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

December 23, 1999

Number: **200013004**
Release Date: 3/31/2000
UILC: 9214.04-00

TL-N-6722-98
CC:DOM:FS:P&SI

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR NORTH CENTRAL DISTRICT COUNSEL

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Lease Stripping Transaction

This Field Service Advice responds to your memorandum dated August 27, 1999. 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:

T	=
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a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
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Year 1	=
Year 2	=
Year 3	=

Year 4	=
Year 6	=
Year 9	=
Year 10	=

ISSUES:

1. Whether the lease stripping transactions lack economic substance.

2. Whether the partnership form should be respected.

3. Whether the purported sale and leaseback of the computer equipment and store equipment are properly characterized for federal income tax purposes.

4. Whether the step transaction doctrine can be applied to collapse the lease stripping transactions.

5. Whether section 482 applies to the lease-stripping transactions at issue, and if so, the consequences of applying section 482.

CONCLUSIONS:

1. The lease stripping transactions lack economic substance because the transactions had no objective economic substance, there was no business purpose for the transactions, and the parties entered into the transactions for tax avoidance purposes.

2. There are insufficient facts to determine if the partnership form should be respected.

3. It appears that the purported sale and leaseback of the computer equipment and store equipment are not properly characterized for federal income tax purposes. We recommend further factual development.

4. It appears that the step transaction doctrine may apply to collapse the lease stripping transactions. We recommend further factual development.

5. Section 482 applies to a portion of the lease-stripping transactions at issue.

FACTS

Introduction

This case involves a lease-stripping transaction with one party realizing rental income from property and another party or parties claiming deductions for rental expenses and/or depreciation on the equipment. The Service has defined and described forms of lease-stripping transactions and the code sections and doctrines that are applicable to such transactions. Notice 95-53, 1995-2 C.B. 334. Depending upon the facts of the case, the Service may apply the following provisions to the transaction: sections 269, 382, 446(b), 482, 701 or 704, 7701(l), and the underlying regulations. It may also recharacterize certain assignments or accelerations of future payments as financings or apply the assignment-of-income principles, the business-purpose doctrine, or the substance-over-form doctrines (including the step transaction and sham doctrines). Notice 95-53.

T entered into two different purported sale and leaseback transactions.[1] In the first transaction, T sold and leased back computer equipment utilized in its business. In the second transaction, T sold and leased back retail store equipment of one of its divisions.

Purported Sale and Leaseback of Computer Equipment

T utilized computer equipment in its business. On October 31, Year 1, T purportedly sold the computer equipment to B for $a.[2] In payment of the purchase price, B executed in favor of T three non-recourse notes totaling $b and three recourse notes totaling $c. The notes were secured by a purchase money security interest in the equipment.

On the same day, T leased back the computer equipment from B for an a year period with an option to extend the lease for another b months. T also acquired an option to purchase the equipment upon the end of either the lease or the lease extension period. The payments due from T to B under the lease-back agreement equaled the principal and interests payments due from B to T under the notes issued for the purchase of the computer equipment.

On the same day, B sold the computer equipment to C for $d. In payment of the purchase price, C assumed B’s non-recourse notes to T totaling $b and executed two notes, one note in the amount of $e and one note in the amount of $f. C is a partnership with three partners. Two partners are individuals and the third, the

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[1] The terms “sale” and “leaseback” are used for convenience only.

[2] T, one of its division, and a wholly-owned subsidiary individually sold the equipment in three different transactions. Because the terms of each of the agreements are similar, we shall refer to the three sales as one sale of computer equipment.

majority partner, D, is an Indian nation believed to be not subject to U.S. federal tax.

On the same day, C sold the computer equipment to E for $g. In payment of the purchase price, E executed in favor of C two nonrecourse notes, one note in the amount of $e and one note in the amount of $h.

On the same day, C leased back the computer equipment from E for a c-year period with an option to extend the lease for another b months, pursuant to the terms of the Master Lease. C agreed to pay rent as follows: one payment of $i payable on January 31, Year 2, eight semiannual payments of $j, payable on January 31 and July 31 of each year beginning on July 31, Year 2, and ending on January 31, Year 6, and one final payment in the amount of $k payable on April 30, Year 6.

On November 30, Year 1, C sold its rights to receive the lease payments from T to F for $l. On December 17, Year 1, T executed an agreement under which it would unconditionally make lease payments to F.

G was a wholly owned subsidiary of T. On December 17, Year 1, T contributed $m to G in exchange for d shares of G common stock. Simultaneously and in conjunction with this transfer, C contribute the two nonrecourse notes executed by E, the lease between C and E, and the note executed by C to B to G in exchange for e shares of Series A preferred stock. (The payments due under E's note and the lease payments due under the lease between C and E are the same and, therefore, offsetting.)

T booked the residual rights under the Master Lease as an asset with a value of $n, in contrast to an appraisal, which placed a future value on the equipment of over $o.

On December 17, Year 1, G entered into an agreement with H under which G agreed to pay a "portfolio acquisition fee" of $p to H for assisting G in arranging the Assignment and Assumption agreement, pursuant to which C contributed certain equipment to G in exchange for Series A preferred stock and for "related matters." G also entered into a Tax Matters Agreement with H under which H agreed to refund a portion of the portfolio acquisition fee if C failed to report the proceeds of the sale of lease payments as income in the year of sale, or if G's basis in the notes from E was less than that agreed upon.

On December 17, Year 1, G paid the note to B it had assumed from C. At the same time, pursuant to the direction of H, G paid to B a $q portion of the portfolio acquisition fee it owed to H. The sum of those two payments to B equaled the $c recourse notes due from B to T. B thus satisfied that note directly from payments made by G. The b nonrecourse notes due to T were satisfied by the sale of the rents due under the leases to F.

In October Year 4, at the end of the initial term under the user leases, T renewed the leases with G for an additional b months, for a total additional cost of $r. This is in contrast to the residual value, booked as part of a section 351 transfer, of $n and an appraisal estimate of almost $s. At the end of the Master Lease period, which coincided with the extended user leases, T repurchased the equipment from E for approximately $t. The estimated value of the computer equipment at the end of the Master Lease term was $u.

Purported Sale and Leaseback of Store Equipment

On December 22, Year 2, T purportedly sold retail store equipment, including wall fixtures, wood fixtures, metal gondola/ wall standards, stockroom shelving, garment rack cubes, fixture accessories, shoe fixtures, pharmacy fixtures, lawn and garden fixtures, errors and omissions and field order modifications, and display items, from one of its store divisions to B for $v. T's cost basis in the equipment was $w and it had claimed $x in depreciation deductions.

On the same day, T leased back the store equipment from B for a term of f years, with an option to extend for another g years. T had an option to purchase the store equipment at the end of the initial lease term or at the end of the renewal period.

On the same day, B sold the store equipment to J, a partnership, for $y, and leased the equipment back from J. The majority partner of J, K, is an Indian nation believed to be not subject to U.S. federal tax.

On the same day, J sold the store equipment to M for $y and J leased back the store equipment from M for a term of h years. J's rental obligations are as follows: one installment of $z, payable on January 31, Year 3, thirteen equal semiannual installments of $aa on January 31 and July 31 of each year commencing on July 31, Year 3, and ending July 31, Year 9, and one final installment of $bb, payable on December 22, Year 9.

On January 6, Year 3, J sold its right to receive the lease payments to M for $cc. On January 24, Year 3, T contributed $dd cash to G in exchange for i shares of G common stock. Simultaneously and in conjunction with this transfer, J transferred its rights and obligations under the notes and equipment in exchange for j shares of Series B preferred stock in G.

On September 30, Year 4, M sold the rights to the rent receivables to N.

According to T's counsel, G "could have reasonably anticipated a profit in excess of "[$ee]" on its out of pocket investment of $ff on a pre-tax, non-discounted basis. T deducted rental expense payments relating to this transaction totaling $gg in excess of related income in the tax years ending January 28, Year 3, and February 3, Year 4.

In a proposal dated December 5, Year 2, the projected total pretax income impact for the Year 2 through Year 10 years was $hh. The projected taxes saved for lease positions was $ii. In this document, the risks to the transaction included the following: "If the second transaction doesn't occur, we are stuck with a market rate sale/leaseback – we'd prefer to own." This second transaction was described as follows: "In a second transaction a month later, our subsidiary ([G]), obtains the rights to use the fixtures for another 2 years (years 6 & 7). This partnership transfers its favorable tax positions to us, for a fee. After 7 years, we have the option to purchase the fixtures at fair market value."

LAW AND ANALYSIS

1. Lack of Economic Substance

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, Inc. 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 and the proper tax treatment of the parties to the transaction is determined.

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d

734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998). Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363. See also Notice 95-53, 1995-2 C.B. 334.

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 lacked economic substance. ACM Partnership v. Commissioner, T.C. Memo. 1997-115, 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 Commissioner argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance, and lacking in economic reality. The court found 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 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, that the taxpayer was not entitled to the claimed deductions. The opinion demonstrates that the court will disregard a series of otherwise legitimate transactions where the Commissioner is able to show that the facts, when viewed as a whole, have no economic substance. See also Rev. Rul 99-14, 1999-13 I.R.B. 3 (because lease-in/lease-out transactions have no economic substance, a U. S. taxpayer could not take deductions for rent or interest paid or incurred in connection with the transaction).

While the profit potential or economic risk, relative to the expected tax benefit, necessary to meet the objective economic substance test has not been quantified, a reasonable prospect or possibility for profit is required. See Horn, 968 F.2d at 1237-38 n. 10, 13; Rice's Toyota World, Inc., 81 T.C. at 202. Nominal or de minimis profit potential does not imbue a transaction with economic substance. Knetsch v. United States, 364 U.S. 361 (1960); Hines v. United States, 912 F.2d 736 (4th Cir. 1990), rev'g 89-9 USTC (CCH) ¶ 9523 (E.D.N.C. 1989); Krumhorn v. Commissioner, 103 T.C. 29, 55 (1994); Sheldon v. Commissioner, 94 T.C. 738, 767-68 (1990); Estate of Thomas v. Commissioner, 84 T.C. 412, 438 (1985).

There was no objective economic substance or business purpose for the formation of the sale and lease backs and subsequent sale of the right to receive lease payments. Rather the sole purpose of the transaction was the creation of tax benefits. To the extent the transactions at issue lack economic substance, the expenses and deductions from the sale-leaseback are disallowed.

2. Formation of Partnership

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, appeal filed, No. 98-1583 (D.C. Cir. Dec. 11, 1998); Rev. Rul. 82-61, 1982-1 C.B. 13.

Recently, the Service was successful in making this argument In ASA Investering Partnership. In that case, the primary issue considered by the Tax Court was whether Allied Signal, Allied Signal Investment Corporation (ASIC), Barber Corporation N.V., and Dominguito Corporation, N.V. formed a valid partnership for federal income tax purposes. The court held that the corporations did not. The court disregarded the existence of Barber and Dominguito because the facts demonstrated that those entities were agents for ABN, the lender. See 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, AllliedSigned 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 was AlliedSignal's wholly-owned subsidiary, AlliedSignal, not ASIC, was 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 ABM 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 costs, 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." Culbertson, 337 U.S. at 754.

The taxpayer argued that ASA Investerings Partnership 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 demonstrated that the Bermuda Agreement, not the partnership agreement, governed their affairs.

The court concluded that the characteristics of AlliedSignal and ABN's relationship were 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 another 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 was in substance a lender, the court held that Barber and Dominguito were not partners in ASA Investerings Partnership 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.

3. Proper Characterization of Sale and Leaseback

Whether the purported sale and leaseback of the computer equipment and the store equipment are properly characterized for federal income tax purposes depends upon the substance of the transaction. Levy v. Commissioner, 91 T.C. 838 (1988). A transaction may be considered a sale for federal income tax purposes if the benefits and burdens of ownership have passed to the purchaser of the assets. Levy, 91 T.C. at 859. The taxpayer in Levy entered into sale-leaseback transactions involving computer equipment. In determining that the taxpayer's purchase of the equipment should be respected for federal income tax purposes, the court stated that the factors relevant to this determination are:

(1) the purchaser's equity interest in the computer equipment as a percentage of the purchase price;

(2) a useful life of the property that extends beyond the lease term;

(3) lease renewal or purchase options at the end of the lease term based on fair market value of the equipment at that time;
(4) whether the projected residual value of the equipment plus the cash flow generated by the rental of the equipment allows the investors to recoup at least their initial cash investment;
(5) whether a turnaround point is reached at some point whereby depreciation and interest deduction are less than income received from the lease;
(6) whether the net tax savings for the investors are less than their initial cash investment; and
(7) the potential for realizing a profit or loss on the sale or release of the equipment.

Levy, 91 T.C. at 860. See also Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987), aff'd in part, rev'd in part, Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990).

Additional factors to consider in determining the correct characterization include whether an equity interest was acquired in the property, whether the contract created a present obligation on the seller to execute and deliver a deed and on the purchaser to make payments, and whether the right of possession is vested in the purchaser. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

In Estate of Thomas v. Commissioner, 84 T.C. 412, 434, n.36 (1985), the court stated that a "lessee acquires an equity when he acquires something of value in relation to the overall transaction, other than the mere use of the property." The lessor of the computer equipment being leased retained its ownership in the equipment because it did not lease the equipment for its entire economic life to the lessee and the lessor had the potential for receiving a high residual value of the equipment.

An equity interest in property is acquired when the lessee has the use of the equipment for its entire useful life. In Rev. Rul. 55-541, 1955-2 C.B. 19, the purported lessee, Corporation M, had the use of the equipment for substantially its entire useful life, though Corporation M may have never acquired legal title to the equipment. Because Corporation M was to enjoy all of the benefits of ownership of the equipment, the Service determined that Corporation M was transferred an equitable interest in the equipment.

In Larsen, supra, the court determined that the taxpayer acquired the benefits and burdens of ownership of the computer equipment used in the sale and leaseback transaction. However, the court also determined that the transactions were not motivated by a business purpose, were devoid of economic substance, and were disregarded for federal income tax purposes. Factors that the court deemed to be neutral in determining whether a taxpayer should be respected as the owner of the equipment include the following:

(1) the existence of a net lease;
(2) the absence of significant positive net cash flow during the leaseback term or rent geared to interest and mortgage amortization; and
(3) the use of nonrecourse liability.

Larsen, 89 T.C. at 1267, citing Estate of Thomas v. Commissioner, 84 T.C. 412 (1985). See also Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

An assignment of future revenues is not a bona fide sale, but rather a lending transaction secured by the right to future revenue when the assignee has the right to repayment. Mapco Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977). This certainty is characteristic of a loan. Mapco Inc., 556 F.2d at 1110. In Mapco Inc., the court determined that amounts deposited in the bank by the taxpayer indirectly guaranteed repayment, which was also a characteristic of a loan. Mapco, Inc., supra.

Limited use property is property that is not expected to be useful to or useable by the lessor at the end of the lease term except for purposes of continued leasing or transfer to a member of the lessee group. Rev. Rul. 82-61, 1982-1 C.B. 13. It is the Service's position that—

> If, because of the nature of the property or its location, the property is expected not to be useful or usable by the purported lessor at the end of the lease term except for purposes of transfer or continued "leasing" to the purported lessee or a related party, then future passage of title to the purported lessee is also likely, and consistently the transaction should be treated as a purchase.

G.C.M. 36330. See also Rev. Proc. 76-30, 1976-2 C.B. 647 (the Service will not issue advance rulings on whether a transaction is a lease for U.S. federal income tax purposes pursuant to Rev. Proc. 75-21, 1975-1 C.B. 715, and Rev. Proc. 75-28, 1975-1 C.B. 752, in transactions involving limited use property).

G repurchased the computer equipment for approximately $t pursuant to the section 351 transaction. The residual value of the equipment was estimated to be over $u. The purchase option and the actual purchase price do not appear to have been at the fair market value of the equipment, facts that support recharacterizing the sale and leaseback as a financing.

T had the option to lease the computer equipment for up to c years and had the option to repurchase the equipment upon the expiration of the leases. G repurchased the computer equipment for approximately $t approximately two months after T sold the equipment to B. It appears that T retained its equity interest in the equipment, as defined in Rev. Rul. 55-541, because T retained the benefits of ownership of the equipment for substantially the entire useful economic life of the equipment. Moreover, T retained the right to repurchase the equipment, which is indicative of T's intent never to sell the computer equipment.

T received a payment for its equipment at the beginning of the transaction, and was to make "rent" payments that equaled the purchase price of the equipment. Thus, T was able to recover its rental payments up-front, a fact which supports recharacterizing the sale and leaseback as a financing.

It appears that T's expected "profit" in this case was locked-in because the amounts to be paid for the computer equipment were predetermined and not market-driven. The expected profits were based on residual valuations that were inflated. These facts support recharacterizing the sale and leaseback as a financing.

E purchased and leased back the computer equipment to C. This is inconsistent with T's sale, lease back and repurchase of the equipment, which further underscores the conclusion that T did not sell, lease back and repurchase the computer equipment.

If the purported sale by, and leaseback to, T of computer equipment is properly characterized as a financing arrangement and not as a sale and a leaseback, then the $a that T received from B as "payment" would be properly characterized as a loan and would not be included in T' s gross income. United States v. Centennial Savings Bank FSB, 499 U.S. 573, 582 (1991). Furthermore, if the transaction is not properly characterized as a sale and a leaseback, the rental income to B would then be properly characterized as repayment of the loan principal (which would not be taxable as income) and interest (which would be taxable as income).

In the second above-described transaction, T retained an option to purchase the store equipment at the end of the initial lease term or at the end of the renewal period. T, through its subsidiary G, repurchased the store equipment. Furthermore, T expressed its lack of interest in leasing the equipment in the proposal as follows: "Risks: If the second transaction doesn't occur, we are stuck with a market rate sale / leaseback – we'd prefer to own." It appears that T wanted and intended to retain the benefits of ownership of the store equipment even after the expiration of the lease. These facts suggest that T retained the benefits of ownership of the equipment, and, therefore, retained an equity interest in the property, pursuant to Rev. Rul. 55-541. These facts support recharacterizing the sale and leaseback as a financing.

Additionally, T purportedly expected a “profit” from the sale of the store equipment. This profit, however, was predetermined and locked-in, and based upon the expected residual value of the equipment, which was never realized. This fact supports recharacterizing the sale and leaseback as a financing.

Upon the termination of the lease after either f or h years, the store division was required to return the equipment to B, the lessor. Essentially, the division would have been required to remove the fixtures that had been mounted to the walls and bolted to the floors, had T not repurchased the store equipment. While we do not know the quality of the store equipment or its expected useful life, we question the likelihood that the equipment could be removed without damaging it. We also question the likelihood that the store equipment could be resold to a third party. Arguably, the store equipment is limited use property and the division’s store is the only lessee that could use the equipment upon the expiration of the lease. This fact would support recharacterizing the sale and leaseback as a financing.

If the purported sale and leaseback of the division’s store equipment was not a sale and a leaseback, but rather a financing arrangement, then any amount that T received from B as “payment” would be properly characterized as a loan and would not be included in T’s gross income. Centennial Savings Bank FSB, 499 U.S. at 582. Furthermore, if the transaction is not a sale and a leaseback, the rental income to B would then be properly characterized as repayment of principal and would not be taxable as income.

4. Application of Step Transaction Doctrine

Courts have applied alternative tests in deciding whether to invoke the step transaction doctrine in a particular transaction. One of the tests is the “end result” test. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). The “end result” test of 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 , supra. The end result test is based upon the intent of the taxpayer.

The step transaction doctrine 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 of C and possibly B, and therefore, treat C and possibly B as conduits.

5. Application of Section 482

The transaction is analyzed as being composed of two legs. First, there was a sale leaseback transaction ("T sale and leaseback") in which T sold computers to B, and leased back the equipment from B. The term of this lease ("T lease") was a years with a b month option to renew. B then sold the equipment subject to T's lease to C, a partnership, the majority of which was owned by a tax exempt entity. C then sold the computers to E, and leased back the equipment from E ("C sale leaseback"). The term of this lease ("C lease") was c months with a b month option to renew.

The second leg of the transaction, which occurred on November 30, Year 1 involves C assigning its rights to the lease payments (paid by T) which were assigned to C as a result of the C lease, to F for $l. C recognized the receipt of the $l as income on the assignment of its rights to the lease payments. Of course, since C's majority partner was tax exempt, tax was not paid on that portion of the income. On December 17, Year 1, as part of a section 351 transaction, C then contributed its interest in the C lease, i.e., both its right to use the property for the period following the T lease, and the obligation to make lease payments to E, to G, a subsidiary of T in which T owned all the common stock, in exchange for preferred stock of G. As part of this section 351 transaction, C also transferred the installment note that E gave it in consideration for the sale of the computers. The payments G was to receive pursuant to the installment note were exactly equal to the payments it was required to make under the C lease.

It is not clear whether in the second transaction the rent payments G was obligated to make to M exactly equaled the installment payments on the nonrecourse loan that G was to receive from K. This fact needs further development.

We separately analyze whether section 482 can be applied to each leg of the transaction. Section 482 (emphasis added) 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.

Thus, 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. As there is no common ownership among the participants to the transaction (other than T's ownership of G, and possibly B being affiliated with C,) the primary question under section 482 becomes whether any of the participants, particularly T, G, and C are controlled by the same interests.

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.[3] 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 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); 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.

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 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)

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[3] The taxable years at issue are Year 1, Year 2, and Year 3. Accordingly, there are three sets of section 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. § 1.482-1T(h) (1993); Treas. Reg. § 1.482-1(j)(2) (1994). We are uncertain whether T is a calendar or fiscal year taxpayer, or whether an election to apply the 1994 regulations retroactively has been made. Consequently, we will distinguish between the regulations by referring to their year of promulgation (in parenthesis) when each set of regulations is referred to.

(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 section 482 if income or deduction shifting is present, or if there is common goal to shift income or deductions. But see Forman v. Commissioner, 54 T.C. 912 (1970), rev'd in relevant part, 453 F.2d 1144 (2d Cir. 1972), nonacq, 1975-2 C.B. 3 (nonacquiescence relates to Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 section 482 regulations); Lake Erie & Pittsburgh R.R. 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.

Nevertheless, it is our opinion that section 482 cannot be applied to the first leg of the transaction, the T sale leaseback transaction, since there was no arbitrary shifting of income or deductions in the first leg of the transaction. The necessary shifting of deductions related income is not present in the T sale leaseback in that T is enjoying the use of the property while deducting the lease payments. The only apparent shifting of income is the fact that C, the recipient of the lease payments, is a partnership the majority partner of which is a tax exempt party. Therefore, we do not believe that section 482 should be applied to the first leg of the transaction.

It is our opinion, however, that the control requirement is met when analyzing the second leg of the transaction through the "stripping" of income from the leases to C, an entity whose majority partner is exempt from U.S. tax, and the reporting of the deductions relating to that income by G. 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."). It should be noted that the 1993 temporary regulations and the current regulations (to the extent they apply to the transactions at issue) lend greater support to this conclusion since they refer to parties acting in concert or with a common goal and purpose. See Treas. Reg. § 1.482-1T(g)(4) (1993) ("A presumption of control arises if income or deductions have been arbitrarily shifted as a result of the actions of two or more taxpayers acting in concert or with a common goal and purpose"); Treas. Reg. § 1.482-1(i)(4) (1994) ("*Controlled* includes any kind of control . . . including control resulting from the actions of two or more taxpayers acting in concert or with a common goal and purpose").

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(5), (6) (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.

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. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also H. Rept. No. 350 and S. Rept. 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, 894-5 (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 Co., 366 F.2d at 894-5. See also Brittingham, 598 F.2d at 1378-9, citing, Ach, 42 T.C. at 125-6 (The phrase, "same interests," should not be narrowly construed to frustrate the intent of section 482); Appeal of Rishell Phonograph Co., 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. Inc., supra.

Thus, it is not necessary that the same person or persons own or control each controlled business before section 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 interest is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met. See Hall, 32 T.C. at 409-10 (An arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of section 482 -- whether or not ownership exists.). Accordingly, we believe the requirement that control be held by the "same interests" was met in the second leg of the transaction ("the lease strip") since we assume that there was a common design to separate the rental income from the related deductions by having the income recognized by a partnership, the majority partner of which was a tax exempt entity, and the related deductions recognized by T's subsidiary, G.

Assuming that the threshold requirements of section 482, i.e., control by the same interests, are met the Service may allocate income and deductions among members of the "controlled group." Generally, we have considered applying section 482 to lease-stripping transactions under three alternative analyses.

Under the first section 482 analysis, the economic substance of a transaction subject to section 482 is analyzed by focusing on the parties' actual conduct; the economic risks purported 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 generally Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-1T(d)(3)(ii) (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., Forman, 453 F.2d at 1160-1; Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455 (Royalty payments to a related foreign entity that was not the owner or developer of an intangible were disallowed as deductions. The payments had no economic substance under section 482, because the foreign entity was not the creator, developer, or in substance have the ability to transfer the intangibles.).

The second section 482 analysis that may be applied to the transactions relates to section 482's role in nonrecognition transactions, such as section 351 transactions. Specifically, section 482 may apply in nonrecognition transactions to 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). Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987), aff'g, 82 T.C. 830 (1984); 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'l 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); National Securities Corp. v. Commissioner,

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[4] Forman v. Commissioner, 453 F.2d 1144, 1160-1 (2d Cir. 1972) (Section 482 may overlap with section 162 and result in the denial of deductions where the lack of arm's-length dealings results in payments between parties with a "close relationship" in an attempt to avoid taxes.).

137 F.2d 600 (3rd Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943); 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 section 482's application to nonrecognition transactions in cases of tax avoidance).

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 once the income is stripped off and the obligation to pay rent remains, the combined right to receive (tax-free) rent and the obligation to pay (deductible) rent will generate a tax loss. This is in spite of the fact that the transferee (in the nonrecognition transaction) will pay little, if any, out-of-pocket cash, because the tax-free inflows of rent, or in this case, consideration for the sale of the property, will offset the deductible outflows. 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.”

On the facts relating to this leg of the transaction, the sale-leaseback transaction between C and E effectively converted future rental payments into an interest-bearing installment note. When this note is considered in conjunction with G’s assumption of C’s obligation to pay rent to E, the net effect is akin to a contribution of built-in loss property by C to G. The tax loss was assured by G’s receipt of a section-362(a)-transferred basis in the installment note E issued to C. Thus, the repayment of principal by E to G -- which accounted for the vast majority of payments to G -- was a tax-free recovery of basis, while G was able to take substantial tax deductions for the deemed payment of rent to E. Importantly, these deductions were realized without G having to make cash disbursements, as the payment streams on the E note and the C lease offset. G also apparently accrued a nominal amount of interest income.

Because there appears to have been a tax-avoidance purpose underlying the section 351 transaction between G and C, the built-in loss, i.e., the rental deductions may be allocated to C. This has the result of allocating the rental deductions (of G) arising from the E lease to C, a pass-through entity substantially all of whose interests are owned by persons not subject to the United States’ taxing jurisdiction.

The third theory under which a lease-stripping transaction may be analyzed 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(b)(1) and (d)(1) (1968); Treas. Reg. § 1.482-1T(a)(1) (1993); Treas. Reg. § 1.482-1(a)(1) (1994). Specifically, 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 Unites States' taxing jurisdiction, and (b) by placing the deductions associated with the rental income in an entity subject to United States tax. See Notice 95-53. In such an instance, the Service may prevent this artificial shifting of income and deductions by (a) allocating the rental deductions from U.S. taxpayer to the tax-exempt entity, or (b) 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); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2n Cir.), rev'g, 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952); Advance Machinery Exchange, Inc. v. Commissioner, 196 F.2d 1006 (2d Cir. 1952), cert. denied, 344 U.S. 835 (1952). 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 a lease-stripping transaction. Concomitantly, in the lease-stripping context, the evasion of taxes is prevented.

Application of this section 482 analysis to the G - C section 351 transaction could result in an allocation from G to C of the income and deductions attributable to the items C contributed to G, i.e., the E note and the C lease obligations. In this manner, the second theory under which section 482 may be applied to lease-stripping transactions (section 482's role in nonrecognition transactions) is similar to the third theory (the clear reflection of income and tax evasion standards) where the rental deductions are allocated to C.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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