INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Number: **200115003**
Release Date: 4/13/2001
Index (UIL) No.: 7701.02-00; 1011.01-00
CASE MIS No.: TAM-102096-00/CC:PSI:B1

December 22, 2000

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's EIN:
Years Involved:

Date of Conference:

LEGEND

A =
B =
C =
D =
E =
City =
Appraiser =
Property =
Tax1 =
Country1 =
Country2 =
Year1 =
Year2 =
Year5 =
X business =
a% =
b% =
c% =
d% =
e% =
f% =
g% =
h% =
N1 =
N2 =
N3 =
N4 =

N5	=
N6	=
D1	=
D2	=
D3	=
D4	=
D5	=
D6	=
D7	=
D8	=
D9	=
D10	=
D11	=
D12	=
D13	=
D14	=
D15	=
D16	=
D17	=
D18	=
D19	=
D20	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
$t	=
$u	=
$v	=
$w	=
$x	=
$y	=

$z	=
$aa	=
$ab	=
$ac	=
$ad	=
$ae	=
$af	=
$ag	=
$ai	=
$aj	=
$ak	=

ISSUES

1. Is the substance of the series of transactions involving the Property a sale of part of the Property or an economic sham?

2. Is the substance of the series of transactions involving the Property a financing arrangement?

3. If the substance of the transactions is a sale of part of the Property, what portion of the Property was sold?

4. If the substance of the transactions is a sale of part of the Property, how should the taxpayer's basis in the Property be allocated for determining the gain or loss on the part sold?

PRELIMINARY MATTERS

The facts, as described below, were taken from the agreed upon facts of the taxpayer and District Counsel, and additional submissions made by the taxpayer under penalties of perjury. The parties have submitted several documents as exemplars of the documents executed in carrying out the various transactions. The parties agree that the documents were executed but do not agree on certain facts underlying the execution of the documents. Accordingly, among the issues submitted to the National Office, we consider issue 3 to be a question of fact and, because the facts are not fully developed, we do not definitively resolve that issue herein. However, because we believe that there are numerous factors in the record submitted to the National Office that aid in resolving this issue, we review those relevant factors.

CONCLUSIONS

1. The series of transactions involving the Property is not an economic sham.

2. The series of transactions involving the Property is not a financing arrangement.

3. C sold to D an interest in the Property of at least a% but not d%.

4. A part of the taxpayer's basis in the Property should be equitably apportioned to the percentage interest that is determined to have been sold.

FACTS

The Series of Transactions

A is the common parent of an affiliated group of corporations that files federal income tax returns on the basis of a calendar year. A uses an accrual method of accounting. One of A's subsidiaries is B.

In Year1, B acquired land located in Country1 and, in Year2, commenced the construction of a building (land and building, collectively, the Property) to be used for its City operations. B later considered entering into a sale-leaseback arrangement with a third party to reduce its exposure to the vagaries of the City real estate market, but rejected this option because a sale of the building would have triggered a N5 percent tax in Country1.

On D1, B and C[1], one of B's wholly owned U.S. subsidiaries, entered into an "Agreement for Lease." Under the Agreement for Lease, B agreed to grant a lease of the Property to C for 999 years beginning on D3. The Agreement for Lease recited the facts that B was in the process of constructing an office building for its own use and at its own cost and that B planned to refinance the cost of that building. The parties agreed that the lease shall be executed on the later of completion of the building or D4, which was the intended completion date. C agreed to issue N1 shares of $a nominal value stock to B at the time the lease was executed and to pay B a yearly rent of one peppercorn (if demanded). C did not agree to assume any third-party debt. C agreed to grant an underlease to B. The agreement provided that each party would not assign its interest without the prior written consent of the other, which would not be unreasonably withheld. A draft copy of the lease was attached to the Agreement for Lease.

On D5, B and C entered into an "Agreement for Underlease." This agreement required the parties to enter into an underlease in the Property on the later of the completion of the building or D4. The period of the underlease was scheduled to start on D4, and rents accrued after that date even if the underlease had not been executed by that date. A draft copy of the underlease was attached to the Agreement for Underlease. The underlease is for an initial N2-year period. The underlease provides for N3, N4-year renewal options. The underlease is a net lease requiring B to pay maintenance, repairs, insurance, and other expenses. Also, C is entitled to receive the following annual rents from B: (1) $b from D4 to D6; (2) $c + net income from sub-underleases, up to $d, from D7 to D8; and (3) $d from D9 to D10. The underlease provides that the rent is subject to further adjustment at rent review dates every N3

---

[1] C was incorporated on D2.

years, which begin on D9. The agreement provides that B would not assign its interest other than by sub-underletting (in accordance with certain restrictions) before the underlease was executed, but C could assign its interest.

On D5, C entered into an "Agreement to Assign and Enter Into a Co-Ownership Deed" ("Agreement to Assign") with D, a Country1 corporation.[2] A draft copy of the co-ownership deed was attached to the Agreement to Assign. The Agreement to Assign states that there should also be attached a draft copy of a deed of assignment of the benefit of the Agreement for Lease and of the reversion to the Agreement for Underlease, but no such document was attached to the copy in our file. (See clauses 1.1.17 and 11.4.2.)[3] Under clause 11 of the Agreement to Assign, C agreed to sell, and D agreed to buy, the beneficial interest in the Property to be granted to D by virtue of the co-ownership deed, which was defined to be "a co-ownership deed in the form of the draft annexed." (See also clauses 1.1.15 and 1.1.16.) Clause 17.2.1 provided that the beneficial interest is sold subject to and with the benefit of all matters referred to in the Agreement for Lease as well as the Agreement for Underlease. The sale was scheduled for D4. The Property was unencumbered. The purchase price was $e. Also under clause 11 of the Agreement to Assign, D agreed to make an advance payment of part of the purchase price by depositing $f with C. C agreed to pay D c% percent interest per annum on this deposit money in equal monthly installments from D5 through D12. D was required to pay the $g balance to C on D4. The parties agreed to execute on the day of sale the attached copy of the deed of assignment of the benefit of the Agreement for Lease and of the reversion to the Agreement for Underlease. The parties also agreed to execute the lease, the co-ownership deed immediately after the lease is granted, and the underlease. Additionally, the parties agreed to execute a rent direction notice (in the form of an annexed draft) following the grant of the underlease and, pending the grant of the underlease, direct B to make any payments due under the Agreement for Underlease in the manner prescribed in the rent direction notice. Under clause 13.5, the parties agreed that, with effect from completion of a deed of assignment of the benefit of the Agreement for Lease and of the reversion to the Agreement for Underlease, they shall in all respects observe and perform their respective obligations under the co-ownership deed as if it had been completed. (See also clause 1.1.17.) The Agreement to Assign provided that neither party could assign its benefit under the agreement to a person other than an affiliate.

On D5, B entered into a "Consent" with C and D. The Consent recited that C proposes to assign the benefit of the Agreement for Lease along with the benefit (and subject to) the Agreement for Underlease to both itself and D as tenants in common, pursuant to the terms of the Agreement to Assign. The Consent provided that B consented to that action. The Consent states that there should be attached a draft copy of a deed, which is to be executed after the Lease is completed, but no such

---

[2]We do not know whether D was subject to U.S. income tax.

[3]Apparently, this is the same type of document that was signed on D11, and is discussed below.

document is in our file. (See clause 7.)

On D11, D paid the balance of $g to C. On that same date, C and D signed an Assignment of Agreement for Lease. By this document, C assigned to D an interest in the Agreement for Lease and of the reversion to the Agreement for Underlease, as previously agreed to in the Agreement to Assign. C distributed $e to B as a dividend.

The taxpayer represents that C incurred the following amounts of selling expenses attributable to the transfer of the interest to D:

Tax1 paid on creation of lease	$h
Tax1 paid on transfer of interest to D	$i
Additional Tax1 paid	$j
Legal fees	$k
Total	$l

Between April and July of Year5, the construction of the Property was completed and B commenced physical occupation.

On D13, C and a newly formed, wholly owned subsidiary of B, E, signed an Assignment of Agreement for Lease. By this document, C assigned to E the entire interest C had in the Agreement for Lease and of the reversion to the Agreement for Underlease. E paid C consideration of $m.

On D13, D and E entered into the Lease with B. On that same date, B entered into the underlease with D and E. Also, on that same date, D and E signed the Co-Ownership Deed. The substance of the Co-Ownership Deed was the same in all material respects as the draft copy that was attached to the Agreement to Assign, which was dated D5. However, because C assigned its interest to E, the Co-Ownership Deed is between D and E even though the draft co-ownership deed is between C and D.

A represents that because of an overall decline in the City real estate market, the value of the Property declined between D5, when C and D entered into the Agreement to Assign, and D11, when C and D entered into the actual Assignment of Agreement for Lease. A requested separate market appraisals of C's b% interest and D's a% interest be prepared by Appraiser. The appraisals, dated D14, determined the value of C's b% interest to be $o and D's a% interest to be $n, as of D11. These valuations took into consideration D's right to the Preference Returns, described below, and the corresponding limitation on C's right to rental income from the Property. C's total basis in the Property as of D4 was $p.

The Terms of the Transfer to D

As discussed above, C and D signed an Assignment of Agreement for Lease on D11. By this document, and in consideration of $e, C assigned to D an interest in the Agreement for Lease and of the reversion to the Agreement for Underlease, pursuant to the terms in the Agreement to Assign. Under clause 11 of the Agreement to Assign, C agreed to sell, and D agreed to buy, the beneficial interest in the Property to be granted to D by virtue of the Co-Ownership Deed (which was only in draft form at that time). Under clause 13.5 of the Agreement to Assign, the parties agreed that, when they signed a document in the form of the Assignment of Agreement for Lease, they shall in all respects observe and perform their respective obligations under the co-ownership deed as if it had been completed.

Clause 3 of the draft co-ownership deed contains a declaration to hold the Property in trust with C and D as the trustees. Clauses 1.22.1 and 6.1 designate C as the Principal Trustee with management responsibility for the Property. In clause 5.4.1, the parties agree that their relationship is a partnership for U.S. income tax purposes to which C and D are deemed to have contributed their respective interests in the Property.[4] In addition, clause 5.4.1 provides that all provisions of the co-ownership deed relating to the maintenance of capital accounts "are intended to comply with United States Treasury Regulations applicable under Section 704 of the Code and to provide for allocations which have 'substantial economic effect' within the meaning of those Regulations."

Under clauses 3 and 12.1, the trustees have the power to sell the Property before the expiration of the trust period (N6 years from its inception). However, pursuant to clauses 11.1.1 and 12.3, the trustees cannot sell the entire Property before the expiration of the trust period unless both Beneficial Owners agree. Initially, the Beneficial Owners are C and D. Clause 3 provides that the trustees should hold the proceeds of a partial sale of the Property for the benefit of C and D or their successors. Clause 3 also provides that if the entire Property is sold, the proceeds shall be distributed in accordance with the capital accounts[5] (after giving effect to adjustments attributable to all transactions prior to such distribution) up to the amounts thereof and then any remainder would be distributed b% to C and a% to D. In no event will D receive less than a% of the proceeds. On the expiration of the trust period, a sale is mandated and the distribution of the proceeds are similar to that set forth above. (See clause 12.4.)

Clause 5.1.1 provides generally that, if there is net income[6] from the Property, D is entitled to the annual "Preference Return" until D15, and C is entitled to the balance, if any. Clause 1.21 defines Preference Return to be the following listed amounts or the

---

[4]Clause 5.4.1 expressly states that the parties' relationship is not a partnership for purposes of the laws of any other jurisdiction, including Country1.

[5]Under clause 1.6, the reference to "capital accounts" means the capital accounts maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv).

[6]Under clause 1.19, the term "net income" means gross income less deductions, which could be a negative number. Under clause 1.12, the term "gross income" is generally defined as all sums received in respect of the Property. Under clause 1.9, the term "deductions" is generally defined as all expenses except depreciation.

net income, if less: (1) $b from D4 to D6; (2) $c from D7 to D8; (3) $q from D9 to D16; and (4) $r or a% of the net income (whichever is greater) from D17 to D15. C is entitled to the balance of the net income from the Property during the N5-year period that D is entitled to receive Preference Returns.[7] (See clause 5.1.1.) If the net income for a year (computed before subtracting C's "maximum deduction" for that year) is a negative figure, however, D is not entitled to a Preference Return for that year, and the parties will share the loss b% to C and a% to D. (See clause 5.2.) Under clause 5.3, after D15, C and D are entitled to b% and a%, respectively, of the net income from the Property. (See clauses 1.18 and 1.27.)

Clause 9.1 provides generally that all liabilities and expenditures shall be borne by the Beneficial Owners in the Proportions. Initially, the Beneficial Owners are C and D. (See clause 1.5.) The Proportions are defined to be b% for C and a% for D. (See clause 1.24.) Clause 5 provides special allocations during the first N3 years of the co-ownership. During the period from D4 to D6, C has to pay all deductions[8] in each accounting year up to a maximum of $s minus any amount of rent that exceeds $b. During the period from D7 to D8, C has to pay all deductions in each year up to a maximum of $t minus any amount of rent that exceeds $c. After D8, the parties share liabilities and expenditures based on their Proportions.

Clause 5.4.2 provides special allocation rules concerning the depreciation of the Property. For the period ending D19,[9] depreciation is allocable b% to C and a% to D. For calendar years beginning after D19, all depreciation is allocable to C until its capital account reaches zero at the end of the calendar year to which such depreciation is attributable (after first taking into account other adjustments to C's capital account for such calendar year). If C's capital account reaches zero, depreciation is allocable to D until its capital account reaches zero at the end of the calendar year to which such depreciation is attributable (after first taking into account other adjustments to D's

---

[7]The Response to National Office's Questions states, with respect to question number 13, that D had to achieve a certain minimum rate of return in order to satisfy certain Country2 regulatory requirements and the Preference Return was given to achieve this required minimum rate of return. In footnote 3 of the taxpayer's submission dated D18, it states that D's desire to obtain the Preference Returns was based on Country2 industry accounting conventions that encouraged early and preferred returns. Further, the record of this case also suggests that D received its preference returns in exchange for agreeing to exercise less than its proportionate a% interest in the management of the partnership.

[8]As stated above, the term "deductions" does not include depreciation, which is discussed below.

[9]Clause 1.2 of the co-ownership deed provides that the accounting year of the partnership ends on March 31. Also, given the fact that the building was completed in Year5, it appears that this rule may apply during all times prior to D19.

capital account for such calendar year). If D's capital account reaches zero, depreciation is allocable b% to C and a% to D.

Under clause 5.4.3, a special rule applies for computing the capital accounts if D assigns its interest to a third party that is a United States Person, as defined in clause 1.31. In that situation, depreciation is allocated to such person in proportion to its interest until C's capital account is reduced to zero. Thereafter, depreciation is allocated solely to such person.

Clause 5.4.4 modifies the rules for computing the capital accounts of the two partners in the event of a sale of all or part of the Property. In this event, the income from the sale is allocated between C and D so that the ratio of C's capital account to D's capital account after such allocation equals as nearly as possible the ratio of C's capital account to D's capital account that would have existed if depreciation were allocated between C and D in the amounts of b% and a%, respectively.

Clause 5.4.6 provides that each item of income, gain, loss, deduction, and credit from the Property as determined for U.S. federal income tax purposes shall be allocated to C and D in the same manner as they are allocated for purposes of computing the parties' capital accounts, except to the extent otherwise required by section 704(c).

Clause 11 imposes some restrictions on the parties' ability to transfer or encumber their interests in the Property. First, neither party may assign or encumber its interest in the Property to or in favor of a third party if such action would cause the other party to be in breach of any regulatory or statutory requirements. Second, a party's ability to transfer an interest in the Property to a person carrying on an X Business as defined in clause 1.14, is limited. Third, the non-transferring party shall have a right of first refusal with respect to any transfer. Finally, the non-transferring party is entitled to provide the transferring party with a schedule specifying persons to whom a transfer would be objectionable on reasonable legal, regulatory, or commercial grounds, and no transfer may be made to that party. In the case of transfers to affiliates, in addition to the limitations on transfers to persons carrying on an X Business the transferring party must provide evidence of the financial status of the affiliate and, if the other party reasonably requires, must guarantee the obligations of the affiliate. Furthermore, the affiliate must agree to reassign the transferred interest to the transferring party in the event it ceases to be an affiliate of the transferring party. If the restrictions in clause 11 are met the parties have the right to sell their respective "Share" to a third party. Clause 1.25 defines "Share" to mean the equitable interest in the Property held by a Beneficial Owner under the trust created by the co-ownership deed.

Paragraph four of the First Schedule, attached to the Co-Ownership Deed, requires C to pay b% and D to pay a% of the costs of an appraisal (in the absence of direction) if one is needed to settle a dispute by one of the parties as to the value of its respective Share.

The Taxpayer's Reporting of the Transfer

A's consolidated federal income tax return for Year5 included C as a member. On that return, the following loss was claimed on the sale of the Property from C to D:

Basis	$p
a% of Basis	$u
Present Value of "Preference Returns"	$v
Selling Expenses	$l
Adjusted Basis	$w
Less: Sales Proceeds	$e
(Gain) Loss	$x[10]

On A's amended consolidated federal income tax return for Year5, A claimed a loss greater than that reported on its initial tax return. The calculation of the loss is as follows:

Basis	$p
a% of Basis	$u
Present Value of "Preference Returns"	$z
Selling Expenses	$l
Adjusted Basis	$aa
Less: Sales Proceeds	$e
(Gain) Loss	$ab[11]

On audit, and based upon an appraisal dated D14, A claims it sold an increased interest to D. The appraisal concluded that the fair market value of C's and D's interests in the Property was $o and $n, respectively. Using the values arrived at in the appraisal, A concludes that C actually sold a d% percent interest in the Property to D. A reaches this result by adding the fair market value of C's interest to the fair market value of D's interest to come up with a fair market value for the Property of $ad. A then divides the appraised fair market value of D's interest by the sum of the appraised values of C's and D's interests in the Property ($ad) to conclude that D owned a d% percent share of the Property. By increasing the interest it sold to D, A purports to have recognized a significantly increased loss on the transaction. From the foregoing, A's computation of the loss incurred on the sale of the Property to D is as follows:

Cost Basis	$p
d% of Basis	$ae

[10] The equivalent of the loss claimed in U.S. dollars is $y.

[11] The equivalent of the loss claimed in U.S. dollars is $ac.

Selling Expenses	$l
Adjusted Basis	$af
Less: Sales Proceeds	$e
(Gain) Loss	$ag

LAW AND ANALYSIS

Issue 1: Is the Substance Of the Series of Transactions Involving the Property a Sale of Part of the Property or An Economic Sham

The incoming memorandum states that A reported this transaction as a sale on its original and amended federal income tax returns. The field argues, however, that the transaction is an economic sham.

In general, a "sale" is a transfer of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). The test for determining whether a transaction is a sale, as opposed to either a lease or a mere financing arrangement, is whether the benefits and burdens of ownership have passed to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987). Thus, whether a transaction is a sale, lease, or financing arrangement is a question of fact that must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955).

The Tax Court generally considers the following factors when determining whether the benefits and burdens of ownership have passed to a purchaser: (1) whether legal title passed to the purported purchaser; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the contract of sale created an obligation on the part of the seller to execute and deliver a deed and an obligation on the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays income and property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the operation, retention and sale of the property. See Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981).

Although no single factor under the Grodt test determines whether a sale has occurred, the relative importance of each factor is determined by the facts and circumstances of the particular transaction. For example, whether the buyer has acquired an equity interest in the property is the most significant factor that distinguishes a bona fide sale from a mere financing arrangement. Thus, the acquisition of an equity interest may be considered substantive evidence of a sale, especially when the form of the transaction is a sale. See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976). However, a taxpayer who does not acquire an equity interest in a property will not have a depreciable interest in that property either and, thus, will be viewed as having attempted to acquire mere tax benefits. See Houchins v. Commissioner, 79 T.C. 570, 602 (1982).

Equity is the excess of a property's fair market value over the outstanding balance of any loans encumbering that property. Stated differently, equity is the amount of money that the owner of a property is risking by owning the property. Thus, the owner of a property will profit if the value of the property increases and will suffer a loss if the value of the property decreases.

In contrast, an economic sham is a transaction without economic substance or a business purpose. Economic substance generally is found when the taxpayer has the expectation of economic profit apart from the realization of tax benefits from the transaction. Economic profit exists where the projected or anticipated residual value of the property plus the cash-flow generated by the property permits the new owner of the property to recoup its initial cash investment, pay all debt service and expenses, and return a profit when the property is resold. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91-94 (4th Cir. 1985). Other factors relevant to determining whether a transaction has economic substance apart from tax benefits include the presence or absence of arm's-length price negotiations, Helba v. Commissioner, 87 T.C. 983, 1005-07 (1986); the relationship between the sale price and fair market value, Zirker v. Commissioner, 87 T.C. 970, 976 (1986); the structure of the financing; and the degree of the parties' adherence to contractual terms, Helba, 87 T.C. at 1007-11.

When determining whether a transaction is an economic sham, a court generally will examine the business purpose of the transaction. This inquiry examines the taxpayer's subjective purpose for entering into the transaction. Packard v. Commissioner, 85 T.C. 397, 417 (1985). For example, statements of corporate directors or officers in the minutes of meetings related to the transaction are relevant to finding a business purpose. Statements that indicate legitimate business purposes for choosing a particular structure include those that relate to leveling or removing debt, lowering operating costs, increasing pre-tax revenue, arranging financing or insurance, or complying with federal or state regulations.[12]

---

[12]The economic substance and business purpose inquiries are closely linked to the general inquiry into whether a transaction is an economic sham. The computer leasing cases are excellent examples of the relationship of these three inquiries in determining whether a transaction has been entered into primarily to obtain tax benefits. Compare Levy v. Commissioner, 91 TC 838 (1988) (multiple-party equipment leasing transaction was not a sham; taxpayers had acquired benefits and burdens of ownership of the equipment, investment was at risk, and transaction was entered into for profit) with Goldwasser v. Commissioner, T.C. Memo 1988-523 (petitioner did not have business purpose for entering into lease of certain computer equipment;

For example, Miller v. Commissioner, 68 T.C. 767 (1977), illustrates how a court will examine of all of the facts and circumstances, including whether a valid business purpose exists, to determine the economic substance of a transaction. In Miller, College leased land to CDC for $1 per year. Immediately thereafter, CDC leased the land, plus buildings to be constructed thereon, to College for 25 years under a leaseback agreement. CDC then constructed two buildings on the land to College's specifications. CDC signed a 25-year mortgage note from Bank to finance construction. That note was secured by College's interest in the land and the buildings to be built and by College's payments to CDC under the leaseback. College's net monthly rental payments under the leaseback agreement equaled the sum of CDC's monthly mortgage payments plus $543 per month. At the end of the leaseback term, which coincided with the end of the payments to Bank on the mortgage note, College automatically will acquire title to the buildings (as well as the reversion of the land) with no additional payments being necessary. During the term of the leaseback, College paid all maintenance, taxes, assessments, and insurance on both the land and the buildings. Miller acquired CDC's rights under the leaseback, but not CDC's obligations thereunder, for $49,000.

After examining all the facts and circumstances, the Miller court found that the $543 per month payment to CDC, though denominated as "rent," actually was a series of fee payments for services provided by CDC to College. Thus, all Miller had acquired for his $49,000 payment to CDC was a right to the stream of $543 monthly payments for the duration of the leaseback. He did not acquire ownership of the buildings. 68 T.C. at 776. The court noted that "the key" to CDC's financing package was the fact that nonprofit institutions, (i.e., College) cannot use tax benefits (i.e., depreciation) whereas private investors can. The court distinguished the legal right of every taxpayer to legally reduce taxes from certain business arrangements that must be closely scrutinized to ensure they "have purpose, substance, or utility apart from their anticipated tax consequences." Id. In essence, the court found that the mortgage was made to College, not CDC, and that College, not CDC, had made the capital investment in the buildings. CDC was found to be a mere straw corporation that held only the barest of legal title. Because neither CDC nor Miller made any capital investment in the buildings, the court held that neither was entitled to depreciation or amortization. Accordingly, under the substance of the transaction, College owned the land and the buildings.

C's case differs from the economic sham cases, which often involve a circular flow of funds or an anticipated, pre-tax economic return that is insignificant compared to the anticipated, after-tax net returns. See Knetsch v. United States, 364 U.S. 361 (1960); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998). C and D

---

transaction did not have economic substance, and petitioner did not prove that he acquired burdens and benefits of ownership of equipment or that nonrecourse note used to finance transaction constituted genuine indebtedness).

structured their transaction as a sale to D of a portion of C's interest in the Property, with the Property to be held and managed in a co-ownership arrangement that the parties agreed to treat as a partnership for federal income tax purposes. C received $e from D and both parties acted in accordance with the draft co-ownership deed reflecting D's interest in the Property and entitlement to receive special returns for the first N5 years of the underlease. No one has argued that this flow of funds was circular. Moreover, the facts of the case suggest that the transaction was not motivated solely to avoid taxes or to generate losses. C had valid business reasons for entering into the transaction, principally a desire to reduce its exposure to the vagaries of the local real estate market. Accordingly, unlike the taxpayer in Miller, D acquired more than a series of cash flows for its investment. When the Property is sold, C and D will share the proceeds based upon their relative capital accounts, subject to D's entitlement to receive at least a% of those proceeds. D will enjoy a gain if its share of the proceeds is more than its adjusted basis in the Property or suffer a loss if its share of the proceeds is less than its adjusted basis in the Property.

Applying the Grodt test to the facts of this case, we believe that C sold D an equity interest in the Property. C and D are not related parties. Upon receiving $e from D, C and D observed and performed their respective obligations under the Co-Ownership Deed as if it had been completed. A has consistently reported this transaction as a sale for federal income tax purposes. The fact that D is not entitled to immediate physical possession of the Property and not obligated to pay property taxes after the transaction does not change the outcome of this case because D's role as "co-landlord" under a net underlease to B is essentially a logical extension of its right of possession (i.e., all owners of property give up physical possession when their property is leased). C and D are entitled to profit from that lease. If B were to terminate its lease of the Property, C and D will be entitled to physical possession of the Property and/or rent from another tenant, and their joint obligation to pay property taxes will arise. Thus, we conclude that this transaction is not an economic sham.

Issue 2: Is the substance of the series of transactions involving the Property a financing arrangement?

The incoming memorandum also asks whether this transaction may be viewed as a "sale/leaseback" transaction for a% of the Property and, if so viewed, may be recharacterized as a financing arrangement for federal income tax purposes. Although this transaction was structured as a sale of a partial interest in the Property whose co-ownership would be treated as a partnership, not a sale/leaseback, examination of the precedent involving sale/leasebacks will be helpful. See, e.g., Rev. Rul. 72-543, 1972-2 C.B. 87 (transaction in form of "sale/leaseback" is financing where under terms of leaseback, taxpayer-lessee never actually parts with burdens and benefits of ownership to the property for federal income tax purposes).

The Supreme Court has long recognized the principle that a taxpayer may not disavow the form chosen for its transaction. It has observed that "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, Higgins v. Smith, 308 U.S. 473, 477 (1940); Gregory v. Helvering, 293 U.S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). Although taxpayers may not be able to disavow the form chosen for a particular transaction, the Service and the courts may pierce the form of a transaction and tax it according to substance.

For example, in Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939), a taxpayer conveyed property to a bank as trustee and then leased the property back for a term of ninety-nine years. The Supreme Court acknowledged that "in the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." Id. at 308 U.S. at 260. The Court agreed with the taxpayer that the transaction, though structured in the form of a sale/leaseback, was in substance a loan secured by the property. It held that the taxpayer, as the party who bears the burden of exhaustion of capital investment in the property, is entitled to the deduction for depreciation regardless of the fact that the taxpayer had by agreement designated another party as the legal owner. Lazarus is cited often for the proposition that, in the sale/leaseback area, the substance of the transaction, rather than its form, is controlling for federal tax purposes.

Frank Lyon Co. v. United States, 435 U.S. 561 (1978), is another case in which the Supreme Court examined the realities of a transaction to determine which party is entitled to claim deductions from the ownership of the property. The issue was whether a transaction in the form of a sale/leaseback should be recognized as such. There, a state bank, unable to obtain a mortgage to finance construction of a building for its headquarters, entered into a sale/leaseback agreement under which petitioner, Lyon, took title to the building and leased it back to the bank. The agreement obligated the bank to pay rent equal to the principal and interest payments on Lyon's mortgage and gave the bank an option to repurchase the building at various times at prices equal to the sum of the then unpaid balance of the mortgage, Lyon's initial $500,000 investment, and 6 percent interest compounded on that investment. On its tax return for the year in which the bank took possession of the completed building, Lyon accrued the rent from the bank and claimed as deductions depreciation on the building, interest on its construction loan and mortgage, and other related expenses.

The Service disallowed the deductions on the ground that Lyon did not own the building for tax purposes. The Service argued that while the form of the transaction was that of a sale/leaseback, in substance it was a financing transaction in which Lyon lent the bank $500,000 and acted as a conduit for the payment of principal and interest to the mortgagee. The Supreme Court stated that "[i]n a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred." It explained that "[i]n applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded 'the simple expedient of drawing up papers' [cite omitted] as controlling for tax purposes when the objective economic realities are to the contrary." 435 U.S. at 572-73. It analyzed the economic realities of the transaction and found that the agreement involved a true lease of the building and was not a mere financing device under which the bank would be considered the tax owner of the building. The Court stated:

> [W]here...there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, i.e., imbued with tax independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts.

Id. at 583-84.

The Frank Lyon court held that the taxpayer owned the property for federal tax purposes because his capital was invested therein. While Lyon did transfer the use and possession of the building to the bank, the Court found that he retained substantial burdens and benefits of ownership in the building including liability on the debt. In addition, Lyon was exposed to a residual value risk because the bank could walk away from the relationship at the end of the lease term, and probably would do so if the option price exceeded the then fair market value of the building. Frank Lyon is significant because it illustrates the principle that for federal tax purposes, the substance of a sale/leaseback transaction is controlling. To determine that substance, the Supreme Court will examine which party holds the burdens and benefits of ownership to the property.

Although Frank Lyon involved three parties and this case involves only two, we think that Frank Lyon is relevant because it (1) examined the substance of the transaction, (2) addressed the importance of the taxpayer's having capital at risk in determining the bona fides of the transaction, and (3) looked behind the matching of a flow of funds to determine whether the transaction is, in substance, a financing. Therefore, we conclude that this transaction is not a financing arrangement because D lacks the critical indicia of a creditor. In particular, D did not receive any evidence of indebtedness concerning its $e investment and is not entitled to a stated rate of return on that investment. Furthermore, although D is entitled to special returns under the Co-Ownership Deed, D is not entitled to receive all its money before C receives any of its money in the event the Property is sold. Unlike most financings, D does not receive a sum certain by a certain date that resembles a repayment of principal. Its return can fluctuate. As discussed earlier, if the value of the Property appreciates, D will share in that appreciation. If the value declines substantially, D bears the risk of economic loss. If D wants to transfer or assign its interest in the Property, D first must offer it to C. Each of these features distinguishes this case from a "financing" where the opportunity for gain and risk of loss generally is fixed or subject to a "collar." Accordingly, D's interest in the Property is akin to that of an equity holder, not a mortgagee, which indicates that the transaction is a sale. Lastly, we note that the character of the transaction as a sale is consistent with the form of the transaction as a sale.

Issue 3: If the substance of the transactions is a sale of part of the Property, what portion of the Property was sold?

The key to determining the portion of the Property sold to D is to determine over what portion of the Property the benefits and burdens of ownership passed to D. As discussed above, the Tax Court generally considers eight factors when determining whether the benefits and burdens of ownership have passed to a purchaser. See Grodt & McKay Realty, Inc., 77 T.C. at 1237-38. Whether the benefits and burdens of ownership have passed is a question of fact that must be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956).

The portion of the Property sold is inherently a factual determination. Based on our review of the documents submitted to the National Office, we believe there are definitive indicators that should be considered in resolving this question. Such indicators are found in the documents executed by the parties, the internal memoranda leading up to the transactions, and all the facts and circumstances surrounding the transactions as we know them.

As a legal matter, our interpretation of the four-corners of the Co-Ownership Deed indicates C sold at least a a% ownership interest in the Property to D. The Co-Ownership Deed gives D certain rights and responsibilities vis-a-vis the Property. Clauses 9.1 and 5.4.2 of the Co-Ownership Deed generally require D to be responsible for a% of the liabilities, expenditures, and depreciation of the Property. Clause 5.3 of the Co-Ownership Deed entitles D to a% of the net income from the Property after the period of special allocation of income is complete. If there is a net loss, clause 5.2 requires D to be responsible for a%. However, because the Co-Ownership Deed grants D a preferred or special allocation of partnership income for the first N5 years of the partnership, it is not clear and unambiguous[13] exactly how much, if any, of the Property

[13] Cf. Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959).

in excess of a% was sold. Consequently, it is necessary to consider extrinsic evidence to determine the nature of the item D exchanged to receive the special allocation (i.e., whether it was cash and related to the purchase of a larger than a% interest in the Property, whether it was some non-cash partnership benefit D gave to C, or whether it was some combination of the two.)

On its initial and amended returns, taxpayer calculated its gain/loss from the sale of the Property by allocating a% of its basis against the total consideration received from D. Such a position is rather close to the position taken on the initial tax return filed for the partnership for Year5, in which D's initial capital account was stated at approximately f% and C's capital account was stated at approximately g% of the total capital in the partnership. Further, the partners' respective interests in the capital and profits of the partnership were detailed as a% for D and b% for C. As discussed below, we are not persuaded by the taxpayer's after-the-fact restatement of these accounts for Year6 and beyond.

Upon audit, however, taxpayer now asserts a different theory for calculating the gain or loss from the sale. Taxpayer now asserts that it actually sold a d% ownership interest in the Property. A requested an appraisal of C's b% interest and D's a% interest as of D11. The appraisal valued D's a% interest at $n, taking into account D's right to the Preference Return, and valued C's b% interest at $o, taking into account C's limited right to rental income during the Preference Return period. A used these numbers to determine that D purchased a d% percent interest by dividing the appraised value of D's interest by the sum of the two values (i.e., $n/$ad = d%). By this method, taxpayer attempts to transform an appraisal of an a% interest in the Property into the justification for a claim that it sold a d% percent interest in the Property. We reject taxpayer's theory because it is not consistent with the documents executed by the parties, the internal memoranda leading up to the transactions, or common-sense business practices.

In a straightforward partnership arrangement with no special allocations, if C had sold a a% interest in the Property to D and the parties formed a partnership immediately thereafter by contributing their respective interests in the Property, D would have a a% interest in the partnership capital and profits and would be entitled to a% of the income, deduction, loss, and credits of the partnership. However, the Co-Ownership Deed here, which acts as the partnership agreement among the partners, clearly grants D a preferred or special allocation of partnership income for the first N5 years of the partnership. This preferred allocation is not offset by special allocations of partnership income to C in later years. Rather, after D has received its preferred returns for the first N5 years of the underlease, D is entitled to a% of the net income produced by the partnership. Further, upon disposition of the Property D is entitled to no less than a% of the proceeds.[14] These allocations from the Co-Ownership Deed

---

[14] Taxpayer argues that C sold a d% interest in the Property to D. Taxpayer tries to buttress its argument by stating that the initial capital accounts of the partnership were

suggest that D has an equity interest in the partnership, beyond the period for which its is entitled to preferred or special allocations of rental income, in an amount equal to a%. Accordingly, it appears that C sold at least a a% interest in the Property to D.

A memorandum leading up to the transactions suggests that D received the preferential or special allocations in excess of a% of the rental income in exchange for agreeing to exercise less than a a% interest in the management of the partnership and the Property. Further, another memorandum, dated D20, just four months prior to D5, states that the consideration to be paid by D ($e) would result in D overpaying for its a% interest by $ak. If the overpayment is subtracted from the actual consideration to be paid by D, and divided by the a% described as being sold, the result is the value of the Property according to taxpayer's calculations at that time. The calculation results in a value for the Property of approximately $aj, which is significantly in excess of the value of the Property asserted by taxpayer on audit. If the total consideration paid by D is divided by the estimated value of the Property suggested in the memorandum, D would have been paying approximately f% (with C retaining g%) of the total value of the Property. These percentages are the exact percentages credited to C's and D's capital accounts on the partnership's initial tax return, discussed above, and seem to be a strong indicator of the parties' agreement. The memorandum dated D20 was written just four months prior to D5, and taxpayer has presented no persuasive evidence that the Property significantly declined in value before D5 and that the parties took this into account in their negotiations.[15] This suggests that while C may have sold a greater than a% interest in the Property to D, the amount actually sold was not much greater than a%.

Finally, it appears that standard business practices would dictate that when property is being sold the buyer and seller would first agree on the portion of the property to be sold and then determine the consideration to be paid for such portion. Supporting this conclusion is the fact that ten months prior to D's first payment on D5, D offered (and C rejected) to purchase a h% interest in the Property for the exact consideration eventually paid by D. D's prior offer to purchase the Property indicates

---

established with D's capital account representing d% of the total capital in the partnership and that if the Property were sold the day after the formation of the partnership, D would have been entitled to its $n contribution to the partnership (which taxpayer claims was d% of the total capital of the partnership). Because the partnership's initial tax return shows otherwise, we reject taxpayer's representation that the partnership's capital accounts were initially established with D's capital account showing a d% interest of the total capital in the partnership. Further, and as discussed more fully in the text, we reject taxpayer's reliance on the appraisal it received.

[15] We note that the taxpayer has relied on certain other memoranda to assert that the value of the property was less than that which can be surmised from the memorandum prepared on D5. However, considering all the facts and circumstances, we find taxpayer's assertions unconvincing.

that both C and D were conscious of the need to identify the consideration paid and the portion of the Property being purchased. Further evidence is found in a memorandum dated D20, which is after D's offer and prior to D5, which states that D was going to overpay for its a% interest in the Property but that the preferred returns would make up for the difference. With that in mind, it strains credulity to accept taxpayer's assertion that C sold a d% interest in the Property to D. Taxpayer's position is based upon an appraisal of the Property that was conducted after the actual transaction had been consummated and, as discussed below, is based on a value of the Property on an irrelevant date. It is difficult to accept that sophisticated taxpayers such as C and D would enter into a significant transfer of property without first clearly identifying the portion of the property sold and the amount of the consideration to be paid, especially in light of the fact that the buyer made a prior offer to purchase a specific portion of the property for the exact consideration eventually paid. However, taxpayer would have the Service believe that C and D entered into their transactions agreeing upon the consideration to be paid but with the portion sold to be determined by an appraisal to be completed after the actual sale.[16] Such a position is not only inconsistent with the plain language of the documents carrying out the transactions and the internal memoranda prior to the transaction, but it is inconsistent with what we believe to be common business practices and common sense.

Moreover, taxpayers methodology in determining the portion of the Property which was sold is logically flawed. Taxpayer uses the appraisal conducted by Appraisers, to conclude that C sold a d% interest in the Property to D. However, the appraisal of the Property provided an estimate of the value of the Property as of D4. We believe that the proper time to analyze the portion of the Property sold is D5 which is when D made its first payment and agreed to enter into the transaction to purchase the property. The value of the Property on D5 is a factual matter, but we believe, based upon the documents executed by the parties and the internal memoranda leading up to the transactions, that it was approximately $aj. On the other hand, carrying taxpayer's methodology to its logical extreme results in treating D as purchasing the entire Property if the value of the Property fell sufficiently in value between D5 and D4. This illustrates the flaw in the logic of the taxpayer's methodology. The portion of the Property that was purchased by D was not dependent upon the change in value of the Property after D5. Whatever deal was struck by C and D was struck as of D5, the date that D made a payment of $f and C became legally obligated to follow through with the sale upon D's payment of the remainder of the purchase price. As suggested by the memorandum dated D20, the value of D's interest in the Property as of D5 was approximately $ai and the total value of the Property was approximately $aj.

Based on the legal documents and the substance of the transactions, we believe that C sold at least a a% interest in the Property to D, but the actual portion sold is not

---

[16] We note that the appraisal was completed more than 16 months after D had paid the full purchase price for its interest, and after the due date for the partnership's initial tax return.

the d% interest asserted by the taxpayer. The underlying documents, the internal memoranda leading up to the transactions, and all the facts and circumstances suggest that the actual portion of the Property sold by C to D is much closer to a a% interest in the Property than the d% claimed to have been transferred by taxpayer.

Issue 4: If the substance of the transactions is a sale of part of the Property, how should the taxpayer's basis in the Property be allocated for determining the gain or loss on the part sold?

Section 61(a)(3) of the Internal Revenue Code provides that gross income includes gains derived from dealings in property.

Section 1001(a) of the Code provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in section 1011, and the loss shall be the excess of the adjusted basis over the amount realized. Section 1001(b) defines the amount realized from the sale or other disposition of property as the sum of any money received plus the fair market value of any property received.

Section 1011(a) of the Code provides that the adjusted basis for determining gain or loss from the sale or other disposition of property shall be the basis (determined under section 1012 or other applicable sections of subchapter O and subchapters C, K, and P), adjusted as provided in section 1016.

Section 1012 of the Code provides that the basis of property shall be the cost of the property, except as otherwise provided in subchapter O and subchapters C, K, and P. Section 1.1012-1(a) of the Income Tax Regulations defines cost to be the amount paid for the property in cash or other property.

Section 1016(a)(1) of the Code requires a property's basis be adjusted to reflect expenditures, receipts, losses, or other items properly chargeable to the capital account. Additionally, under section 1016(a)(2), basis is decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion. See also section 1.1016-3(a) of the Regulations. The taxpayer usually bears the burden of proving the adjusted basis of property. Burnet v. Houston, 283 U.S. 223, 227-228 (1931).

When only a part of a larger property is sold, section 1.61-6(a) of the Regulations provides that the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part.

B's basis in the Property was $p. Under the Agreement for Lease between B and C (dated D1), B transferred the right to obtain a 999-year lease of the Property. C agreed to issue N1 shares of $a nominal value stock to B at the time the lease was executed and to pay B a yearly rent of one peppercorn (if demanded). We do not know whether C ever issued the stock to B, who, as we understand the facts, already owned all of C's stock. We do know that the lease was not executed until D13, but at that time the parties were B and D and E. Nevertheless, the transfer of the right to obtain a 999-year lease of the Property at stated nominal consideration under the Agreement for Lease is a transfer of property subject to section 351 of the Internal Revenue Code. As a result, C's basis in the Property carries over from B under section 362.

Under section 1.61-6(a) of the Regulations, C is required to equitably apportion its basis between the part sold and the part retained. The portion of the Property sold must be determined by the field. Based upon the information we have reviewed, it appears that the basis of the Property should be allocated in the same proportion as the portion determined to be sold in issue three.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.