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

OFFICE OF
CHIEF COUNSEL

May 25, 1999

CC:INTL:Br.6

Number: **199936007**
Release Date: 9/10/1999
UILC: 482.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: Elizabeth G. Beck
Senior Technical Reviewer CC:INTL:Br.6

SUBJECT:

This Field Service Advice responds to the memorandum of your office dated June 30, 1997. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND: =
=
Amount A =
Amount B =
Amount C =
Amount D =
Amount E =
Amount F =
Amount G =
Amount H =
Amount I =
Amount J =
Amount K
Amount L =
=
Country A
Country B

| | |
|---|---|
| Date 1 | = |
| Date 2 | = |
| Date 3 | = |
| Date 4 | = |
| Date 5 | = |
| Date 6 | = |
| Foreign Partner | = |
| Percent A | = |
| Percent B | = |
| Percent C | = |
| Percent D | = |
| Percent E | = |
| Percent F | = |
| Promoter | = |
| State A | = |
| U.S. Corp | = |
| U.S. Partnership | = |
| U.S. Sub | = |
| Year 1 | = |
| Year 2 | = |
| Year 3 | = |
| a | = |
| b | = |
| c | = |

ISSUE:

Whether section 482 may apply to prevent a misallocation of income and deductions when burned-out leveraged leases are contributed to a limited liability corporation (treated for Federal income tax purposes as a partnership) that is controlled by the contributing member and almost all of the “phantom” income from the leases is specially allocated to a foreign (tax-exempt) minority partner.

## CONCLUSION:

This is the type of transaction with which Notice 95-53 is concerned and, in the circumstances of this transaction, case authority supports the application of section 482 to reallocate the income attributable to the leases from the controlled limited liability company to the controlling contributing member.

## FACTS:

### A. Background

This advice relates to a transaction designed to shift, to a tax-exempt foreign entity, substantially all of the taxable income attributable to certain leveraged leases. All of the depreciation deductions attributable to the leases had already been recognized by the U.S. lessor when the transaction occurred.

Beginning in Year 1 and during the following seven years, U.S. Corp, a U.S. corporation, invested in leveraged leases. The assets subject to the leases were financed on a nonrecourse basis by third-party lenders. The lessees are major corporations. The lessees pay rent directly to the lenders in amounts that are sufficient to cover the required payments due on the debt used to finance the lease assets. Because the rent payments from the lessees to the lenders benefit the lessor, these payments constitute income to the lessor. For each of the leveraged leases, all amounts to be reported for income tax purposes during the life of the lease, including rent income, depreciation and interest expense, were determined as of the closing date of each lease.

Cash flow to the lessor while the leases are in effect, both before and after the lease assets have been fully depreciated, is limited to the excess, if any, of rent payments over the debt service payments. The taxable income of the lessor arising from lease payments made after the lease assets have been fully depreciated is not accompanied by significant offsetting deductions or by any significant cash flow to the lessor. Such taxable income is sometimes referred to as “phantom” income.

The leases also provide for relatively large “balloon” payments to be made by the lessees at the end of the lease terms. We understand that such payments would probably represent the exercise by the lessees of options to purchase the lease assets. The taxable income that would result from such payments would not be “phantom” income for the lessor because the lessor, rather than the lenders, would receive these balloon payments.

On Date 1, U.S. Corp held certain leveraged leases (number a) through grantor trusts. Some of these leases (number b) had assets that were fully

depreciated for tax purposes. By owning these leases, U.S. Corp had, for Federal income tax purposes, recognized depreciation deductions on lease assets that significantly exceeded the lease income that it had recognized from the leases. Thus, as of Date 1, U.S. Corp's ownership of these leases had allowed it to reduce the amount of Federal income tax that it paid with respect to income unrelated to the leases.

These leases were scheduled to begin generating substantial taxable income for U.S. Corp in Year 2. This taxable income would be "phantom" income. U.S. Corp would therefore need to pay the taxes with respect to this income out of other income, unrelated to the leases. This scheduled tax liability would offset, in part, the tax benefits U.S. Corp realized from depreciation deductions in excess of lease income in the early years of the leases.

On Date 2, U.S. Corp was contacted by representatives of Promoter, an investment banking firm. These representatives proposed a plan for U.S. Corp to contribute its interests in leases having fully-depreciated lease assets to a partnership. Under the plan, substantially all of the taxable lease income scheduled to be reported on U.S. Corp's income tax returns for Year 2 and subsequent years would be allocated by the partnership agreement to a foreign entity, not subject to U.S. tax, which Promoter would approach to become a partner.

A promotional booklet prepared by Promoter described the substantial tax and accounting benefits available to U.S. Corp from participating in the transaction. The allocation of taxable income to a foreign partner would relieve U.S. Corp of tax liability for the taxable income scheduled to be produced by the leases. In addition, and as a result of this reallocation of taxable income, U.S. Corp could, for financial accounting purposes, reduce its current liability for tax and its book account for deferred income taxes. This adjustment to the deferred tax account would generate substantial income for financial statement purposes.

The only cost to U.S. Corp for participating in the transaction would be the payment of fees to Promoter and to others for legal and professional services. The amount of future income tax liability of U.S. Corp that the transaction was designed to avoid greatly exceeded the fees U.S. Corp would have to pay to participate in the transaction.

B. The Transaction

U.S. Corp chose to go forward with the transaction, substantially as proposed by Promoter. On Date 3, U.S. Corp and U.S. Sub, a wholly owned U.S. subsidiary of U.S. Corp, formed U.S. Partnership. U.S. Sub files its income tax return as part of a consolidated group including its parent, U.S. Corp. U.S. Partnership is a State A limited liability company that elected to be treated as a partnership for Federal

income tax purposes. U.S. Partnership has its principal office in Country A. On Date 3, U.S. Corp contributed to U.S. Partnership its interest in certain leases (number c), all with fully depreciated assets. The fair market value of the contributed lease assets on the date of contribution was approximately $ Amount A. U.S. Sub contributed approximately $ Amount B in cash. Three days later, on Date 4, Foreign Partner, a Country B bank, was added to U.S. Partnership and contributed capital of approximately $ Amount C (about 25 percent of total contributed capital) to U.S. Partnership.

Under the terms of U.S. Partnership's operating agreement (the "Agreement"), almost all (Percent A) of U.S. Partnership's taxable income for a specific year is to be allocated to Foreign Partner. However, this amount is not related to the amount of cash to be distributed to Foreign Partner.

In order to ensure that Foreign Partner will earn a specified return, Percent B, the Agreement provides for the maintenance of a Cash Account for the Foreign Partner. The Cash Account was initially credited with Foreign Partner's contribution to U.S. Partnership. It is subsequently increased each period to provide Foreign Partner's specified return and decreased by any distributions to Foreign Partner. In addition, Foreign Partner is entitled to an annual distribution from U.S. Partnership, the "Priority Distribution," which is based, in part, on the balance in the Cash Account.

The Agreement provides for the mandatory redemption of Foreign Partner's partnership interest on Date 5 for cash equal to the balance in Foreign Partner's capital account. However, U.S. Partnership's allocation structure is designed so that Foreign Partner's capital account cannot exceed the specified return on Foreign Partner's initial contribution. Under the Agreement, U.S. Partnership's net income each year and any disposition gains can only be allocated to Foreign Partner to the extent necessary to provide the specified return. Any additional income or disposition gains are to be allocated to U.S. Corp.

If U.S. Partnership's assets are sold, U.S. Corp is to be allocated most of the appreciation in the assets under section 704(c). To the extent there is any gain above the section 704(c) built-in-gain, the Agreement provides that Foreign Partner may share in the gain only to the extent necessary to generate the specified return.

The original cost of the assets subject to the leases transferred to U.S. Partnership was $ Amount D. At their inception, these leases were scheduled to produce, during the life of the leases, $ Amount E in net taxable income. At the date of transfer, U.S. Corp had recognized less than one-third of the gross taxable income that the leases would produce during their term. However, by fully depreciating the assets subject to the leases, U.S. Corp had claimed substantially all of the deductions that would be attributable to these leases during their term. At

the date of transfer, U.S. Corp had claimed deductions in excess of income of $ Amount F. The substantial gross taxable income that remained to be recognized during the lease terms was scheduled to offset the deductions in excess of income previously recognized by U.S. Corp, $ Amount F, and also to result in net taxable income to U.S. Corp of $ Amount E. Accordingly, a total of $ Amount G in taxable income was inherent in these lease agreements when they were transferred. Inasmuch as the lease assets were fully depreciated, virtually all of this income was scheduled to be net taxable income.

Not all of this taxable income was intended to be shifted to Foreign Partner. As noted above, the lease agreements provide for certain balloon payments to be made at the end of the lease terms. It appears that the cash flow and taxable income attributable to these end-of-lease payments will be allocated and distributed to U.S. Corp because the distributions to be made to Foreign Partner, under the terms of the Agreement, are limited to the amounts necessary to repay Foreign Partner's initial investment in U.S. Partnership, plus the specified return.

The transfer of the leases to U.S. Partnership had no effect on the leases and did not change the rent payments being made by the lessees to the third-party lenders, the limited cash flow available from the leases during their term, or the predetermined amounts attributable to the leases that are reportable for tax purposes.

As noted above, the transaction was designed not only to avoid future taxable income for U.S. Corp, but also to provide U.S. Corp with substantial current income for financial statement purposes. When the leases were transferred, U.S. Corp reduced the amount of the deferred tax accounts carried on its financial accounting books for the transferred leases by about $ Amount H. As a result, U.S. Corp increased the income shown by its financial statements for the quarter ending Date 6 by $ Amount H.

Management of U.S. Partnership is vested in a group of managers elected by U.S. Corp, U.S. Sub and Foreign Partner. U.S. Corp is entitled to elect three managers, U.S. Sub one, and Foreign Partner one. The voting power of Foreign Partner is limited to not more than Percent C.

### C. Allocations and Management Under the Agreement

For the first two tax years in which this arrangement was in place, U.S. Partnership reported taxable income of $ Amount I in Year 2, of which Percent D was allocated to Foreign Partner, and of $ Amount J in Year 3, of which Percent E was allocated to Foreign Partner. Taxable income allocated to U.S. Corp was $ Amount K for Year 2 and $ Amount L for Year 3.

For the Year 2 and Year 3 tax years, Foreign Partner did not elect a manager for U.S. Partnership.

LAW AND ANALYSIS:

A. Introduction

This transaction falls within the class of transactions that the Service has characterized as "lease strips" or "stripping transactions" because the parties claim that one party (Foreign Partner) realizes the income from property (the leveraged leases) and that another party (U.S. Corp) is entitled to take related depreciation deductions. Notice 95-53, 1995-2 C.B. 334. As in this case, such transactions usually involve a party that is not subject to Federal income tax or has available net operating losses. The Service believes the claimed tax treatment in these transactions improperly separates income from related deductions and that such transactions, therefore, do not produce the tax consequences desired by the parties. *Id.* The Service has announced that it intends to use the authorities available to it, including section 482, to insure that income is clearly reflected and to prevent the evasion of taxes. *Id.* at 335.

The facts of this case are within the area of concern that section 482 was intended to address, as section 482 was "designed to prevent the avoidance of tax or the distortion of income by the shifting of profits from one business to another." *Rooney v. United States*, 305 F.2d 681, 683 ($9^{th}$ Cir. 1963) (authorities omitted).

B. Section 482 -- Generally

Section 482 provides as follows:

> 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, credits, or allowances between or among such organizations, trades, or businesses, 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, trades, or businesses.

The first requisite for applying section 482 is that the taxes or income of two or more "organizations, trades, or businesses" be involved. This phrase has been broadly construed. Thus, section 482 can be applied to reallocate income from a partnership to a corporate partner of such partnership. *See, e.g.*, *Aladdin Industries, Inc. v. Commissioner*, T.C. Memo. 1981-245. Section 482 may also

apply to reallocate income among corporate partners. *Rodebaugh v. Commissioner*, T.C. Memo. 1974-36, *aff'd*, 518 F.2d 73 (6th Cir. 1975).

Another requisite for applying section 482 to a transaction is that the transaction take place between two or more entities owned or controlled by the same interests. In this case, U.S. Corp controls U.S. Partnership by virtue of its Percent F voting interest in U.S. Partnership and the election by U.S. Corp and U.S. Sub of all of the managers of U.S. Partnership.

Where there are controlled transactions between two or more of the requisite entities, the Service may reallocate income "in order to prevent evasion of taxes or clearly to reflect the income of any [party to the controlled transaction]." I.R.C. § 482.

C. Case Authorities

Several cases have upheld the use of section 482 to prevent taxpayers from artificially separating deductions from related income, in order to obtain tax benefits. *Foster v. Commissioner*, 80 T.C. 34 (1983), *aff'd in relevant part*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986), applied section 482 to prevent the avoidance of taxes. In *Foster*, expenses incurred by a partnership in developing land for sale as residential property were used by the partners to reduce their individual income taxes. Then, "as the land was developed, certain lots were transferred from the Partnership to its controlled corporations, in an effort to shift income" and "to split it among taxpayers subject to a lower rate of tax." 756 F.2d at 1433. "[O]nly highly appreciated inventory pregnant with income was conveyed." *Id.*, *citing* 80 T.C. at 179. In these circumstances, the transfers were held to have had no business function and their purpose was tax avoidance. *Id.* at 1436.

The fact that the transfers were made as nonrecognition transactions (under sections 351 and 1032) did not prevent the application of section 482 to reallocate income derived from the disposition of the property acquired in such nonrecognition transactions. *Id.* at 1433, *citing Rooney, supra,* and Treas. Reg. § 1.482-1(d)(5) (1984).

Just as in *Foster*, the lease assets that U.S. Corp transferred to U.S. Partnership are "pregnant with income," all of which is attributable to U.S. Corp's business activities, and all of which was predetermined as of the date the leases were executed. And, as in *Foster*, the fact that U.S. Corp contributed its lease interests to U.S. Partnership in a nonrecognition transaction does not prevent the application of section 482 to reallocate the income derived from the leases to U.S. Corp, when U.S. Partnership seeks to dispose of that income by allocating it to Foreign Partner.

In this case, there is no need for U.S. Partnership to dispose of "property" for income to be recognized. The taxable income that U.S. Corp is seeking to shift is recognized automatically as the lease payments are made by the lessees to the third-party lenders. It is the way that U.S. Partnership disposes of the taxable income that gives rise to a distortion in income, because such disposition separates that income from its related deductions.

We believe that the fact that this distortion in U.S. Corp's income occurs over time, as the lease payments are made and income is recognized, is the same as the circumstances in *Foster.* There, income that was allocated to the partnership that developed the land was recognized, following the transfer of property, over time, as individual lots were sold by the transferee corporations. Thus, the Court of Appeals held in *Foster* that "[u]nder section 482, the Commissioner may allocate income earned subsequent to the income evading event or transfer. The fact that some of it is attributable to a time following the transfers makes no difference." *Id.* at 1436.

We are aware that the opinion of the Tax Court in *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1124 (1985), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988), might be urged to stand for the proposition that the clear reflection of income standard of section 482 does not allow income to be reallocated unless a "mismatching of income and expenses" occurs "within a single taxable year," as in *Rooney v. United States*, *supra*, and in *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (2d Cir. 1952), *rev'g*, 16 T.C. 882 (1951), *cert. denied,* 344 U.S. 874 (1952).

In the *Rooney* case, individuals contributed all of the assets of their farming business, including a growing crop, to their newly formed corporation, in a non-recognition transaction under section 351. The individuals took deductions for the expenses of raising the crop on their individual Federal income tax returns and reported the income from the sale of the crop on the return of their new corporation. The court upheld a reallocation under section 482 of the crop expenses, from the individuals to the corporation, as necessary to prevent the distortion of true taxable income. *Rooney Corp, supra,* 305 F.2d at 685. The *Central Cuba Sugar Co.* case also concerned the transfer of a crop that was about to be harvested. In this instance, the transfer occurred under a plan of reorganization under section 112(g) and was made for business reasons not primarily related to tax saving. The court upheld the reallocation under section 482 of the expenses related to the crop to the successor corporation.

We do not believe *Eli Lilly & Co.* limits the time within which the income distortion that section 482 was designed to address must occur. In *Eli Lilly & Co.*, the Commissioner sought to reallocate to a U.S. corporation income attributable to intangibles that had been transferred in a non-recognition transaction to the

corporation's wholly owned Puerto Rican subsidiary. The Tax Court did not allow the requested reallocation. In *Eli Lilly & Co.,* the intangibles were transferred in 1966. The Commissioner sought to reallocate income earned through the use of the intangibles in the manufacture and sale of products in 1971, 1972, and 1973. The Tax Court contrasted the situation in *Rooney* and *Central Cuba Sugar Co.,* where the transferor incurred the expenses of growing the crop and the transferee had only to sell the crop to realize the related income, *id*. at 1124, with that in *Eli Lilly & Co.*, where "all expenses related to [the transferred intangibles] were recovered by [the transferor] prior to the transfer of the intangibles." *Id.* at 1124-25. The Tax Court found that "the expenses giving rise to the development of the [intangibles] simply are too remote in time to be matched with the income earned by [the Puerto Rican subsidiary] during the years at issue" and that the "transfer of intangibles . . . *did not create a mismatching of income and expenses*." *Id*. at 1125 (emphasis added) (footnote omitted). The Tax Court pointed out that "[w]e do not imply that [the Service's] authority to invoke sec. 482 is limited to within a 1 year period." *Id*. at n.63, *citing G.U.R. Co. v. Commissioner*, 117 F.2d 187 (7th Cir. 1941), *aff'g*, 41 B.T.A. 223 (1940).

The facts regarding the transaction between U.S. Corp and its controlled U.S. Partnership give rise to a mismatch of expenses and income that creates the same type of distortion in income as occurred in *Rooney* and *Central Cuba Sugar Co.*, although the distortion does not occur within a single tax year. However, like the crops at issue in *Rooney* and *Central Cuba Sugar Co.*, the leases transferred by U.S. Corp have a predictable cycle of generating early expenses (or tax deductions) followed by taxable income. The only difference is that, for the leases, the cycle of expenses followed by income extends over more than one taxable year. The Tax Court's opinion in *Eli Lilly & Co.* rested on the critical issue of whether a mismatching of expenses and income resulting in a distortion of income had, in fact, occurred and not on whether there was a certain time following the transfer of an asset within which a distortion of income must occur in order to allow section 482 to be applied. *Eli Lilly & Co.*, *supra*, at 1125. The passage of time in *Eli Lilly & Co.* between when expenses related to the intangibles were incurred, when the intangibles were transferred to another corporation, and when the intangibles were used to earn the income the Commissioner sought to reallocate, was simply a factor that contributed to a finding that no mismatching of income and expenses had occurred. *Id.* For the leases transferred in this case, there can be no doubt that the expenses and income at issue are matched to the leases that were transferred, because all of the lessor's items of expense and income attributable to the leases were determined when the leases were executed.

We note, also, that even if *Eli Lilly & Co.* were to be given an expansive reading, so as to limit the use of the clear reflection of income standard of section 482 to cases in which a mismatching of income and expenses occurs in a single

taxable year, there is no similar argument that can be made to limit the use of the tax avoidance standard of section 482. The decision of the U.S. Court of Claims in *Ruddick Corp. v. United States*, 643 F.2d 747, 751 (Cl. Ct. 1981), *on remand*, 3 Cl. Ct. 61, 65 (1983), *aff'd without op.*, 732 F.2d 168 (Fed. Cir. 1984), also described the holdings in *Rooney* and *Central Cuba Sugar Co.* in somewhat limiting terms, as involving "a sharp separation of the expenses or costs of producing the gain from the gain itself, with the Service successfully using Section 482 to tie the costs and the gain to the same taxpayer and same year so that there could be a true reflection of income." The *Ruddick Corp*. court determined that, absent the "taint" of tax avoidance, section 482 could not be applied to prevent the distortion of income that was "contemplated and authorized" by Congress when it provided for non-recognition for particular types of transactions. *Id*. at 752. In contrast, we believe the form of the transaction in this case, with its shifting of taxable income (but not cash flow) to a tax exempt entity, results in a distortion of income not contemplated by Congress when it enacted section 721 and is, in any event, strong indication of the tax avoidance purpose of the transaction.

Another case exemplifying the use of section 482 in circumstances analogous to the transaction at issue here is *Southern Bancorporation v. Commissioner*, 67 T.C. 1022 (1977). A banking corporation distributed in kind appreciated U.S. Treasury obligations to its parent bank holding company, which qualified for more favorable tax treatment than its subsidiary with regard to the gain that would be realized on the sale or redemption of these obligations. The court sustained a section 482 reallocation to the subsidiary bank of the income that was then recognized by the parent holding company on the disposition of these obligations. Among the reasons for its decision, the court found that the distribution in kind was "motivated, at least in part, by the tax savings which would result upon the sale of such obligations by [the holding company]," *Id*. at 1027. The court reasoned that

> [t]he appreciation in the U.S. Treasury obligations was attributable to the purchase of such obligations by [the subsidiary bank]. It was the bank's money that was invested and produced the income. In fact, it may be assumed that [the bank] paid its depositors for the use of that money. The corresponding income or gain was sought to be diverted to the [parent holding company] prior to the sale of the obligations by the distribution of a dividend in kind. This clearly resulted in the distortion of the income of [the bank]. Accordingly, there were present in this case the prerequisites for the application of section 482.

*Id*.

The court's language in *Southern Bancorporation* again demonstrates the basis for applying section 482 in this case. The income from the leases transferred

by U.S. Corp is attributable to the purchase of the leases by U.S. Corp. It was U.S. Corp's money that was invested and produced the income. The income was sought to be diverted, prior to its recognition for Federal income tax purposes, by the contribution of the leases to U.S. Partnership. We believe this resulted in the distortion of the income of U.S. Corp. Accordingly, as in *Southern Bancorporation*, there are present in this case the prerequisites for the application of section 482.

Similarly, in *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234, 235 (2d Cir. 1935), *cert. denied*, 296 U.S. 645 (1935), a U.S. corporation held appreciated stock, which the court described as giving it "an actual profit . . . though yet unrealized for income taxation." The stock was transferred to a foreign affiliate in exchange for a payment by the affiliate of an amount equal to the U.S. corporation's cost basis for the stock. The court held that the term "evasion of taxes," as used in section 45, the predecessor to present section 482, was "broad enough to include the avoidance of the realization for taxation of such a profit through its transfer to another branch of the same business enterprise. . . ."

Another instructive case in which there was an attempt to avoid tax by shifting of income is *Ballentine Motor Co., Inc. v. Commissioner*, 39 T.C. 348 (1962), *aff'd*, 321 F.2d 796 (4th Cir. 1963). Here, one of three commonly owned corporations, all engaged in car sales, had a net operating loss carryover. To take advantage of this loss, the inventories of unsold cars, including replacements, owned by the other two profitable corporations were transferred, at cost, to the loss corporation. These inventories had, at the time they were transferred, inherent profits. After the profits from the sales of these inventories had overcome the deficit of the loss corporation, the inventories were returned to the other two corporations.

The Tax Court held that the income from the sale of the transferred inventory was properly allocated under section 482 to the original transferors.

> The substance of this entire transaction was that profit which would otherwise have gone to petitioners [the transferor corporations] was received by Georgia [the loss corporation] as long as it could be offset by Georgia's net operating loss carryforward, and no longer. Georgia used the established business of petitioners . . . to sell their automobiles. These business enterprises earned the income in question. Their facilities were used. Their business reputations were used. All Georgia did was procure title to the inventory. We find this to be the type of tax evasion which Congress sought to remedy by enacting the predecessor of section 482.

39 T.C. at 361 (authority omitted).

The taxable income U.S. Corp seeks to shift to Foreign Partner appears similarly limited to only the amount of income that is scheduled to be recognized under the leveraged leases without the receipt by the lessor of any significant cash flow. When the balloon payments at the end of the lease are made, it appears from the Agreement of U.S. Partnership that the actual cash flow scheduled to be received by the lessor as a result of such payments will be allocated and distributed to U.S. Corp.

The taxpayer in *Ballentine Motor Co., Inc.* argued that section 482 could not be applied to reallocate net income that did not exist at the time the property was transferred. The Tax Court held

> that when, as here, assets from which income is expected are transferred from one business to another business (both controlled by the same interests) and the *primary* object of the transfer is tax evasion by the shifting of anticipated profits, as it was here, that section 482 is not rendered inapplicable merely because the profits to be shifted have not yet been realized.

*Id.* (emphasis in original).

*Spicer Theatre, Inc. v. Commissioner*, 44 T.C. 198 (1964), *aff'd*, 346 F.2d 704 (6th Cir. 1965), also applied section 482 to a comparable transaction. Here, a corporation operating profitable drive-in theatres leased the operations of the theatres to a commonly owned corporation that was dormant and insolvent. The two-year lease was designed to provide sufficient income to absorb most of the dormant corporation's net operating loss. The Tax Court noted that the only change made after execution of the lease was the recording of the operations on the lessee corporation's books of account, and that the "anticipated profits generated by the [lessor corporation's] reputation and effort, . . . properly can be primarily attributed to the activities of [the transferor corporation]." 44 T.C. at 207.

So, too, in the transfer of the leveraged leases from U.S. Corp to U.S. Partnership, the Agreement of U.S. Partnership was designed to assign sufficient taxable income to Foreign Partner to absorb most of the taxable income U.S. Corp was scheduled to recognize without the receipt of any significant cash flow. The only change with respect to the performance of the lease agreements after they were transferred to U.S. Partnership was that they were recorded on U.S. Partnership's books of account. As in *Spicer Theatre, Inc.,* the lease profits properly can be attributed to the activities of U.S. Corp. *See, also, Aiken Drive-In Theatre Corp. v. United States*, 281 F.2d 7 (4th Cir. 1960) (shifting of loss to a profitable corporation gave an artificial picture of the corporation's true income that the Commissioner was not required to accept).

Many of the foregoing cases involve the application of section 482, in circumstances that include nonrecognition transactions, when necessary to prevent the avoidance of taxes or clearly to reflect income. On this issue, other supporting authorities include Treas. Reg. § 1.482-1(d)(5) (1968); Temp. 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)*; 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); *and Dolese v. Commissioner*, 811 F.2d 543 (10th Cir. 1987), *aff'g*, 82 T.C. 830 (1984).

D. Conclusion

Based on the facts provided, we believe the net effect of U.S. Corp's transfer of leveraged leases to its controlled U.S. Partnership and the shifting to Foreign Partner of the significant taxable income the leases are scheduled to produce, with U.S. Corp having already taken all available depreciation deductions attributable to the lease assets, results in a distortion of true taxable income and in tax avoidance. Accordingly, the taxable income attributable to the leases may be allocated, pursuant to the authority granted in section 482, to U.S. Corp, the entity that was responsible for generating the taxable income attributable to the leases and which has received the tax benefits of all of the depreciation deductions attributable to the leases.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We note that the application of section 482 to a stripping transaction does not preclude the application of other theories. For example, section 482 applies whether or not a transaction is a sham or otherwise intended to evade or avoid tax. Treas. Reg. § 1.482-1(f)(1)(i) (1994). Section 482 may also apply whether or not a partnership allocation conforms to the requirements of section 704. Treas. Reg. § 1.704-1(b)(1)(iii).

If you have any further questions, please call the branch telephone number of (202) 874-1490.

______________________

ELIZABETH G. BECK
Senior Technical Reviewer
Branch 6
Office of Associate Chief
Counsel (International)