46 T.C. at 382. See Ellison v. Commissioner, 80 T.C. 378 (1983) (holding that amounts of rental income reserved to the seller are taxable to the buyer of the properties because, in substance, the amounts were deferred payments of the purchase prices of the properties); see also Bryant v. Commissioner, 399 F.2d 800 (5th Cir. 1968) (reaching a similar result where the sales contract between the parties reserved to the seller "production payments" to be satisfied from an undivided one-tenth of the property's gross income until the amount paid totaled the required contractual amount, plus interest).

Consistent with Alstores, F may be treated as having purchased the equipment from C for the equipment's fair market value, including the right to receive rental income during the term of the C lease. Thus, F's cost basis would be composed of F's assumption of the E loan, the balloon notes (which F would be treated as having issued to C in the sale, rather than as having assumed from B), and the fair market value of the right to receive rents during the term of the C lease, which (depending on the facts) may be approximated by the outstanding principal balance of the installment notes.

[redacted]

[redacted] In Alstores, the court held that the buyer who leased the property back to the seller had rental income in the year of the sale equal to the fair market value of the lease. If the same timing rule applies in the instant case, [redacted]

[redacted]

[redacted] Compare section 467(f) (granting Treasury the authority to promulgate regulations leveling advance rental income);Treas. Reg. § 1.1273-2(g)(2)(i) (treating payments made by a borrower to a lender, other than for property or services provided by the lender, as reducing the issue price of the debt instrument, rather than constituting immediate income to the lender); Treas. Reg. § 1.446-3(f)(2) (allocating up-front payments on swaps over the term of the swap); Notice 89-21, 1989-1 C.B. 651.

c. [redacted]

[redacted]

[redacted] Tax Court in McCulley Ashlock v. Commissioner, 18 T.C. 405 (1952), acq. 1952-2 C.B. 1, [redacted]. There, the buyer purchased real property from the seller and contractually agreed to permit the seller to retain possession of the property for several months following the sale. The seller retained all rents collected during this period of retained possession, and also paid real estate taxes, insurance premiums, and other expenses of the property during that period. Similar to Alstores, the issue was whether the buyer purchased only a remainder interest in the rental property with the seller retaining the legal right to the rental income, or whether the buyer purchased the entire property and then assigned the rents to the seller, to be applied toward the purchase price. Unlike Alstores, the court in McCulley Ashlock concluded that the seller legally retained the rents and that the buyer purchased only a remainder interest in the property. In reaching this decision, the court focused on the contracts executed by the parties, as well as the fact that the seller retained the benefits and burdens of ownership of the property during the period that it retained the right to receive the rental income. McCulley Ashlock, 18 T.C. at 411-12. Compare Ellison, supra (distinguishing the result reached in McCulley Ashlock based on who the court concluded retained the benefits and burdens of ownership of the property during the period the seller retained the rental income of the property).

Geneva Drive-In Theater, Inc. v. Commissioner, 67 T.C. 764, 770-74 (1977), aff'd per curiam, 622 F.2d 995 (9th Cir. 1980), [redacted] There, the buyers purchased an interest in land and depreciable assets, subject to a pre-existing lease. The buyers paid $200,000 for the depreciable assets and attempted to take depreciation deductions on the assets prior to the termination of the pre-existing lease. The court determined that the buyers' interest in the property was a remainder interest and that they could not take depreciation deductions in their $200,000 investment until their interest became a present one, which would occur when the lease terminated. Similar to McCulley, the court focused on the parties' choice of form in their agreements, as well as which party retained the benefits and burdens of ownership of the depreciable assets. See also Coleman v. Commissioner, 87 T.C. 178, 208 (1986); see generally, Wagner v. Commissioner, T.C. Memo. 1974-42 (1974), rev'd, 518 F.2d 655 (10th Cir. 1975).

d. [redacted].

[redacted]

[redacted]. This is a question of fact as evidenced by the written agreements read in light of the attendant facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956).

In determining whether a sale of the equipment should be respected, the relevant factors are: (1) the investor's equity interest in the property as a percent of the purchase price; (2) renewal or purchase options at the end of the lease term based on fair market value of the equipment; (3) whether the useful life of the property exceeded the lease term; (4) whether the projected residual value of the equipment plus the cash-flow generated by the rental of the equipment allowed the investors to recoup at least their initial cash investment; (5) whether at some point a turnaround was reached whereby depreciation and interest deductions were less than income received from the lease; (6) whether the net tax savings for the investors were less than their initial cash investment; (7) whether there was the potential for realizing a profit or loss on the sale or release of the equipment; (8) whether the documentation was consistent with the substance of the transactions; and (9) whether the parties acted in a manner consistent with the purported sale. Levy v. Commissioner, 91 T.C. 838, 860 (1988).

The Tax Court has said the following factors are neutral in making the determination of ownership in sale-leaseback transactions: the existence of a net lease; the absence of significant positive net cash-flow during the leaseback term or rent geared to interest and principal amortization; and the use of nonrecourse liability. Larsen v. Commissioner, 89 T.C. 1229, aff'd in part, rev'd in part, Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Estate of Thomas v. Commissioner, 84 T.C. 412, (1985). But see Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995) (distinguishing transaction with economic substance from sham transactions in which nonrecourse notes were a significant part of the transaction); James v. Commissioner, 899 F.2d 905, 911 (10th Cir. 1990) ("[W]hen lack of cash flow is created by extraordinary management fees and inflated purchase prices . . ., any element of neutrality rapidly dissipates.")

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Recharacterizing the form of this transaction presents certain litigating hazards and requires additional factual development. Additional facts to develop include all communication between C, the taxpayer and F.

In addition to the case development recommended in the prior FSA, in this case, [redacted]

[redacted]

Please call if you have any further questions.

By: _________________________

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