 APPEALS

COMPLIANCE COORDINATED ISSUE PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: Leasing Promotions

ISSUE: Losses Reported From Inflated Basis Assets

From Lease Stripping Transactions (Supersedes Appeals Settlement Guidelines dated May 3, 2004)

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SETTLEMENT GUIDELINES

LOSSES REPORTED FROM INFLATED BASIS ASSETS

FROM LEASE STRIPPING TRANSACTIONS

UIL 9226.01-00

Appeals has reevaluated its settlement position with respect to Losses Reported from Inflated Basis Assets from Notice 2003-55, 2003-2 C.B. 395 Lease Stripping Transactions. The reevaluated settlement position on this issue is set forth in this document and compliments the revised Coordinated Issue Paper on Losses Reported from Inflated Basis Assets from Lease Stripping Transactions, approved March 15, 2005. The Service has successfully litigated several cases involving Lease Stripping Transactions where the courts denied taxpayers losses or deductions because they relate to transactions that lack business purpose and economic substance.[1]

STATEMENT OF THE ISSUE

Whether losses and deductions reported from assets with bases traceable to lease stripping transactions are allowed for federal income tax purposes?

COMPLIANCE POSITION

The theories upon which the Service will challenge losses and deductions stemming from assets with bases traceable to lease stripping transactions must be determined on a case-by-case basis depending on the specific facts and circumstances of each case. In appropriate cases, the bases of such assets either will be limited to their fair market value or take into account the amount of liabilities assumed in the initial Internal Revenue Code (IRC) § 351 transaction, so that a taxpayer's later taxable sale of such assets will result in an appropriate amount of loss. In other cases, the initial sale of the leased property may be recast to eliminate a tax neutral entity's transitory ownership of the property.

The Service will disallow such losses for one or more reasons, including but not limited to the following theories, code sections and regulatory provisions: the economic substance doctrine and various substance-over-form arguments; IRC §§ 351, 357, 358, 269, and 482; and Treasury Regulation § 1.701-2 (the partnership anti-abuse rule).

On March 15, 2005 the Compliance Coordinated Issue Paper on Losses Reported from Inflated Basis Assets from Lease Stripping Transactions was approved. Compliance has raised the following theories with respect to this issue:

A. Lack of Economic Substance

[1] Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006), also involved a Contingent Liability shelter. The court rejected the Service's statutory legal arguments under §§ 357(b) and 357(c).

B 1. Substance Over Form Analysis

2. Section 351

3. Reduction of Stock Basis Due to Assumption of a Transferor’s

Obligations

a. Section 357(b)(1)(B)

b. Sections 357(c)(3) and 358(d)(1)

c. Section 358 (h)

d. Sections 358(d) and 358(a)(1)(A)(i)

4. Section 362 (e)

5. Section 269

6. Section 482

7. Alternate Transaction: Transfer to Partnership – Treas. Reg. Section 1.701-2

C 1. Section 6662 Accuracy-related Penalty

2. Section 6663 Fraud Penalty

3. Section 6664(c)(1) Reasonable Cause Exception

4. Disclosure Initiative under Announcement 2002-2

Appeals Officers, Team Case Leaders, and Team Managers should consult with the Appeals Technical Guidance Coordinator, Corporate Tax Shelters-Leasing Promotions, with respect to alternative positions.

BACKGROUND

Inflated basis transactions are transactions in which assets with bases that exceed their fair market values are created in conjunction with lease stripping transactions. (An earlier Compliance Coordinated Issue Paper (CIP), effective July 21, 2000, addresses the abuses in lease stripping transactions. See also Appeals Settlement Guidelines (ASG), Lease Stripping Transactions, effective May 21, 2003.) The inflated basis assets are then transferred to entities that utilize the built-in losses from such assets to reduce their taxable income. The initial steps of the transaction described below that purportedly create either an inflated basis stock interest or an inflated basis partnership interest are designated as listed transactions pursuant to Notice 2003-55, 2003-2 C.B. 395 ("Accounting for Lease Strips and other Stripping Transactions").

The transactions in question involve a series of exchanges, several of which purport to comply with § 351. In one configuration of the transaction a partnership (the "transferor"), which is 99% owned by tax neutral partners, transfers a third party note to a corporation (the "transferee") in exchange for preferred stock of the transferee, and the transferee's assumption of a rental obligation of the transferor that is roughly equal to the amount of the note. The transferor claims its basis in the transferee's stock is equal to the transferor's basis in the third party note, unreduced by the amount of the rental obligation assumed (thereby creating an inflated basis asset). The transferor subsequently exchanges the transferee's stock in a second § 351 (carryover basis) transaction, thereby allowing the second transferee to claim a substantial, non-economic capital loss when it subsequently sells the first transferee's stock.

In an alternative configuration of the transaction, the tax neutral partners of the first transferee (above) (who claim an inflated basis in their partnership interest as a result of § 705(a)(1)(A)), transfer their partnership interest to a corporation (the transferee) in a purported § 351 transaction. As a result of the transferee's purported carryover basis in the partnership interest, the transferee later claims a substantial deduction.

While there will be differences among the various cases with respect to the purported business purpose and the structure of these transactions, it is the Service's position that any business purpose is far outweighed by the taxpayers' interest in generating tax deductible losses. Adequate factual development is necessary to evaluate and assess the taxpayers' purported business reasons for entering into these transactions. Many of the legal arguments require adequate factual development, and not all arguments will be applicable to each case.

EXAMPLE INFLATED BASIS TRANSACTIONS (See Diagrams Below)

A, a corporation, owns depreciable equipment subject to a pre-existing user lease with an X year term. B, a partnership, purchases the equipment (subject to the user lease) from A in exchange for a $100x note. B immediately leases the equipment back to A for a term of X years and total lease payments due of $99x. B then sells the equipment (subject to the user lease) to I, another corporation, in exchange for I's $100x note; I immediately leases the equipment back to B for a term of X years and total lease payments due of $99x. The residual value of the equipment at the end of X years is minimal or zero.[2] B then sells its right to receive rental payments from A to an unrelated party (a bank), thereby accelerating the income due under the lease. B allocates 99% ($98x) of the income to C, its 99% majority partner. C, which had contributed a negligible amount for its interest in B, is a tax neutral entity. Under § 705(a)(1)(A), C's basis in B is increased by approximately $98(x), which is the amount of C's distributive share for the taxable year in which the income due under the lease was accelerated. B uses the sale proceeds to satisfy its note to A.

[2] The Lease Stripping Coordinated Issue Paper (July 21, 2000) addresses the theories upon which the Service might successfully challenge the tax consequences reported from lease stripping transactions. See also Notice 2003-55, 2003-2 C.B. 395.

Thereafter, two possible transactions take place. In the first configuration of the transaction, B transfers its I note to D, a corporation, in exchange for D preferred stock and D's assumption of B's liability to make lease payments to I. D's parent, E, makes a simultaneous transfer of property to D as a party to a purported § 351 transaction. B takes the position that this exchange qualifies as a § 351 exchange and, thus, that its basis in the D preferred stock is equal to its basis in the I note ($100x), unreduced by the amount of the liability assumed by D. See §§ 357(c)(3) and 358. Subsequently, B transfers the D preferred stock to F in exchange for F preferred stock. F's parent, G, makes a simultaneous transfer of property to F as a party to the purported § 351 transaction. Although the fair market value of the F preferred stock received by B is $1x, F claims a $100 carryover basis in the D preferred stock pursuant to § 362. When F later sells the D preferred stock to H for its fair market value ($1x), F claims a $99x loss. (At the time B transfers the D preferred stock to F, F's sale of the D stock to H may have been prearranged. H is acting as an accommodation party.)

F stock(8) D stock (FMV=$1x)$1xGFBDED stockI note(6) §351F stock (FMV=$1)H(7) §351D stock (high basis/ low FMV)PropertyPropertyD stock and assumption of B liability to I(F claims $99 loss on the sale of D stock)X C

In the second configuration of the transaction, after B sells A's rental obligation to the bank and uses the proceeds to pay off its note to A, C has an inflated basis in B. C exchanges its interest in B to D corporation in exchange for D preferred stock; D's parent, E makes a simultaneous transfer of property to D as parties to a purported § 351 transaction. Although the fair market value of the B interest received by D is approximately $1x, D takes the position that C's inflated basis in B carries over to D pursuant to § 362.[3] D then sells the B interest to H for its fair market value ($1x), claiming a $97x loss.[4] (The sale to H is prearranged when C transfers its interest in B to D. H is acting as an accommodation party.)

D stockInterest in B (high basis/ low FMV)$1xCDH§351D stockInterest in B (FMV=$1x)E(D claims $97x loss on the sale of the interest in B)XBProperty

This Appeals Settlement Guideline addresses various legal arguments that may be raised to prevent either F (in the first configuration) or D (in the second configuration) from claiming a loss as a result of acquiring an interest in an asset having an inflated basis traceable to a lease stripping transaction.[5]

TAXPAYER'S POSITION

Taxpayers assert that the basis results from bona fide third party indebtedness and unrelated end uses. Taxpayers disagree with each of the issues raised herein.

[3] C's purported basis in B was approximately $98x, which is C's 99% distributive share of B's income reported from the sale of the right to receive rent payments from A. See § 705(a)(1)(A) (providing that a partner's distributive share of the taxable income of the partnership increases that partner's basis in the partnership). This sale of 98% of the B interest also causes a termination of Partnership B under § 708(b)(1)(B). Therefore, B is deemed to contribute its assets to New B in exchange for New B interest and distributes out the New B interest to X and D in liquidation. See § 1.708-1(b)(4).

[4] Section 704(c) was amended by the American Jobs Creation Act of 2004, P.L. 108-357, § 833(a). Section 704(c)(1)(C) was added which disallows built in losses being allocated to noncontributing (which includes transferee) partners; however, those amendments are effective for contributions occurring after October 22, 2004, so they might not apply to the cases at issue.

[5] Although the discussion that follows focuses on the inflated bases of the D preferred stock and the B partnership interest, these assets' inflated bases can be replicated in a variety of other assets through subsequent carryover basis transactions. This Appeals Settlement Guideline applies to any asset with an inflated basis traceable to a lease stripping transaction.

DISCUSSION

Depending upon the facts and circumstances of the case, the Service may raise any one or combination of issues. The resolution of inflated basis cases is highly dependent upon the facts and circumstances. The following is a discussion of the legal theories advanced by the Service in response to losses and deductions reported from assets with inflated bases traceable to lease stripping transactions.

A. Primary Argument

LACK OF ECONOMIC SUBSTANCE

When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for Federal income tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Nicole Rose Corp. v. Commissioner, 117 T.C. 328, 336 (2001), aff'd, 320 F.3d 282 (2d Cir. 2003); ACM Partnership v. Commissioner, 157 F.3d 231, 246-47 (3d Cir. 1998), aff'g in part and rev'g in part, T.C. Memo 1997-115; United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994); Andantech L.L.C. v. Commissioner, T.C. Memo. 2002-97, aff'd in part and remanded in part, 331 F.3d 972 (D.C. Cir. 2003); Long Term Capital Holdings v. United States, 330 F. Supp.2d 122, 171 (D. Conn. 2004), aff'd without published opinion, 150 Fed. Appx. 40, 96 A.F.T.R. 2d 2005-6344, 2005-2 USTC-2 ¶ 50,575 (2d Cir. 2004); CMA Consolidated, Inc. v. Commissioner, T.C. Memo. 2005-16; and Santa Monica Pictures, LLC et.al. v. Commissioner, T.C. Memo. 2005-104.

The lack of economic substance argument hinges on all of the facts and circumstances surrounding the transaction. No single factor will be determinative. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). Whether a court will respect the taxpayer's characterization of the transaction depends on whether 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 primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978); ACM Partnership v. Commissioner, supra at 246-48; Casebeer v. Commissioner, 909 F.2d 1360, 1362-64 (9th Cir. 1990), aff'g Sturm v. Commissioner, T.C. Memo. 1987-625; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279-80 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001).

An evaluation of whether the lease stripping transaction lacked economic substance requires separate, but interrelated, inquiries: (1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an inquiry into the objective economic effect of the transaction. See ACM Partnership, supra at 247-48;

Casebeer, 909 F.2d at 1363; Kirchman v. Commissioner, 862 F.2d 1486, 1490-91 (11th Cir. 1989).

To satisfy the business purpose inquiry, the transaction must be "rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation." ACM Partnership, T.C. Memo. 1997-115, aff'd in relevant part, 157 F.3d 231 (3d Cir. 1998); see Kirchman, supra at 1490-91.

To satisfy the objective economic effect inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, supra at 248. Offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. See Knetsch, supra; Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543, 1549 (9th Cir. 1987); Bealor v. Commissioner, T.C. Memo. 1996-435 and cases discussed therein; Waegemann v. Commissioner, T.C. Memo. 1993-632. In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions. Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, supra at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-68 (1990). In conducting this economic review, it is appropriate to focus on the taxpayer's calculations at the outset of the transaction. ACM Partnership, supra at 257.

In ACM Partnership, the Tax 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. T.C. Memo. 1997-115. The Tax Court further 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 transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. Id. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

The Service has successfully litigated several cases involving Lease Stripping Transactions. In these cases, the courts denied taxpayers losses or deductions because they relate to transactions that lack business purpose and economic substance. See Andantech L.L.C. v. Commissioner, supra; Nicole Rose Corp. v. Commissioner, supra; Long Term Capital Holdings v. United States, supra; CMA Consolidated, Inc. v. Commissioner, supra; Transcapital Leasing Associates 1990-II, L.P. v. United States, 2006 WL 897723 (W.D. Tex., Mar. 31, 2006); and TIFD III-E Inc. v. United States, Dkt. No. 05-0064cv, Doc. 2006-14691.

In Andantech L.L.C. v. Commissioner, supra, the Tax Court disallowed deductions from a taxpayer's involvement in a lease stripping transaction. The taxpayer had acquired an interest in a partnership in a purported § 351 transaction, claimed a carry-over basis, and took depreciation deductions passed through from the partnership. The partnership held depreciable property whose income stream was stripped to an unrelated third party in return for a lump sum payment that was then allocated to a tax neutral entity, prior to the purported § 351 transaction. The Tax Court based its holding upon the following theories: 1) the partnership was a sham; 2) the participation of the initial partners was disregarded under the step transaction doctrine; and 3) the sale-leaseback lacked economic substance.

In addition, the Tax Court addressed alternative theories for disallowing the deductions. The Tax Court posited that, assuming the transaction did not lack economic substance, petitioners would still not be entitled to the depreciation because there was no true sale and the seller financing did not constitute bona fide debt.

On appeal, the D.C. Circuit agreed that the parties never intended to join together as partners to run a business and that the partnership had no legitimate non-tax purpose. As a result, it affirmed the Tax Court's holding that the Andantech partnership should be disregarded for tax purposes and remanded the other issues for further proceedings consistent with its opinion.

In Nicole Rose Corp. v. Commissioner, supra, representatives of Loral Aerospace Corp. (Loral) and Quintron Corp. (Quintron) were negotiating Loral's purchase of Quintron. Loral wanted to purchase the assets of Quintron. Quintron wanted Loral to instead purchase the stock of Quintron. Intercontinental Pacific Group, Inc. (IPG), facilitated the transaction by causing its dormant shell subsidiary QTN Acquisition, Inc. (QTN) to purchase the stock of Quintron. QTN then merged into Quintron, which sold its assets to Loral. The sale resulted in income to Quintron of approximately $11 million and produced cash to repay most of the loan that QTN had taken to purchase the Quintron stock. In the same month as the sale, Quintron obtained from an accommodation party an interest that included, among other things, an obligation to make lease payments, an interest in a trust fund that offset the obligation to make lease payments, and the right to receive lease payments that might be due on leased property during a 4-year renewal period under the terms of a "residual value certificate" (RVC). On the same day it acquired the interest, Quintron transferred it (minus the RVC) to a bank. As explained in the Tax Court opinion, Quintron reported approximately $22 million as ordinary business expense deduction from the transfer to the bank. The deduction offset Quintron's $11 million of income from its asset sale to Loral and resulted in Quintron reporting a net operating loss which it carried back to earlier years to produce refunds for those years.

The Tax Court stated that the complicated nature of the transactions "fails to mask the lack of business purpose and economic substance in key aspects of the transactions and the tax avoidance objectives thereof." Id. at 117 T.C. 338. The Tax Court found that the RVC was worthless. Id. Moreover, the Tax Court found that the intermediary, Quintron, “never had any genuine obligation with respect to the [interest in the trust fund and the offsetting obligation to make lease payments]” and that its sole purpose for engaging in the same day acquisition and transfer of the interests was to create the claimed tax deductions. Id. The Tax Court explained that the interest in the trust fund and the obligation to make lease payments “created essentially a circular flow of funds” so that no money was actually changing hands. Id. at 339. As a result, the Tax Court reasoned that the “petitioner had no legitimate interest of value in the trust fund and no legitimate obligations associated therewith.” Id. The Tax Court concluded that the petitioner's claimed tax deductions constituted “merely a tax ploy, a sham, without business purpose and without economic substance.” Id. at 340. The transactions were therefore to be disregarded for federal income tax purposes. The Tax Court’s holding was upheld by the Second Circuit.

In Long Term Capital Holdings v. United States, supra, the court found that a transaction from which the taxpayer reported a $106 million deduction from the sale of preferred stock that originated from lease stripping transactions lacked economic substance. The court concluded that the taxpayer had no business purpose for engaging in the transaction other than tax avoidance and that the transaction itself had no economic substance beyond the creation of tax benefits given that the taxpayer “could not have had any realistic or reasonable expectation that it would make a non-tax based profit” from it. Id. at 174. The appeals court agreed with these conclusions. The court rejected the taxpayer’s reliance on United Parcel Serv. of Am. v. Commissioner, 254 F. 3d 1014 (11th Cir. 2001). In that case the 11th Circuit determined that an internal restructuring of an ongoing business had a business purpose. In contrast, the court reasoned that the transaction in Long Term Capital Holdings was a one-time purchase of a tax product by the taxpayer “that would not have occurred, in any form, but for tax-avoidance reasons.” Id. at 190.

In CMA Consolidated, Inc. v. Commissioner, supra, and Transcapital Leasing Associates 1990-II, L.P. v. United States, 2006 WL 897723 (W.D. Tex., Mar. 31, 2006), courts held that two lease stripping transactions lacked economic substance. As a result, they sustained the disallowance of deductions that the taxpayers had reported from the transactions. The wins provide further support for the Service's position that the economic substance doctrine applies to disallow losses from transactions that lack business purpose and economic substance in general and lease stripping transactions in specific.

TIFD III-E Inc. v. United States, supra the Second Circuit found that the purported equity partners in a lease stripping transaction were not equity partners because they had no meaningful stake in the success or failure of the partnership. The Court noted in its opinion that the purported partners had income that was 98% defeasible, and was more in the nature of window dressing to give ostensible support to the characterization of equity participation, essential to the dominant tax objective, and was not a meaningful stake in the profits of the venture.

Based upon these decisions, Appeals believes the transactions outlined above, taken as a whole, have no business purpose independent of tax considerations. Because the lease stripping transactions in which B acquired the D preferred stock and in which C acquired the basis of its interest in B lacked economic substance, B's basis in the D preferred stock is limited to the value of the property B contributed in exchange for that stock, and C's basis in the interest in B is limited to the negligible amount it contributed in exchange for that interest. As a result, B would have minimal or zero basis in the D preferred stock for F to assume under § 362 in the first configuration, and C would have minimal or zero basis in the B partnership interest for D to assume under § 362 in the second configuration.

Moreover, because F and D had no valid business purpose for acquiring and selling the stock of D and the B partnership interest, respectively, those transactions lacked economic substance. As a result, F and the G consolidated group in the first configuration, and D and the E consolidated group in the second configuration, are not entitled to the losses reported from the transactions.

B. SECONDARY ARGUMENTS

The theories contained in the remainder of this paper assume that the lease stripping transactions, F's acquisition and sale of the D preferred stock in the first configuration, and D's acquisition and sale of the B partnership interest in the second configuration, are transactions that have sufficient economic substance to be respected for tax purposes. Although some of the facts that support a lack of economic substance argument also support the following arguments, a court's decision that a given transaction has sufficient economic substance under the Primary Argument section of this paper will not preclude the Government from arguing and prevailing upon the following theories. Moreover, some of the following arguments may assume that, solely for purposes of a specific argument, certain steps of the transactions are to be respected. This does not preclude the Government from arguing that these steps should not be respected in other arguments. The arguments, thus, apply in the alternative. Finally, Appeals Officers should be aware that many of these arguments reallocate losses and deductions away from the taxpayer under audit, to other parties to the transaction.

1. Substance Over Form Analysis

To curb inappropriate tax avoidance transactions, courts have created a broad array of common law doctrines that are designed to limit or eliminate unreasonable tax benefits. The central question in each of these doctrines is whether the form of a transaction reflects its real economic substance. If not, the Government may recharacterize a transaction so that its substance determines the tax consequences. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935).

The various doctrines, which all apply a "substance over form" analysis, go by a variety of names, including the substance over form doctrine, the step transaction doctrine, the business purpose doctrine, the sham transaction (or entity) doctrine, and the assignment of income doctrine. No bright line delineates when effective tax planning ends and abusive tax avoidance begins. The Government's success rate in applying these doctrines is highly dependent on the facts and circumstances of each case. The outcomes vary by jurisdiction. Generally, it makes little difference which doctrine a court uses to uphold a substance over form analysis because each doctrine will ultimately achieve a tax consequence that reflects the economic reality of the transaction. Accordingly, development of the underlying facts of these transactions and the application of appropriate judicial doctrines to those particular facts[6] is necessary. A brief description of the some of the various doctrines follows.

First, the substance over form doctrine allows the Service and the courts to recharacterize the form of a transaction if its economic substance is clearly at odds with its form. Gregory v. Helvering, supra*.* As with all these doctrines, its application is highly dependant on the underlying factual background of the transaction.

Similar to substance over form is the step transaction doctrine. Under this doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused towards a particular result. Courts have developed three alternative step transaction tests. The binding commitment test collapses separate steps only if, at the time the first step was taken, there was a binding commitment to undertake the later transactions. The end result test ignores formally individual steps if they constitute prearranged parts of a single transaction intended from the outset to reach a specific end result. Courts focus on whether the parties intended from the outset to reach a particular result, and on whether that result was actually achieved; the focus is not on whether the taxpayer had a tax avoidance motive. Finally, the interdependence test looks to whether the legal relations created by one step would have been fruitless without the completion of later steps. Steps are generally accorded independent significance if, standing alone, they were undertaken for valid and independent economic or business reasons.

The business purpose doctrine requires a taxpayer to have a valid business purpose for entering into a transaction, other than tax avoidance. When a transaction merely follows the literal letter of the Code, solely to achieve a tax result that was neither contemplated by the drafters of the statute nor reflective of the transaction's economic reality, the tax results can be successfully challenged under this doctrine. As stated by the Supreme Court, "[T]he question for determination is whether what was done, apart from tax motive, was the thing which the statute intended." Gregory v. Helvering, supra at 469.

[6] The Andantech and Long Term Capital Holdings opinions, supra, contain particularly good examples of the level of factual development that will be needed in order for the government to prevail on a substance over form argument.

A fourth weapon in the Government's arsenal is the sham transaction doctrine. In some circumstances, factual development may uncover that the purported transaction never actually occurred. In other transactions, the economics are such that no actual change in the legal or economic positions of the parties occurred (due to circular cash flows, guarantees and/or the unwinding of certain steps of the transaction shortly after the purported tax consequences were achieved). In these cases, the formalistic steps of a purported transaction may be ignored for tax purposes.

Finally, the assignment of income doctrine provides that a taxpayer may not shift income it has earned to another taxpayer.[7] For purposes of the transactions under consideration here, the principles underlying this doctrine may be relevant for determining who actually sold a built-in-loss asset, or alternatively, who actually owns the property generating the loss. Income and deductions should be reported by the party that sustains them.

Obviously, there is a great deal of overlap between the facts that support each of these doctrines (as well as the economic substance requirement set forth in the Primary Argument section of this paper). The application of one or more of these doctrines may be appropriate where, as here, a complex series of formalistic steps creates a desired tax benefit, and each step cannot be shown to have an independent business purpose that is necessary to achieve the stated business goal.

The factual record must flush out the substance of a given transaction. Important questions concern the transaction's stated non-tax business purpose and whether it was actually achieved, who actually financed and negotiated the transaction, who could actually profit from it, and who carried a legitimate risk of loss. The presence of certain factors increases the likelihood that the Government will prevail on a substance over form argument. These include: the presence of a promoter of tax avoidance transactions; tax neutral parties that take income or gains into account, while deductions flow to a taxable entity; newly created, transitory entities that are formed solely for the purpose of facilitating the creation of a tax benefit; transitory "ownership" interests in entities or assets having built-in losses, especially when such interests have little relation to the historic business of the acquirer; transactions that "unwind" themselves shortly after the tax benefit is achieved; circular or illusory transfers of property; and contractual arrangements that limit a participant's risk of economic loss and/or possibility of economic gain, apart from the tax consequences.

The transactions covered by this paper take many different forms and utilize many different structures. Accordingly, the hazards of litigation inherent in a given case are dependent upon a complete factual record. If the factual record shows that tax

[7] Though the assignment of income doctrine is a common law doctrine, its principles have been codified to some extent in § 482.

avoidance or evasion was the primary or sole motivation for the participants engaging in these convoluted transactions, then multiple arguments may be applicable to the case. The final determination of which of these doctrines is likely to prove most effective can only be made in light of the facts developed, taking into consideration the jurisdiction in which the case will be tried.

2. Section 351

Each purported § 351 transfer must be closely scrutinized to determine if all the technical requirements and the business purpose requirement of § 351 are satisfied. If the exchange fails to qualify under § 351, the transaction is taxed as a § 1001 exchange. Thus, each transferor and transferee would have a fair market value basis in any property it received in the exchange.

Section 351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock[8] in such corporation, and, immediately after the exchange such person or persons are in control of the corporation. For purposes of § 351, control is defined as ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation. Sections 351(a) and 368(c). The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met.[9]

[8] Note that for transactions occurring after June 8, 1997, the terms of the preferred stock received in any purported § 351 exchange should be closely scrutinized to determine if the stock is nonqualified preferred stock within the meaning of § 351(g). For purposes of § 351(g), preferred stock is defined as stock which is limited and preferred as to dividends and that does not participate in corporate growth to any significant extent. § 351(g)(3)(A). Preferred stock that meets this definition will be considered nonqualified preferred stock if it satisfies any one of several objective conditions set forth under § 351(g)(2)(A). Consideration should be given to the following: whether the stock is restricted; whether the rate of return on the stock is fixed or predetermined; whether there are repurchase and sale options and the likelihood that such options will be exercised, and whether the transferor has retained all business risks. If the transferor receives stock other than nonqualified preferred stock in the transaction, then the nonqualified preferred stock would be treated as “other property” and its basis would be limited to its fair market value under § 358(a)(2).

[9] Generally, to determine "control", a group of transferors may include all of the transferee stock owned directly (or, in the case of a transferor that is a member of a consolidated group, stock owned by any member of the transferor's group [Treas. Reg. § 1.1502-34]) by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. However, a transfer of transferee stock to an existing shareholder of the transferee will not be considered a part of the § 351 exchange if the value of the new stock issued to that transferor is relatively small compared to the value of the transferee stock already owned by that transferor and the primary purpose of the transfer to that transferor was to qualify other transferors for § 351 treatment. See Treas. Reg. § 1.351-1(a)(1)(ii) and § 3.07 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570.

In addition to the above statutory requirements, courts have developed a business purpose requirement in § 351.[10] See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989), contains the most thorough judicial exploration of § 351's business purpose requirement. Whether a valid business purpose underlies a transaction in which a taxpayer acquires an inflated basis asset traceable to a lease stripping transaction is a factual issue. Generally, a purported § 351 transaction will have sufficient business purpose if a taxpayer can substantiate that it had any valid business purpose for the transaction other than just pure tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191.

As noted above, if the transfer fails to qualify as a § 351 exchange, it is subject to § 1001. The transferor recognizes gain or loss at the time of the exchange.[11] The transferee generally does not recognize any gain or loss on the transaction. See § 1032.[12] Both the transferor and the transferee (B and D, and B and F, in the purported § 351 transactions involving D's preferred stock, and C and D in the purported § 351 transaction involving the transfer of the B partnership interest) would have a cost basis in the property received, determined in accordance with the provisions of § 1012 and the regulations thereunder. Thus, if the purported § 351 transaction involving B and D did not qualify as a § 351 exchange, B would have a fair market value basis in the D stock. Further, even assuming B's basis in the D stock was inflated as a result of the first § 351 transaction, if the purported § 351 transaction between B and F is successfully challenged, F would acquire the D stock with a fair market value basis. See § 1.1012-1(a) (providing that such property will take a basis equal to the fair market value of the property exchanged).

Similarly, in the second configuration, if the transaction between C and D fails to qualify for § 351 treatment, D's basis in the B partnership interest would be its fair market value, and no loss would be realized on D's subsequent sale of the B partnership interest to H.

[10] It has similarly been held that a transaction cast as a contribution under § 721 will not be given effect for tax purposes unless a valid business purpose motivated the transfer. Jacobson v. Commissioner, 96 T.C. 577, 590 (1991), aff'd, 963 F.2d 218 (8th Cir. 1992).

[11] Note that if the transferor and the transferee are members of the same consolidated group, recognition of any gain or loss will be deferred.

[12] Section 1032 provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation.

In sum, each purported § 351 transaction must be carefully scrutinized to determine whether the requirements of § 351 have been satisfied. If any exchange fails to qualify under § 351, it should be treated as a § 1001 transaction.

3. Reduction of the Transferor's Basis in the Transferee's Stock Due to the Assumption of the Transferor's Rental Obligation

When a transferor liability or obligation is assumed in a § 351 exchange, there are numerous alternative arguments that result in a reduction of that transferor's basis in the transferee's stock. Accordingly, in the transaction in which B transferred I's note to D in exchange for D's preferred stock and an assumption by D of B's rental obligation to I, the following arguments may be available to reduce B's basis in the D preferred stock.

a. Section 357(b)(1)(B)

Even if a court were to decide that the transaction between B and D qualified as a § 351 exchange, if the principal purpose for D's assumption of B's rental liability to I was not a bona fide business purpose, then such assumption (in the total amount of the liabilities assumed on the exchange) will be treated as money received by D on the exchange. See § 357(b)(1)(B). Additionally, if the assumption falls within § 357(b)(1)(B), then B's basis in the D preferred stock must be reduced by the total amount of B's liabilities assumed by D on the exchange. See § 358(a)(1)(A)(ii).[13]

Under § 357(a), a liability assumption in an otherwise tax-free exchange generally is not considered "other property or money received by the taxpayer". The legislative history of what is now § 357(a) indicates that it was designed to protect assumptions and transfers of liabilities occurring in the ordinary course of converting a business from one form to another.

Under § 357(b)(1)(B), if, taking into consideration the nature of the liability and the circumstances under which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption was not a bona fide business purpose, then for purposes of § 351 such assumption will be considered as money received by the taxpayer on the exchange. A taxpayer is under a statutorily imposed obligation to prove by a clear preponderance of the evidence that the principal purpose of a liability assumption is a bona fide non-tax business purpose.[14] Section

[13] In Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006), the 4th Circuit recently rejected the Service's argument that the assumption of a liability meeting the requirements of § 357(b) results in a reduction of the transferor's basis in the transferee's stock under § 358(a)(1)(A)(ii).

[14] Section 357(b)(1)(B) applies if the taxpayer's principal purpose is not a bona fide business purpose. Thus, § 357(b) can apply even if the taxpayer in fact has some business purpose, as may arguably be the case in some of the transactions under consideration.

357(b)(2). The provision that is now § 357(b) was enacted to prevent the tax deferment rule in § 357(a) from encouraging schemes to avoid taxes. Campbell v. Wheeler, 342 F.2d 837, 838 (5th Cir. 1965); Simpson v. Commissioner, 43 T.C. 900, 915 (1965), acq. 1965-2 C.B. 6. These provisions should be applied consistent with the legislative purpose they were designed to serve. Griffiths v. Commissioner, 308 U.S. 355 (1939).

Complex series of transactions must be evaluated in their entirety in determining whether a liability assumption violates § 357(b). Investment Research Associates v. Commissioner, T.C. Memo. 1999-407. All relevant facts relating to the structuring of the transaction should be analyzed, including the timing of the transaction, tax advice received, structuring to avoid capital gains, and the business activities of the parties to the transaction before and after the liability assumption. The circumstances surrounding the transaction and the nature of the liability will bear upon whether the taxpayer's principal purpose for the assumption is a bona fide non-tax business purpose.

Courts have distilled several factors that are relevant in determining whether the primary purpose of a liability assumption is a bona fide business purpose within the meaning of § 357(b) (or its predecessor § 112(k)). Among the factors are the following:

1) Whether the assets subject to the liabilities assumed were also transferred. Stoll v. Commissioner, 38 T.C. 223 (1962).

2) Whether the liability assumption was incident to the transfer of a business, or closely related to the taxpayer's business, or motivated primarily by business, not personal, considerations. Campbell v. Wheeler, supra at 841.

3) Whether the taxpayer incurred the liabilities to which the transferred property was subject immediately prior to the transfer and in anticipation thereof. Drybrough v. Commissioner, 376 F.2d 350 (6th Cir. 1967).

In the typical transaction presented herein, the primary purpose for D's assumption of B's rental obligation is to enable D to report rent deductions that are divorced from any corresponding income stream, while at the same time creating an inflated basis asset (D's stock) that can be sold by another taxpayer to create a substantial capital loss. Despite the formidable evidentiary burden placed on taxpayers, these transactions are specifically structured to have the liability (B's obligation to pay rent to I) transfer without the transfer of the asset associated with the liability (i.e., the right to use or receive any income from the property to which the rental expense relates). Further, no ongoing business activity is transferred. And finally, the tax savings resulting from the transfer of the liability (i.e., rental deductions unencumbered by any income inclusion as well as the creation and later sale of a purportedly inflated basis asset) far outweigh any non-tax profit from the transaction. No bona fide business purpose is evident.

Accordingly, D's assumption of B's liability to make rental payments to I is squarely within the scope of § 357(b)(1)(B). The assumption is treated as a distribution of money to B, which results in a reduction to B's basis in the D preferred stock by the total amount of liabilities assumed by D on the exchange. Section 358(a)(1)(A)(ii). The reduced basis carries over to F, thereby reducing or eliminating F's allowable loss on its subsequent sale of the D stock to H. For further discussion of this argument, contact the Appeals Technical Guidance Coordinator, Corporate Tax Shelters Leasing Promotions.

b. Because D's liability assumed by B is not within the scope of § 357(c)(3), § 358(d)(1) operates to reduce B's basis in the D stock by the amount of the liability assumed.

Even if a court were to determine that the transaction in which B acquired the D preferred stock qualified as a § 351 exchange and that the liability assumed was not within the scope of § 357(b), B's basis in the D stock must still be decreased under § 358(d)(1) and § 358(a)(1)(A), because D's rental obligation to I remains deductible by B and thus is not within Congress' intended scope of § 357(c)(3).

For purposes of calculating the transferor's basis in the transferee's stock, § 358(d)(1) generally requires that a transferee's assumption of a transferor's liability be treated by the transferor as a receipt of money, thereby reducing the basis of such stock. The only exception to this rule is an assumed liability that is excluded from § 357(c)(1) by § 357(c)(3). Section 358(d)(2)[15]. The flush language of § 357(c)(3) excludes assumed liabilities, "the payment of which . . . would give rise to a deduction". All other assumed liabilities continue to be treated as money received, thereby reducing the basis of the property received by the transferor by the amount of the liability assumed. Sections 358(d)(1) and 358(a)(1)(A). Although taxpayers may argue that D's assumption of B's rental obligation to I is within the scope of §§ 357(c)(3) and 358(d)(2), because B remains entitled to the rental deduction when it is paid by D, the assumption is not the type of liability Congress intended to exclude from § 357(c)(1) under § 357(c)(3). Accordingly, B's basis in the D preferred stock must be reduced by the amount of B's liability assumed by D on the exchange. Sections 358(d)(1) and 358(a)(1)(A).

Under § 357(c)(3), liabilities may be excluded from § 357(c)(1) only to the extent payment by the transferor would have given rise to a deduction had the liability not been transferred. To the extent the transferor had deducted the amount of the liability prior to the § 351 exchange, or the incurrence of the liability had resulted in the creation of or

[15] Congress provided § 357(c)(3) liabilities with an exemption from the normal basis reduction rules because, if a transferor were required to reduce its basis in the transferee's stock by the amount of the assumed liability, the basis reduction would ultimately have the effect of taxing the transferor on the very liability assumption that Congress had concluded it would be incorrect to tax. As a result of § 358(d)(2), the tax benefit of the deduction to the transferor is preserved in the basis of the transferee stock, to be realized on its later sale.

increase to the basis of any property, such liability is not excluded from § 357(c)(1). Section 357(c)(3)(B). See also Senate Report for the Technical Corrections Act of 1979, S. Rep. No. 96-498 (1979), 1980-1 C.B. 517, 546. See also S. Rep. No. 95-1263 (1978) and Pub. L. 95-600 (General Explanation of the Revenue Act of 1978).

While the flush language in § 357(c)(3) does not specify whether the deduction must be deductible by the transferor or the transferee after the transfer, the legislative history expressly states that § 357(c)(3) was intended to codify the approach taken in Focht v. Commissioner, 68 T.C. 223 (1977), which set forth the rule that:

[T]he assumption of a deductible obligation of a cash method taxpayer is a nonrealizable event because it is improper to treat the assumed liability as income to the transferor and deny him the tax benefit for its satisfaction. However, a cash basis taxpayer transferring a nondeductible liability realizes gain irrespective of whether he enjoyed a prior tax benefit, as actual payment would generate no additional tax deduction.

Id. at 237-38 (emphasis added). The statute and the legislative history compel the conclusion that Congress adopted § 357(c)(3) to address its concern that taxing a transferor on the assumption of a deductible liability for which it would never get a deduction produced an incorrect tax result. However, where there is an assumption of a transferor liability for which the transferor has already received tax benefit (i.e., asset basis or a previous deduction) or for which it would never have been allowed a deduction (i.e., a non-deductible expense), Congress did not intend to exclude such assumptions from the normal § 357(c) and § 358 rules. Congressional concern centered on the transferor having symmetry of one income inclusion and one deduction (if a deduction were appropriate). Certainly where a transferor is entitled to a deduction for an assumed liability after a § 351 exchange, Congress would not have meant to provide the transferor with the inappropriate and asymmetrical tax result of allowing the transferor both an exclusion from the normal income and basis computations of § 357(c) and § 358(d) and (a) and a deduction when the liability is later satisfied.

D's assumption of B's liability to I is not a § 357(c)(3) liability because B retains its right to a deduction when D pays the rental expense. There are several principles compelling this conclusion. First, D's payment to I does not give rise to a deductible expense by D because D's assumption of B's rental obligation is simply a part of D's cost of acquiring the I note.[16] Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), see also Smith v. Commissioner, 418 F.2d 589, 596 (5th Cir. 1969); Buten v. Commissioner, T.C. Memo. 1972- 44.[17] Additionally, under § 162, the payment of B's

[16] Note that D's basis in the I note is determined under § 362; therefore D's payment of B's liability to I gives rise to no additional basis. See Ways and Means Committee Report, H. Rept. No. 855, 76th Congress 1st Sess. (1939), 1939-2 C.B. 518, 519.

[17] Although Rev. Rul. 95-74, 1995-2 C.B. 36, permits a corporate transferee to claim deductions accruing upon payment of assumed liabilities, it applies only if there is a transfer of a trade or business and, at the

obligation to I is not a deductible business expense of D. Deputy v. du Pont, 308 U.S. 488, 494 (1940)(no deduction allowed to an individual for payment of corporate expenses).[18] Rather, the deduction accrues to B. Hood v. Commissioner, 115 T.C. 172 (2000)(legal fees paid by a corporation on behalf of its shareholder are deductible as an ordinary and necessary expense of the shareholder).

time of the § 351 exchange, the transferor had no plan to dispose of the stock received. In the transaction here, neither of these requirements is satisfied. Therefore, the transaction is not within the scope of Rev. Rul. 95-74, and D is subject to the rule set forth in Holdcroft, supra.

Because B will ultimately get the tax benefit associated with the rental obligation, D's assumption of B's liability is not within the scope of § 357(c)(3). Because the liability assumed in the present transaction is not excluded under § 358(c)(3), B's basis in the D stock must be reduced pursuant to § 358(a)(1)(A) and (d)(1). However, in Black & Decker Corp. v. U.S., supra, the 4th Circuit rejected this argument in connection with a Notice 2001-17, Contingent Liability tax shelter transaction, while remanding the case for a trial on the facts, in order to determine whether the transaction had economic substance[19]. The government does not agree with this decision. See also Coltec Indus., Inc. v. United States, 05-5111, United States Court of Appeals for the Federal Circuit, 454 F. 3d 1340, 7/12/2006 decided. In that case, the government prevailed on the economic substance argument. The Federal Circuit found that based on the lack of objective economic realities of the portion of the transaction that generated the tax benefits, the tax benefits were not deductible.

If a court were to determine that § 357(c)(3) did not apply to B's assumed liability, then under §§ 358(d)(1) and 358(a)(1)(A)(ii), B's basis would be reduced by the amount of the liability. That basis would carry over to F, reducing or eliminating any loss on F's sale to H of the D stock.

For further discussion of this argument, contact the Appeals Technical Guidance Coordinator, Corporate Tax Shelters Leasing Promotions.

c. Section 358(h): Stock acquired in transactions occurring after October 18, 1999

Section 358(h)(1) provides that if, in a transfer to which § 358(a) applies, after application of the other provisions of § 358, the basis of the property permitted to be received on the exchange exceeds its fair market value, then such basis shall be reduced (but not below fair market value) by the amount of any liability assumed (unless

[18] Section 162 permits deductions only for a taxpayer's own ordinary and necessary business expenses. It does not permit deductions of expenses paid or incurred for the benefit of another person or entity. Welch v. Helvering, 290 U.S. 111, 113-114 (1933).

[19] Note that the Fourth Circuit concluded that the liability could be deducted by the transferee corporation, which is not necessarily a correct conclusion.

the assumption was treated as money received by the transferor under § 358(d)(1)). Except as provided by the Secretary, § 358(h)(2)(A) excludes the assumption of any liability that is assumed in connection with the transfer of the trade or business with which the liability is associated; § 358(h)(2)(B) provides a similar exclusion for the assumption of a liability in connection with the transfer of substantially all of the assets with which the liability is associated.[20] The term "liability" is broadly defined for purposes of § 358(h). Section 358(h) was added to the Code by § 309(a) of the Community Renewal Tax Relief Act of 2000, P.L. 106-554, and is effective for transfers after October 18, 1999.

If a court were to determine that § 358(d)(1) does not apply to B's assumed liability, then, in a transaction occurring on or after October 18, 1999, under § 358(h), B's basis in the preferred stock of D would be reduced (but not below fair market value) by the amount of liabilities assumed by D. That basis carries over to F, reducing or eliminating any loss on F's sale of the D stock to H.

Until regulations under § 358(h) are promulgated, the application of § 358(h) to transactions covered by this coordinated issue paper should be coordinated with the national office through the Appeals Technical Guidance Coordinator, Corporate Tax Shelters Leasing Promotions.

d. If a taxpayer claims, and a court agrees, that B's rental obligation to I is not a "liability" for purposes of § 358(d), then, under § 358(a)(1)(A)(i), B's basis in the D preferred stock must be reduced by the fair market value of D's agreement to pay that obligation, because D's agreement is a form of consideration ("other property") received by B on the exchange

Taxpayers may argue that because B has not yet used the rental property, B's future rental obligation is not a "liability" for Federal income tax purposes. If a court were to conclude that the rental obligation is not a "liability", then B's basis in the D preferred stock would not be reduced under § 358(a)(1)(A)(ii). However, if D's promise to pay B's future rental obligation is not a "liability" assumption for purposes of § 358, it must be a form of consideration or "other property" received by B on the exchange. Section 358(a)(1)(A)(i) operates to decrease B's basis in the D preferred stock by the fair market value of this consideration.

As noted above, § 351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation, and, immediately after the exchange, such person or persons are in control of the corporation. By statute, the only non-stock consideration a taxpayer may receive in a § 351 exchange without potential gain recognition is an assumption of liabilities not in excess of the basis of the property transferred. See I.R.C. §§ 351, 357. All other consideration continues to be treated as money or other property (i.e., "boot") that

[20] Section 358(h)(2)(B) does not apply to exchanges occurring on or after June 24, 2003. Treas. Reg. § 1.358-5T.

results in a reduction to the basis of the property received by the transferor on the exchange. Section 358(a)(1)(A)(i).

Under the facts presented here, B transferred I's $100x note to D in exchange for D's preferred stock (that was worth $1x), and D's agreement to fulfill B's future rental obligation to I. The negligible fair market value of the D preferred stock, as compared to the value of the I note, is objective evidence that D's agreement to pay B's future rental obligations constitutes a form of consideration received by B that induced B to transfer the note. Accordingly, if a court were to conclude that B's future rental obligation is not a "liability" for Federal income tax purposes, then D's agreement to pay B's rental obligation is a form of taxable consideration received by B, which reduces B's basis in the D stock under § 358(a)(1)(A)(i).

4. Section 362(e): Limitation on importation or transfer of built-in losses in § 351 transactions after October 22, 2004

The American Jobs Creation Act of 2004, § 836(c)(1),118 Stat.1418 (2004), effective October 22, 2004, enacted § 362(e) to prevent taxpayers from importing (i.e., bringing losses into the U.S. tax system) or transferring and duplicating a single economic loss that is already in the tax system. It is effective for transactions occurring after October 22, 2004.

Under § 362(e)(1), if there would be an importation of a net built in loss (in either a § 351 transaction, a capital contribution, as paid-in surplus or in a reorganization transaction), then the transferee corporation's basis in the property received will be its fair market value immediately after the transfer.[21] Section 362(e)(1) is designed to prevent the importation of economic losses into the United States' tax system if the losses arose prior to the property being subject to U.S. tax.[22]

If there is a transfer of property having a net built-in loss (in either a § 351 transaction, a capital contribution or as paid-in surplus) in a non-importation transaction, § 362(e)(2) reduces the aggregate adjusted basis of the transferee's loss property so that it will not exceed the property's fair market value immediately after the transaction. The required basis adjustment is allocated among the assets in proportion to their built-in loss immediately before the transfer. Alternatively, if both the transferor and transferee

[21] Under § 362(e)(1), an importation of a built-in loss would have occurred if the transferee's aggregate adjusted basis in the property received would (absent § 362(e)(1)) exceed the property's fair market value immediately after the transfer, and the gain or loss with respect to such property was not subject to U.S. tax in the hands of the transferor immediately before the transfer, but would be subject to such tax in the hands of the transferee immediately after such transfer.

[22] The legislative history indicates that "in the cases of a transfer by a partnership (either domestic or foreign) this provision applies as if each partner had transferred such partner's proportionate share of the property of such partnership. S.Rep. No. 108-192.

(irrevocably) elect, the transferor's basis in the transferee's stock may be reduced to no more than its fair market value (in lieu of the asset basis reduction). Section 362(e)(2)(C).[23]

For transactions occurring after October 22, 2004 that are described in the first configuration of the transaction under discussion, if gain or loss with respect to B's interest in the D preferred stock was not subject to U.S. tax immediately before its transfer to F, then § 362(e)(1) will operate to reduce F's basis in such stock to its fair market value immediately after the transaction. If there is no importation of a built-in loss with respect to B's transfer of the D stock to F, then F's basis in the D stock will be reduced to its fair market value, unless both parties elect to have B reduce its basis in the F stock to its fair market value. Section 362(e)(2).

For transactions occurring after October 22, 2004 that are described in the second configuration of the transaction under discussion, assuming that gain or loss with respect to C's inflated basis partnership interest in B was not subject to U.S. tax immediately before the § 351 transfer, then D's basis in its B partnership interest will equal the fair market value of such interest immediately after the transaction. § 362(e)(1). However, if gain or loss on the B partnership interest is subject to U.S. tax in the hands of C, then D's basis in the B partnership interest will be reduced to its fair market value, unless both parties elect to have C's basis in the D stock reduced to its fair market value. Section 362(e)(2).

Until regulations under § 362(e) are promulgated, the application of § 362(e) to transactions covered by this coordinated issue paper should be coordinated with the National Office through the Appeals Technical Guidance Coordinator, Corporate Tax Shelters Leasing Promotions.

5. Section 269

Section 269(a) provides that, if

(1) any person or persons acquire, directly or indirectly, control of a corporation, or

(2) any corporation acquires, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of § 269, control means ownership of stock possessing at least 50 percent of

[23] For procedures to make this election see Notice 2005-70, 2005-41 IRB (Oct. 11, 2005).

the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. Treas. Reg. § 1.269-3(c)(1).

Under Treas. Reg. § 1.269-3(a)**,** if the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, then the acquisition is subject to the provisions of § 269. The comparison is based on all the facts and circumstances. Bobsee Corp. v. United States, 411 F.2d 231, 238 (5th Cir. 1969).[24] The requisite purpose must exist at the time of the acquisition.

Some of the factors that courts have considered when deciding this question include: (1) whether the taxpayer had a policy of, or predisposition to, tax avoidance, (2) whether the taxpayer made contemporaneous statements and actions showing its dominant purpose to be the use of tax benefits, (3) whether subsequent transactions indicated that federal income tax consequences were an important aspect of the deal, (4) whether obtaining the acquired assets was a significant purpose for the acquisition, (5) whether the acquirer had a substantial interest in carrying on the business or businesses it acquired, (6) whether the value of the acquisition outweighed the value of the tax benefits, (7) whether the acquisition served a formally documented expansion plan of an ongoing business, (8) whether the acquired/acquiring business providing the tax benefits was an inoperative shell, and (9) whether the tax benefits were not otherwise able to be used by the taxpayer. See U.S. Shelter Corp v. United States, 13 Cl. Ct. 606, 623-41 (1987), Federated Department Stores Inc. v. United States, 170 B.R. 331, 351 (S.D. Ohio 1994); Cromwell Corp. v. Commissioner, 43 T.C. 313 (1964); VGS Corp. v. Commissioner, 68 T.C. 563, 594-98 (1977).

In the transactions presented here, both F (in the first configuration) and D (in the second configuration) acquired property with a basis that was determined by reference to the transferor's basis in such property. Further, the principal purpose for F's acquisition of the D stock in the first configuration and D's acquisition of the B partnership interest in the second configuration was to secure F and D the benefit of non-economic tax losses from the inflated bases of the D stock and B partnership interest, respectively (and even if F or D were to assert a business purpose, it would be out weighed by their principal purpose of avoiding Federal income tax). However, because F and D neither acquired control of a corporation, as required by § 269(a)(1), nor acquired property from another non-controlling corporation, as required by § 269(a)(2), § 269 is inapplicable to the facts presented in this paper.

[24] Some courts have determined "the principal purpose" of a transaction by grouping all of the tax avoidance purposes of the transaction together and all of the business purposes of the transaction together, and then weighing the two groups against each other. See Bobsee Corp. v. United States, supra; U.S. Shelter Corp v. United States, 13 Cl. Ct. 606 (1987).

In a case before Appeals, if a party to one of the § 351 transactions acquired control of a corporation within the meaning of § 269, or if the entity acting in B's capacity were a corporation, the additional requirements of either § 269(a)(1) or (2) may be satisfied. When all the requirements of either section are satisfied, § 269 should operate to disallow any loss claimed from the disposition by F of the D stock in the first configuration and D of the B partnership interest in the second configuration.

6. Section 482

Under § 482, the Service may allocate losses between entities owned or controlled by the same interests in order to prevent the evasion of taxes or clearly reflect income. Control is defined to include any kind of control, direct or indirect, whether legally enforceable, and however exercised. 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. § 1.482-1(i)(4). The analysis of control focuses on the reality of control, rather than rigidly on equity ownership. Ach v. Commissioner, 42 T.C.114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966).

In cases in which the taxpayer that reports the loss from the inflated-basis asset is under common control with the party from whom it received the asset, § 482 provides the Service with authority to allocate any loss from the disposition of the asset from the taxpayer that reports the loss to the party from which it received the inflated-basis asset, where such an allocation is necessary to clearly reflect income or to prevent the avoidance of tax. The application of § 482 to allocate income and deductions from lease stripping transactions has received special scrutiny. In Rev. Rul. 2003-96, 2003-34 I.R.B. 386, the Service ruled up to and including the time the income is stripped, the facts described in the ruling do not support an application of § 482 to reallocate income and deductions arising from property subject to a lease stripping transaction entered into and effected among unrelated parties solely on the basis that the parties were acting in concert, regardless of any arbitrary shifting of income. Revenue Ruling 2003-96 expressly reserved, however, on whether § 482 control could be established as a result of parties joining together in a purported § 351 transaction.

In cases where the party who receives an inflated-basis asset in a nonrecognition transaction disposes of that asset a short time after the transfer, § 482 may potentially apply to allocate the loss back to the contributor of the inflated-basis asset. In National Securities v. Commissioner, 137 F.2d 600 (3d Cir. 1942), the Third Circuit Court of Appeals sustained the allocation of built-in loss from a subsidiary to its parent in the same taxable year, where the subsidiary disposed of stock it had received from the parent ten months earlier. Pursuant to the principles of National Securities, since codified in regulations, the Service will consider the application of § 482 to allocate such losses on a case-by-case basis. Treas. Reg. § 1.482-1(f)(1)(iii). In appropriate cases, the facts may demonstrate that unrelated parties were "acting in concert" to effect a transfer of inflated basis property and a subsequent disposition of that property by the transferee. In evaluating a potential application of § 482 based on a theory that parties acted in concert in making a non-recognition transfer, a relevant factor is whether the parties had, at the time of the transfer, a plan to effect the realization of losses by the transferee. For example, in situations where the contributor of the inflated basis asset redeems its stock in the transferee prior to the transferee's disposition of the asset, § 482 may still potentially apply where a plan existed prior to the time the asset was transferred. See generally DHL v. Commissioner*,* T.C. Memo. 1998-461, 106-06 (1998), aff'd in part, rev'd in part on other grounds, 285 F.3d 1210 (9th Cir. 2002) (common ownership for purposes of control under § 482 evaluated at the time parties bind themselves to a transaction).

In making this determination, the Service will give due consideration to the amount of time elapsed between the transfer and the subsequent disposition of the inflated basis assets and the relationship between the contributor and the taxpayer that reports the loss. In evaluating § 482 in this context, the Service will carefully scrutinize the factors in National Securities, including the year the property is received and disposed of, the amount of time the property is held, the amount of the built-in loss at the time the property is received, and the amount of loss sustained at the time of the disposition.

Section 482 control might also be established by proving as a factual matter actual control of one partner or shareholder over another partner or shareholder. In accordance with Revenue Ruling 2003-96, actual control cannot ordinarily be established merely as a result of the contractual dealings between the parties. See also Treas. Reg. § 1.482-1(i)(9) (defining true taxable income). However, where contractual dealings involve the irrevocable surrender of shareholder or partnership rights of control by one party in favor of another party, where as a result of receiving the rights the party controls the entity, actual control has been found despite the ceding party's retention of majority economic ownership. See Charles Town, Inc. v. Commissioner, 372 F.2d 415, 417-418 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967).

7. Alternate Transaction: Transfer to a Partnership

In one variation on the transaction described above, B contributes D preferred stock to a partnership J, instead of contributing the D stock to a corporation. B then sells its J partnership interest to K, a party that can utilize the built-in losses to offset other gain. In this situation, the anti-abuse regulation § 1.701-2 supports denying the losses reported by J from the sale of the D preferred stock.

BDED stockI note§351J interest (FMV=$1)§721D stock (high basis/ low FMV)PropertyD stock and assumption of B liability to IX CJKJ interest$1Accommodating Party (so J is a partnership)D stock (high basis/ low FMV)D stock (sells after B sells J interest to K)Accommodating Party$1

If B contributes property in exchange for a partnership interest in J, under § 723, J partnership would take a carryover basis in the D preferred stock that exceeds its fair market value. Under these circumstances § 704(c) would apply. That section provides that where a partner contributes property to a partnership and the property has a fair market value that is different than the basis of the property to the partnership, then under regulations prescribed by the Secretary, gain or loss with respect to the property shall be shared among the partners so as to take into account the variation. In other words, losses from built-in loss property such as the D preferred stock must be allocated to the partner that contributed the property.[25] Treasury Regulations issued under § 704(c) explain that its purpose is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Treas. Reg. § 1.704-3.

Section 1.704-3(a)(7) provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Thus, under this fact pattern, J and B may attempt to rely on that provision to allocate the built-in loss from the preferred stock to K, a pre-existing partner of J, with sufficient basis to take the loss. This shift in loss allocations is accomplished by K's purchase of B's partnership interest in J before J sells the D preferred stock. After the sale, under Treas. Reg. § 1.704-3(a)(7), the loss inherent in the D preferred stock is allocated to K, who uses the loss to offset other gain.

Section 1.701-2, the partnership anti-abuse rule, in pertinent part, provides that Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of Subchapter K are the following requirements: (1)

[25] Section 704(c) was amended by the American Jobs Creation Act of 2004 (AJCA), P.L. 108-357, § 833(a). Section 704(c)(1)(C) was added and disallows built in losses being allocated to noncontributing (which includes transferee) partners; however, those amendments are effective for contributions occurring after October 22, 2004, so they might not apply to the cases at issue. See also §§ 833(b) and (c) of the AJCA, amending §§ 743 and 734 respectively requiring the partnership to adjust its basis, regardless of whether a § 754 election is in place, when the partnership has a substantial built-in loss under § 743 after the transfer of a partnership interest or there is a substantial basis reduction under § 734 with respect to the transfer of property to a partner. **Revision 1 – Supersedes Appeals Settlement Guidelines dated May 3, 2004** **Any line marked with a # is for Official Use Only** 28

the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (3) except as otherwise provided, the tax consequences under Subchapter K to each partner of the partnership operations and of transactions between the partnership and the partner must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

However, certain provisions of Subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement is treated as satisfied with respect to a transaction that satisfies requirements (1) and (2) to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by the provision.

Section 1.701-2(b) provides that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of Subchapter K. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of Subchapter K: (1) the purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Treas. Reg. § 1.701-2(c). Section 1.701-2(c) lists various factors that may be considered in making the determination.

Section 1.701-2(d), example 8, provides an example of a plan to duplicate losses through the use of a partnership, lacking a § 754 election, that is not consistent with the intent of Subchapter K. In example 8, A wanted to sell land to B with a basis of $100x and a fair market value of $60x. A and B devised a plan, a principal purpose of which was to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. A, C, and W formed a partnership ("PRS"). A contributed the land and C and W each contributed $30x. PRS invested the $60x in an investment asset. In year 3, when the values of the partnership's assets had not materially changed, PRS agreed with A to liquidate A's interest in exchange for the investment asset held by PRS. Under § 732(b), A's basis in the asset was $100x. A sold the investment asset to X, an unrelated party, recognizing a $40x loss.

PRS did not make an election under § 754. Accordingly, PRS's basis in the land contributed by A remained at $100x. PRS sold the land to B for $60x, its fair market value. Thus, PRS recognized a $40x loss that was allocated equally between C and W, and they each reduced the bases in their partnership interests to $10x. Thus, upon liquidation of PRS (or their interests therein), each of C and W would recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. In § 1.701-2(d), example 8, PRS was used with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under § 707), the Commissioner can recast the transaction as appropriate under Treas. Reg. § 1.701-2. Compare, Treas. Reg. § 1.701-2(d), example 9, in which the use of a partnership for which no election under § 754 had been made is consistent with the intent of Subchapter K. That is, PRS was a bona fide partnership the purpose of which was to conduct joint business activity through a flexible arrangement, and the ultimate tax results were clearly contemplated by § 754. For these reasons the transaction is treated as satisfying the proper reflection of income standard and will be respected.

Here, B's contribution of the D preferred stock to J partnership and the sale of B's interest in J partnership to K were part of a plan to duplicate losses through the absence of a § 754 election. B contributed high basis, low fair market value D preferred stock to J partnership in exchange for an interest in J. B then sold its J partnership interest to K and presumably recognized a tax loss. Since J did not make an election under § 754, J's adjusted basis in the D preferred stock remained high. Upon the sale of the D preferred stock, J partnership reports a loss, which is allocated to K. K uses the losses to offset other gains.

The transactions here are subject to re-characterization under Treas. Reg. § 1.701-2, based on the following factors:

First, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. If the transactions were respected for federal tax purposes, K would be allocated capital losses (resulting from transactions in which K did not sustain a corresponding economic loss), which K would use to offset capital gains.

Second, the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. If B and K had conducted the activities directly rather than through J partnership, B would have sold the D preferred stock directly to K rather than contributing the D preferred stock to J partnership. Upon the sale of the preferred stock to K, B would have recognized a tax loss. K would have taken a cost basis in the preferred stock equal to the fair market value of the preferred stock. Upon the subsequent sale of the preferred stock at fair market value, K would not have recognized a capital loss, which it claimed through the partnership. Conducting the activities through J partnership allowed K to claim capital losses, which it used to offset capital gains. Because B and K conducted the activities through J partnership, K's aggregate federal tax liability was substantially less than it would have been if B and K had dealt directly.

Third, the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. As discussed above, the present value of K's federal tax liability was substantially less than would be the case if the transactions were integrated into a direct sale of B's D preferred stock to K. It was contemplated that B, whose J partnership interest was necessary to allocate the purported built-in loss in the preferred stock to K, would hold the interest for a transitory period, until the sale to K.

Accordingly, the Service may conclude that the contribution by B of the D preferred stock to J partnership, and the subsequent sale of the J partnership interest to K, were in substance a sale by B of the D preferred stock to K and a subsequent contribution by K of the D preferred stock to J partnership.

C. APPLICABILITY OF PENALTIES

1. The Accuracy-related Penalty

Section 6662[26] imposes an Accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement under chapter 1. See I.R.C. § 6662(a), (b). The penalty increases to 40 percent of the underpayment if the underpayment is due to a gross valuation misstatement. I.R.C. § 6662(h). There is no stacking of the Accuracy-related penalty components. Treas. Reg. § 1.6662-2(c). Thus, the maximum Accuracy-related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation misstatement) even if that portion of the underpayment is

[26] Section 6662 was amended by Section 819 of the American Jobs Creation Act of 2004, P.L. 108-357; however, those amendments are effective for tax years ending after October 22, 2004, so they might not apply to the cases at issue.

attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). The Accuracy-related penalty provided by § 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663. I.R.C. § 6662(b).

a. Negligence or intentional disregard of rules and regulations

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. § 6662(c) and Treas. Reg. § 1.6662- 3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Neely v. United States, 775 F.2d 1092, 1095 (9th Cir. 1985); Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g in part, remanding in part, 43 T.C. 168 (1964). Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii). If the facts establish that a taxpayer reported losses from a transaction that lacked economic substance or reported losses or deductions from assets with bases traceable to lease stripping transactions that would have seemed, to a reasonable and prudent person, to be "too good to be true," then the Accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed losses or deductions. The focus of inquiry is the reasonableness of the taxpayer's actions in light of the taxpayer's experience and the nature of the investment. See Henry Schwartz Corp. v. Commissioner, 60 T.C. 728, 740 (1973); see also Sacks v. Commissioner, 82 F.3d 918, 920 (9th Cir. 1996) (stating that whether a taxpayer is negligent in claiming a tax deduction "depends upon both the legitimacy of the underlying investment, and the due care in the claiming of the deduction").

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the Accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of a notice or revenue ruling.

The Accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. Treas. Reg. § 1.6662-3(c). If the position relates to a reportable transaction within the meaning of Treas. Reg. § 1.6011-4(b), however, the position must also be disclosed in accordance with Treas. Reg. § 1.6011-4. Treas. Reg. § 1.6662-3(c)(1). This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Treas. Reg. § 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2). This exception for positions with a realistic possibility of success does not apply to reportable transactions, however. Id.[27]

b. Substantial understatement

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies). I.R.C. § 6662(d)(1); Custom Chrome, Inc. v. Commissioner, 217 F.3d 1117, 1127-28 (9th Cir. 2000).[28] Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there is or was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. § 6662(d)(2)(B).

If the taxpayer is an individual or other non-corporate taxpayer, an understatement attributable to a tax shelter item is generally reduced by the portion of the understatement attributable to the tax treatment of items for which there was substantial authority for such treatment, but only if the taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. I.R.C. § 6662(d)(2)(C)(i).[29] The adequate disclosure reduction does not apply. Id. In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) above applies. I.R.C. § 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the Accuracy-related

[27] The rules with respect to reportable transactions are effective for returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Treas. Reg. § 1.6662-2(d)(5).

[28] For taxable years ending after October 22, 2004, an understatement of income tax by a corporation (other than an S corporation or personal holding company) is substantial if it exceeds the lesser of (1) 10 percent of the tax required to be shown on the return (or, if greater, $10,000) or (2) $10,000,000. I.R.C. § 6662(d)(1)(B) as amended by The American Jobs Creation Act ("AJCA"), P.L. 108-357, § 819.

[29] For taxable years ending after October 22, 2004, there is no reduction in the amount of the understatement attributable to tax shelter items for both corporate and non-corporate taxpayers. I.R.C. § 6662(d)(2)(C) as amended by AJCA § 812(d).

penalty applies unless the reasonable cause exception discussed below at section 3 applies. See Treas. Reg. § 1.6664-4(f) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

In this case, the transaction fits within the definition of a tax shelter. The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(C)(iii). For transactions entered into before August 6, 1997, the relevant standard was whether tax avoidance or evasion was the "principal purpose" of the entity, plan, or arrangement. Treas. Reg. § 1.6662-4(g)(2)(i). The transaction involved in this case is one that is the same, or substantially similar to, the transaction described in Notice 95-53, 1995-2 C.B. 334 (modified and superseded by Notice 2003-55, 2003-2 C.B. 395). The IRS's position is that this transaction should be treated as an entity, plan, or arrangement a significant purpose of which is the avoidance or evasion of federal income tax and, therefore, a "tax shelter" for purposes of the substantial understatement rules. Thus, corporate taxpayers will not be able to have an understatement reduced, and individuals or other non-corporate taxpayers will only be able to have an understatement reduced for tax years that ended on or before October 22, 2004 if the taxpayer had substantial authority and the taxpayer reasonably believed that it was more likely than not the proper treatment.

The substantial authority standard is an objective standard that requires an application of the law to relevant facts. Treas. Reg. § 1.6662-4(d)(2). There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(i). All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. Treas. Reg. § 1.6662-4(d)(3). Conclusions reached in legal opinions or opinions rendered by tax professionals are not authority for purposes of the substantial authority standard. Treas. Reg. § 1.6662-4(d)(3)(iii). The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority. Id. For further discussion of how to analyze whether there is substantial authority see Treas. Reg. § 1.6662-4(d)(3)(ii).

A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer analyzes the pertinent facts and authorities and, based on his or her independent analysis, reasonably concludes in good faith, that there is a greater than 50 percent chance that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6662-4(g)(4)(i)(A). Alternatively, a taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer relies in good faith on the opinion of a professional tax advisor. Treas. Reg. § 1.6662-4(g)(4)(i)(B). The opinion must clearly state that, based on the advisor's analysis of the facts and authorities, the advisor concludes that there is a greater than

50 percent chance that the tax treatment will be upheld if the Service challenged the position. Id.

In summary, if the facts establish that an understatement attributable to the disallowance of losses or deductions from assets with bases traceable to lease stripping transactions exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies), the substantial understatement component of the Accuracy-related penalty may apply.

c. Substantial valuation misstatement

For the Accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. I.R.C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." I.R.C. § 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20 percent Accuracy-related penalty under § 6662(a) is increased to 40 percent. I.R.C. § 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Long Term Capital Holdings, supra at 199; Gilman v. Commissioner, 933 F.2d 143, 149-52 (2d Cir. 1991). If the facts establish that the claimed adjusted basis of an asset with a basis traceable to a lease stripping transaction is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the facts establish that the claimed adjusted basis of an asset with a basis traceable to a lease stripping transaction is 400 percent or more of the correct amount, then a gross valuation misstatement exists.

2. The Fraud Penalty

Section 6663 imposes a penalty for fraud in an amount equal to 75 percent of the portion of the underpayment that is attributable to fraud. Fraud is established if it is shown that a taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983). Knowingly understating income by overstating basis can constitute evidence of fraud. Slaughter v. Commissioner, T.C. Memo. 1954-58 (holding that fraud existed with respect to return on which taxpayer had reported a loss by overstating the basis of an asset sold); Smith v. Commissioner, T.C. Memo. 1992-353 (holding that fraud existed with respect to a return on which taxpayer claimed an asset was "placed in service" earlier than it was in order to claim depreciation and an investment tax credit), aff'd without published opinion, 993 F.2d

1539 (4th Cir. 1993). The existence of fraud is a question of fact to be resolved based on the entire record. Mensik v. Commissioner, 328 F.2d 147, 150 (Cir. 1964); Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), aff'd without published opinion, 578 F.2d 1383 (8th Cir. 1978). Fraud is never presumed and must be proven by clear and convincing evidence. Stone v. Commissioner, 56 T.C. 213, 220 (1971), acq. in result, 1972-2 C.B. 3.; Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Fraud may, however, be proven by circumstantial evidence and, as a result, a taxpayer's entire course of conduct can be considered in determining whether fraud exists. Rowlee v. Commissioner, supra; see also Stone v. Commissioner, supra at 223-24.

Facts establishing that a taxpayer attempted to conceal or mislead, such as by deliberately mislabeling an item, incorrectly reporting the relevant facts, or reporting an item so as to reduce the likelihood that it would be identified for examination, can constitute evidence of fraud. Spies v. United States, 317 U.S. 492, 499 (1943). Similarly, implausible or inconsistent explanations of behavior are indicia of fraud. Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980). In addition, failing to cooperate during an examination is evidence of fraud. Korecky v. Commissioner, 781 F.2d 1566, 1568 (11th Cir. 1986); Marcus v. Commissioner, 70 T.C. 562, 578 (1978), aff'd without published opinion, 621 F.2d 439 (5th Cir. 1980). If factors discussed above are present, then the fraud penalty may be applicable.

3. The Reasonable Cause Exception

The Accuracy-related and fraud penalties do not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. I.R.C. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1). All relevant facts, including the nature of the tax investment, the complexity of the tax issues, issues of independence of a tax advisor, the competence of a tax advisor, and the sophistication of the taxpayer must be developed to determine whether there was reasonable and good faith. Id. Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Id*.*

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Nicole Rose Corp. v. Commissioner, 320 F.3d at 284-85 (sustaining a finding that a tax avoidance scheme "was so clear and obvious that the participation of professionals could not shelter [the taxpayer] from the penalties"). Reliance on professional advice constitutes reasonable cause and good faith only if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1). In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. Treas. Reg. § 1.6664-4(c)(1).

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. Treas. Reg. § 1.6664-4(c)(1)(i). For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purpose) for entering into a transaction and for structuring a transaction in a particular manner. Id*.* A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. Id*.* The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Treas. Reg. § 1.6664-4(c)(1)(ii). For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Id*.*

Further, where a tax benefit depends on non-tax factors, the taxpayer also has a duty to investigate such underlying factors. See Novinger v. Commissioner, T.C. Memo. 1991-289 (stating that taxpayer cannot avoid the negligence addition to tax merely because his professional advisor has read the prospectus and had advised the taxpayer that the underlying investment is feasible from a tax perspective, assuming the facts presented are true). If the tax advisor is not versed in these non-tax factors, mere reliance on the tax advisor does not suffice. See Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994) (holding taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was unreasonable where accountant lacked industry knowledge); Freytag v. Commissioner, 89 T.C. 849, 887-89 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (holding reliance on tax advice unreasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Collins v. Commissioner, 857 F.2d 1383, 1386 (9th Cir. 1988) (holding that taxpayer's reliance on tax advice from accountant who knew nothing firsthand about the venture was unreasonable).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. Treas. Reg. § 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a § 6662(a) Accuracy-related penalty, the Tax Court in Neonatology Associates P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002), stated that the taxpayer has to satisfy the following three-prong test: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer gave to the advisor the necessary and accurate information; and (3) the taxpayer actually relied in good faith on the advisor's judgment.

Reliance on representations by insiders or promoters is an inadequate defense to negligence. See LaVerne v. Commissioner, 94 T.C. 637, 652-53 (1990), aff'd without published opinion, 956 F.2d 274 (9th Cir. 1992); Neonatology Associates*,* P.A. v. Commissioner, 115 T.C. at 98-100. Similarly, it is unreasonable to rely on tax advice given by a tax advisor who has an inherent conflict of interest, such as a tax advisor retained by a promoter to draft a tax opinion. See Addington v. Commissioner, 205 F.3d 54, 59 (2d Cir. 2000) (holding it was unreasonable to rely on tax advice from lawyer hired by promoter to provide tax opinion for tax shelter); Goldman v. Commissioner, 39 F.3d at 408 (holding it was unreasonable to rely on tax advice from accountant with conflict of interest); Carroll v. Commissioner, T.C. Memo. 2000-184, aff'd, 22 Fed.Appx. 52 (2d Cir. 2001) (holding it was unreasonable to rely on tax advice from law firm hired by promoter to provide tax opinion for tax shelter). In addition, if the taxpayer did not receive the opinion letter until after the return was filed, the taxpayer could not have reasonably relied on the opinion and thus should not be relieved from penalties. See Long Term Capital Holdings v. United States, supra at 208.

When a portion of the underpayment results from a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), and the taxpayer failed to disclose that transactions in accordance with Treas. Reg. § 1.6011-4, there is a strong presumption that the taxpayer did not act in good faith with respect to that portion of the underpayment. Treas. Reg. § 1.6664-4(d). This rule applies to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Treas. Reg. § 1.6664- 1(b)(2)(ii). Note, however, that the preamble to the temporary regulations under I.R.C. § 6011 promulgated in February 2000 stated that failure to disclose a reportable transaction in accordance with Treas. Reg. § 1.6011-4T (which at that time applied only to corporate tax shelter transactions) "could" indicate that the taxpayer had not acted in good faith. See Preamble to T.D. 8877 (2/28/2000).

Rules for determining reasonable cause for purposes of a substantial understatement attributable to tax shelter items of a corporation

Special rules apply with respect to determining reasonable cause for purposes of applying the substantial understatement component of the Accuracy-related penalty to underpayments attributable to tax shelter items of a corporation. A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if, at a minimum, there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(f)(2)(i).

The regulations provide that, in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6664-4(f)(2)(i)(B)(2). Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met.

Although satisfaction of the "substantial authority" and "reasonable belief" requirements is necessary to find that a corporation had reasonable cause for an underpayment attributable to a tax shelter item of a corporation for purposes of the substantial understatement penalty, that may not be sufficient. For example, reasonable cause may still not exist if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. Treas. Reg. § 1.6664-4(f)(3).

4. Disclosure Initiative under Announcement 2002-2

Accuracy-related penalties will generally be waived for taxpayers that properly disclosed the lease stripping transaction as described in Notice 95-53 (modified and superseded by Notice 2003-55) as part of the disclosure initiative under Announcement 2002-2, 2002-1 C.B. 304 (December 22, 2001). As explained in Announcement 2002-2, however, the penalty waiver is not available in situations where the disclosed item had been raised as an examination issue prior to the time when the taxpayer made the disclosure. In addition, the penalty waiver is not available for certain transactions that did not actually occur, transactions that involve fraudulent concealments, and transactions that involve deductions of personal, household, or living expenses.

SETTLEMENT GUIDELINES

Each inflated basis case is unique and hence the issues raised may differ. Many of the arguments and points addressed herein, in particular in section A, may apply to alternative issues and transactions. For this reason it is recommended that the reader review the contents of each of the various theories and coordinate as appropriate with the Appeals Technical Guidance Coordinator, Corporate Tax Shelters-Leasing Promotions and Intermediary Transactions.

As such, Form 906 (Closing Agreement on Final Determination Covering Specific Matters) should be executed upon any settlement. The Appeals Technical Guidance Coordinator for Corporate Tax Shelters-Leasing Promotions and Intermediary Transactions should be consulted before discussing a settlement position with the taxpayer.

A. PRIMARY ARGUMENT

Lack of Economic Substance

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As discussed above the courts have provided a wealth of insight into transactions that are structured to produce results that are not intended by Congress. In those instances where the evidence establishes such orchestration, the courts have found for the Commissioner. Based upon the facts and circumstances exhibited to date, there is strong support for the Service's position that inflated basis transactions are abuses that Congress had not intended. When coupled with the fact that inflated basis transactions, taken as a whole, have no business purpose independent of tax considerations and lack economic substance, the Service is posed with limited hazards in litigation. Although this is one of the Service's strongest theories, there may be instances where the Appeals Officer finds that an alternative position is stronger. If that occurs, it is recommended that the case settlement reflect the merits of the alternative argument.

In evaluating the merits of a particular inflated basis transaction, it is important to understand the flow of the transactions and monies, including those that occurred both before the taxpayer's investment and after the tax years at issue. Recent court decisions Nicole Rose Corp. v. Commissioner, supra; Andantech L.L.C. v. Commissioner, supra; CMA Consolidated, Inc. v. Commissioner, supra; Transcapital Leasing Associates 1990-II, L.P. v. United States, supra; and Long Term Capital Holdings v. United States, supra, indicate that the courts will look beyond the form of the transactions, including steps that were entered into prior to the taxpayer's investment, to ascertain the true intent (substance) of the transactions. In this regard, the more facts that can be developed that show the relationships between the parties and the prearrangements between them, the more likely the victory for the Service.

In formulating an inflated basis case settlement, it is important to consider all of the facts and circumstances. The burden is upon the taxpayer to provide the answers. Some of the questions that should be answered include the following: What is the motivation behind the transaction? Would the taxpayer have invested in the transaction if it were not for the tax benefits? What was actually being purchased, a tax product or an investment with a tax by-product? Is the asset's basis traceable to a lease stripping transaction? Is the lease stripping transaction under audit or has it been settled? What steps did the taxpayer take to investigate the activity and were those steps different from those the taxpayer took with respect to its non-tax motivated transactions? Were there any side agreements?

The factual development of the case is crucial in formulating a settlement. Driving facts will include: whether the transactions are transactions in which assets with bases that exceed their fair market values are created in conjunction with lease stripping transactions; and whether the inflated basis assets (such as preferred stock) are then transferred to entities that utilize the built-in losses from the assets to reduce their taxable income. Under these circumstances the courts would find that the transactions have no business purpose and lack economic substance. See Nicole Rose Corp. v. Commissioner, supra; Andantech L.L.C. v. Commissioner, supra; CMA Consolidated, Inc. v. Commissioner, supra; and Long Term Capital Holdings v. United States, supra.

In ACM Partnership v. Commissioner, supra, the Third Circuit allowed a relatively small portion of the losses; those associated with the LIBOR notes that were distinctly separate from the transactions orchestrated by Colgate to take advantage of the § 453 regulations. The Court noted that these transactions alone were separable, economically substantive elements that gave rise to deductible interest expense. These losses were distinct from the ratable basis recovery rule under § 453.

Inflated basis transactions typically do not involve transactions that are separable and economically substantive.

It should be stressed that ACM does not stand for the proposition that transaction costs associated with the shelter activity or any other investment amounts are deductible. In instances where the Courts have found that a transaction lacks economic substance or is a sham, no deductions have been allowed.

It should be emphasized that if the taxpayer chooses not to settle the issue, the Service will continue to argue that the taxpayer is not entitled to any deductions relative to the investment, inclusive of their cash investment, a/k/a transaction costs.

Settlement Guidelines

Assuming that the Service is able to establish facts similar to those set forth in the examples addressed in this ASG or in the CIP, the Service has a substantially stronger case than the taxpayer. Given the recent judicial climate with respect to tax shelters, the taxpayer has significant litigation hazards.

Based on the strength of the Service's position that inflated basis assets originating from lease stripping transactions are not to be respected for tax purposes,

The presumption is that the bases claimed from the original lease stripping or other transaction are not to be respected for tax purposes. Moreover, the opinion in Long Term Capital Holdings v. United States, supra, demonstrates that courts may apply the economic substance and step transaction doctrines to disallow losses from inflated basis assets without the need to conclude that the original lease stripping transactions lacked economic substance. The decision was affirmed by the Second Circuit of the United States Court of Appeals. The strength of the case development will dictate the appropriate percentage of the claimed losses allowed for settlement purposes. It should be emphasized, however, that the taxpayer is faced with significant hazards in litigation.

In some instances, it may also be more appropriate to settle the case on the basis of one of the alternative theories. After all, it is the strength of the overall case that should be reflected in the settlement.

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 Revision 1 – Supersedes Appeals Settlement Guidelines dated May 3, 2004 Any line marked with a # is for Official Use Only 41

B. SECONDARY ARGUMENTS

As in the CIP, some of the theories contained in the remainder of this paper may argue that the lease stripping transaction, F's acquisition and sale of the D preferred stock, and D's acquisition and sale of the B partnership interest lacked sufficient economic substance to be respected for tax purposes. Although some of the facts that support the primary economic substance theory also support the following theories, the economic substance theory and the theories contained in the remainder of the paper are mutually exclusive. Sometimes one argument may contradict another argument that is being made in this paper. Accordingly, the various arguments must be set up as alternative arguments. Note that some arguments target the taxpayer by reallocating losses away from the taxpayer under audit to other parties to the transaction.

1. Substance over Form Analysis

Even where a court has concluded that a transaction is not a sham or wholly lacking in economic substance, it may conclude that the step transaction doctrine is applicable to realign the taxpayer’s chosen form to more accurately reflect its substance. Accordingly, this doctrine should be considered in addition to the economic substance argument. See Packard v. Commissioner, 85 T.C. 397, 419 (1985). The step transaction doctrine has been argued successfully in several lease stripping cases. See Andantech L.L.C. v. Commissioner, supra ; Long Term Capital Holdings, supra; and CMA Consolidated, Inc. v. Commissioner, supra.

It is well settled that the substance of a transaction rather than its form governs the Federal income tax consequences. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). As explored in the earlier CIP, the question of the applicability of any substance over form doctrine requires "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974). See also, Gordon v. Commissioner, 85 T.C. 309, 327 (1985); Gaw v. Commissioner, T.C. Memo. 1995-531, aff’d without published opinion, 111 F.3d 962 (D.C. Cir. 1997).

Of particular interest in the context of this document is the step transaction doctrine, which has been successfully argued in several lease stripping cases. See Andantech L.L.C. v. Commissioner, supra (applying the step transaction doctrine to disregard an entity that acted as a mere shell or conduit to strip income from a transaction in an attempt to avoid taxation); Long Term Capital Holdings, supra (applying step transaction doctrine to recharacterize contribution to partnership in exchange for partnership interest followed by sale of contributed property and redemption of partnership interest as sale of contributed property to partnership followed by sale of contributed property by partnership); and CMA Consolidated, Inc. v. Commissioner, supra.

Courts have applied the step transaction doctrine to realign the taxpayer's chosen form, even when the court concluded that the transaction was not wholly lacking economic substance. Accordingly, this doctrine should be considered in addition to the economic substance argument. See Packard v. Commissioner, 85 T.C. 397, 419 (1985).

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result.

The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. [Citation omitted.]

Smith v. Commissioner, 78 T.C. 350, 389 (1982). See also Andantech v. Commissioner, (supra); Long-Term Capital Holdings, et al. v. United States, (supra). Courts have applied three alternative tests in deciding whether the step transaction doctrine should be invoked in a particular situation: the binding commitment test, the end result test, and the interdependence test.

The binding commitment test is the most limited of the three tests. It looks to whether, at the time the first step was entered into, there was a binding commitment to undertake the later transactions. This is the most rigorous test of the step transaction doctrine. Commissioner v. Gordon, 13 F.3d 577, 583 (2d Cir. 1994). If there were a moment in the series of the transactions during which the parties were not under a binding obligation, the steps can not be collapsed under this test. As a practical matter, the binding commitment test is seldom used. See, e.g., Andantech v. Commissioner, supra; Long Term Capital, supra.

The end result test analyzes whether the formally separate steps merely constitute prearranged parts of a single transaction intended from the outset to reach a specific end result. This test relies on the parties' intent at the time the transaction is structured. The intent that courts focus on is not whether the taxpayers intended to avoid taxes, but whether the parties intended from the outset to "to reach a particular result by structuring a series of transactions in a certain way". Additionally, they focus on whether the intended result was actually achieved. True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999).

Finally, the interdependence test looks to whether the steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the later series of steps. See Penrod v. Commissioner, 88 T.C. 1415, 1428-1430 (1987). Steps are generally accorded independent significance if, standing alone, they were undertaken for valid and independent economic or business reasons. Green v.

United States, 13 F.3d 577, 584 (2d Cir. 1994); Sec. Insurance Company v. United States, 702 F.2d 1234, 1246 - 7 (5th Cir. 1983).

The existence of economic substance or a valid non-tax business purpose in a given transaction does not preclude the application of the step transaction doctrine.

Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine. True v. United States, supra, at 1177.

See also Associated Wholesale Grocers v. United States, 927 F.2d 1517 (1991); Long Term Capital Holdings, supra, at 193. Compare Falconwood Corporation v. United States, 422 F.3d 1339 (Fed. Cir. 2005), rev'g 60 Fed. Cl. 485 (2004) (the step transaction doctrine is inapplicable in the context of the consolidated return continuation of the group regulation [§ 1.1502-75(d)(2)(ii)] where the taxpayer establishes an independent business purpose for the transaction).

The three tests are not mutually exclusive and the requirements of more than one test may be met in one transaction. Further, the circumstances of a transaction need only satisfy one of the tests for the step transaction to operate. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-1528 (10th Cir. 1991) (finding the end result test inappropriate but applying the step transaction doctrine using the interdependence test). And finally, even if the step transaction doctrine does not apply to an entire transaction, it may allow the Government to collapse a portion of a transaction, which may be sufficient to prevent the intended tax avoidance result. For a recent detailed discussion of the application of the three alternative tests in lease stripping transactions, see Andantech L.L.C. v. Commissioner, supra, and Long Term Capital, supra.

The step transaction doctrine is particularly tailored to the examination of transactions involving a series of potentially interrelated steps for which the taxpayer seeks independent tax treatment. True v. United States, 190 F.3d at 1177. As a general rule, courts have held that in order to collapse a transaction, the Government must have a logically plausible alternative explanation that accounts for all the results of the transaction. Del Commercial Props. Inc. v. Commissioner, 251 F.3d 210, 213-214 (D.C. Cir. 2001), aff'g T.C. Memo. 1999-411; Penrod v. Commissioner, supra, at 1428-1430; Tracinda Corp. v. Commissioner, 111 T.C. 315, 327 (1998). The explanation may combine steps; however, some courts have declined to apply the doctrine where the Government's alternative explanation would invent new steps or simply reorder the actual steps taken by the parties. "'Useful as the step transaction doctrine may be . . . it cannot generate events which never took place just so an additional tax liability might be asserted.'" See Grove v. Commissioner, 490 F.2d 241, 247-248 (2d Cir. 1973), aff'g T.C. Memo. 1972-98 (quoting Sheppard v. United States, 176 Ct. Cl. 244; 361 F.2d 972, 978 (1966)); see also Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171, 196 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989); But cf. Long-Term Capital, supra, at 196 (footnote 94)(indicating that Esmark may be of limited applicability and distinguishable where all of the parties necessary to achieve the ultimate result are privy to the mutual understanding between the parties).

In the context of the transactions under discussion here, if the factual record establishes that from the outset the parties intended to insert a tax neutral party into a transaction merely to strip out income, or that certain other transitory owners were inserted into a convoluted transaction solely to create favorable tax attributes, then the step transaction doctrine is a potent weapon. For example, the end result test and/or the interdependence test of the step transaction doctrine may allow the government to ignore F (in the first configuration) and D's (in the second configuration) acquisition and sale of the D stock and the B partnership interest, respectively. That is, the steps by which the stock of D was transferred from B to F and from F to H (in the first configuration), and the steps by which the B partnership interest was transferred from C to D and from D to H, may be collapsed and treated as a sale of the D stock directly from B to H, and a sale of the partnership interest in B directly from C to H. See Andantech LLC v. Commissioner, supra; see also, Estate of Kluener v. Commissioner, 154 F.3d 630, 634-37 (6th Cir. 1998) (reasoning that the record supported a conclusion that the transferor in a purported § 351 transaction was the true seller of the transferred asset, where the transferee immediately sold the property received in the exchange). If the factual record of a case supports this application of the step transaction doctrine, the G and M consolidated groups would not be entitled to the losses they reported from these transactions.

Consideration should also be given to whether the interdependence test and/or end result test could be used to disregard B's transitory ownership of the equipment, thereby treating the transaction as if A sold the property directly to I, and I immediately leased the property back to A. If it can be shown that B's transitory ownership of the equipment and its subsequent acceleration of the income related to the equipment, added nothing of substance to the transaction (other than to provide D with rental deductions from the equipment unreduced by any income stream, and to create inflated bases in both C's interest in B and B's interest in the D stock, then B's transitory ownership of the equipment may be disregarded.

Settlement Guidelines

When the substance over form analysis applies to a transaction in which losses are claimed from assets with inflated basis traceable to lease stripping transactions,

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The presumption is that the bases claimed from the original lease stripping or other transaction are not to be respected for tax purposes. Moreover, the opinion in Long Term Capital Holdings v. United States, supra, demonstrates that courts will apply the economic substance and step transaction doctrines to disallow losses from inflated basis assets without the need to conclude that the original lease stripping transactions lacked economic substance. The strength of the case development will dictate the appropriate percentage of the claimed losses allowed for settlement purposes. It should be emphasized, however, that the taxpayer is faced with significant hazards in litigation.

2. Section 351

If, upon analyzing the purported § 351 exchanges, it is determined that any exchange fails to qualify as a § 351 exchange, then that exchange is a taxable transaction subject to § 1001. In that case, the tax consequences are as follows. The transferors recognize gain or loss at the time of the exchange. The transferee corporation does not recognize any gain or loss on the transaction. See I.R.C. § 1032. However, both the transferor and the transferee (B and D, and B and F, in the purported § 351 transactions involving D's preferred stock, and C and D in the purported § 351 transaction involving the transfer of the B partnership interest) would have a cost basis in the property received, determined in accordance with the provisions of § 1012 and the regulations thereunder. See Treas. Reg. § 1.1012-1(a), which provides that such property will take a basis equal to the fair market value of the property exchanged.

It is important to note that this analysis is to be made with respect to each exchange that purports to qualify as a § 351 exchange (i.e., not only the first transfer [in which the inflated basis stock is created] but all successive transfers as well [in which the inflated basis, if permitted, would be replicated]. If any exchange fails to qualify under § 351, it should be treated as a § 1001 transaction.

As was stated in the discussion section of this document, § 351 has both business purpose and statutory requirements. In contrast to the statutory requirements that provide the Service with strong grounds for determining whether a transaction fails to qualify under § 351, judicial authority imposing a business purpose requirement on § 351 transactions is limited. Further, it is possible that the business purpose requirement under § 351 might be satisfied with a relatively low showing of business purpose.

Given the broad latitude that taxpayers are given in conducting their affairs, the arguments and evidence would have to convince a judge that the taxpayer was acting outside the boundary intended by Congress. For this reason, the development that is required with respect to the sham/lack of economic substance theories is equally pertinent to this issue. The success of this issue will be predicated upon the development of the facts supporting the lack of business purpose.

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Revision 1 – Supersedes Appeals Settlement Guidelines dated May 3, 2004 Any line marked with a # is for Official Use Only 46

Although the transaction may present a viable argument for disqualification under § 351 by virtue of the business purpose requirement, the courts have not exhibited a tendency to require a strong business purpose to establish the validity of the purported § 351 transaction. See Caruth, supra. Consequently, unless the examiner has furnished persuasive evidence of a lack of business purpose, the business purpose/§ 351 argument presents greater hazards to the government than those posed in the previously discussed theories. If the issue is raised in conjunction with other positions, any settlement should reflect the merits of the strongest position advanced.

3. Reduction of stock basis due to assumption of transferor's liabilities

The reduction of stock basis due to the assumption of transferor's liabilities is addressed above. Appeals will evaluate the strength of this argument based on the facts of the case. If a case involves the application of § 358(h), contact the Appeals Technical Guidance Coordinator for Corporate Tax Shelters-Leasing Promotions for guidance.

4. Section 362(e)

The discussion portion of this document discusses application of § 362(e) to transactions occurring after October 22, 2004. Appeals will evaluate the strength of this argument based on the facts of the case. In any case involving a potential § 362(e) argument, contact the Appeals Technical Guidance Coordinator for Corporate Tax Shelters-Leasing Promotions for guidance.

5. Section 269

The CIP notes that each acquisition should be carefully scrutinized to determine whether the additional requirements of either § 269(a)(1) or § 269(a)(2) are satisfied. Section 269(a)(1) does not apply to a loss claimed on the sale of the preferred stock unless the seller acquired control of the corporation that issued the preferred stock in connection with the transaction in which it acquired the stock. Thus, the corporation that issued the preferred stock will need to be a newly formed corporation, or a corporation not previously controlled by the transferor, in order for § 269(a)(1) to apply. Additionally, § 269(a)(2) does not apply to a loss claimed by F on the sale of the D preferred stock or D on the sale of B partnership interest unless the entity transferring such stock (B in our fact pattern) is a corporation.

Appeals will evaluate the strength of this argument based on the facts of the case.

6. Section 482

When taxpayers such as F or D that report losses from inflated basis assets are under common control with the parties from which they received the assets, § 482 might allow the Service to allocate the losses back to the parties from which they received the assets. The regulations provide a presumption of control where income and deductions have been arbitrarily shifted amongst the participants. See Treas. Reg. § 1.482-1(i)(4).

The Service bears the burden of establishing the shifting of income and deductions when it relies upon that fact to create the presumption of control. See Dallas Ceramic Company v. United States, 598 F.2d 1382, 1390 (5th Cir. 1979).

The applicability of § 482 to inflated basis transactions is essentially a factual inquiry, to be resolved based upon all of the facts and circumstances. As with the other issues discussed herein, the strength of the factual development of the case will dictate the appropriate settlement range.

7. Alternate Transaction: Transfer to Partnership – Reg. § 1.701-2

a. Application of the Anti-Abuse Rule, in General

On June 19, 1995, the Subchapter K Anti-Abuse Rule Regulation Section 1.701-2 Coordinated Issue Paper was approved. The related Appeals Settlement Guideline (ASG) was issued September 23, 1998. Both documents consider, in general, the application of Subchapter K Anti-Abuse Rule § 1.701-2 ("the partnership anti-abuse rule").

The Losses Reported from Inflated Basis Assets from Lease Stripping Transactions Coordinated Issue Paper discusses the application of the partnership anti-abuse rule to a specific fact pattern, i.e., the fact pattern involved in the partnership variation of the lease stripping transaction. In that fact pattern, B contributes D preferred stock to a partnership J, instead of contributing the D stock to a corporation. B then sells its J partnership interest to K, a party that can utilize the built-in losses to offset other gain. Likewise, this ASG will discuss the application of the partnership anti-abuse rule to that fact pattern.

The discussion of the specific application of the partnership anti-abuse rule in this ASG should be read in conjunction with the discussion of the general application of the partnership anti-abuse rule in the ASG covering Subchapter K Anti-Abuse Rule § 1.701-2.

b. Field Coordination with the National Office

The Subchapter K Anti-Abuse Rule Regulation Section 1.701-2 Coordinated Issue Paper requires that the application of the partnership anti-abuse rule be coordinated with both a Partnership Technical Advisor[30] and with the National Office.

Therefore, when applying the partnership anti-abuse rule to the partnership variation of the lease stripping transaction, Compliance personnel are required to coordinate with a Partnership Technical Advisor and Chief Counsel (National Office).

[30] The Subchapter K Anti-Abuse Rule Treas. Reg. 1.701-2 Coordinated Issue Paper refers to the Issue Specialist on the Partnership Industry Specialization Program team. Since the issuance of that Coordinated Issue Paper, the Internal Revenue Service has been reorganized. The comparable position after the reorganization is the Partnership Technical Advisor.

Settlement Guidelines

The administrative file should contain documentation that the issue has been properly coordinated prior to Appeals consideration of the application of the partnership anti-abuse rule.

c. Application of the Partnership Anti-Abuse Rule to the Specific Facts of the CIP

Taxpayers may take the position that, according to §§ 723 and 704(c) and Treas. Reg § 1.704-3(a)(7), the proper reporting of the partnership variation of the transaction is as follows:

1. B contributes D preferred stock to J partnership. J partnership takes a carryover basis in the D preferred stock. Since the basis of the D preferred stock exceeds its fair market value, the D preferred stock has a built-in loss that will be allocated to B upon disposition of the D preferred stock.

2. B sells its partnership interest to K, a party that can utilize the built-in losses to offset other gain. The built-in loss that had been allocated to B is now allocated to K.

3. J partnership sells the D preferred stock. The loss is allocated to K.

The Service's position is that the partnership anti-abuse rule supports denying the losses reported by J partnership from the sale of the D preferred stock.

Discussion

When a partner transfers property to a partnership in exchange for a partnership interest, neither the partnership nor the partner recognizes any gain or loss. I.R.C. § 721.[31]

A partnership's basis in contributed property is equal to the contributing partner's basis in the asset immediately prior to the asset's transfer to the partnership. I.R.C. § 723.

If the contributed property's basis is not equal to its fair market value, then the built-in gain or loss must be allocated to the contributing partner. I.R.C. § 704(c).

[31] The facts and legal analysis in the Coordinated Issue Paper assume that the partnership receiving the assets is not an investment partnership covered by § 721(b). This ASG makes the same assumption.

If the contributing partner transfers its partnership interest, the built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Treas. Reg. § 1.704-3(a)(7).[32]

The partnership anti-abuse rule, Treas. Reg. § 1.701-2(b), provides that if the principal purpose of a partnership transaction is to substantially reduce the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, then the Commissioner can recast the transaction to achieve tax results that are consistent with the intent of Subchapter K.

Section 1.701-2(c) provides that whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Under Treas. Reg. § 1.701-2(c) there are seven factors that may indicate that a partnership was used inconsistently with the intent of Subchapter K. The presence or absence of any factor described in Treas. Reg. § 1.701-2(c) does not create a presumption that a partnership was (or was not) used in such a manner. Generally, the factors are:

1. The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's activities directly;

2. The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction;

3. One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities, or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

4. Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

[32] Section 704(c) was amended by the AJCA, P.L. 108-357, § 833(a). Section 704(c)(1)(C) was added and disallows built in losses being allocated to noncontributing (which includes transferee) partners; however, those amendments are effective for contributions occurring after October 22, 2004, so they might not apply to the cases at issue.

5. Partnership items are allocated in compliance with the literal language of Treas. Reg. §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of § 704(b) and those regulations;

6. The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

7. The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related partner).

Section 1.701-2(d), example 8, provides an example of a plan to duplicate losses through the absence of a § 754 election and concludes that this is a use of a partnership that is not consistent with the intent of Subchapter K.

On these facts, the regulation holds that any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes. Accordingly, the transaction lacks a substantial business purpose. Also, the partnership was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of Subchapter K because:

1. The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets directly. Treas. Reg. § 1.701-2(c)(1).

2. The present value of the partners' aggregate federal tax liability is substantially less than if separate transactions that are designed to achieve a particular end result are treated as steps in a single transaction. Treas. Reg. § 1.701-2(c)(2).

3. Substantially all of the partners are related to one another. Treas. Reg. § 1.701-2(c)(4).

On these facts, the partnership is not bona fide, and the transaction is not respected under applicable substance over form principles. Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of § 754 to partnerships such as in example 8, which was formed for a principal purpose of producing a double tax benefit from a single economic loss.

Therefore, under Treas. Reg. § 1.701-2(b) the Commissioner can recast the transaction to achieve tax results that are consistent with the intent of Subchapter K. But see, Treas. Reg. § 1.701-2(d), example 9 (providing an example in which the lack of an election under § 754 is determined to be consistent with the intent of Subchapter K).

Settlement Guidelines

The ability of the Service to recast transactions under the partnership anti-abuse rule is dependent on the facts and circumstances of each case. Development of the issue must be thorough and complete.

In order to recast a transaction under the partnership anti-abuse rule, a principal purpose of the transaction must have been to substantially reduce the present value of the partners' aggregate federal tax liability and this reduction must be inconsistent with the intent of Subchapter K.

Compliance relies on Treas. Reg. § 1.701-2(b) for its authority to recast the transaction at issue. Whether a partnership was formed or availed of with a principle purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K is determined based on all the facts and circumstances. Section 1.701-2(c) lists various factors indicative of whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K. The presence or absence of any factor described in Treas. Reg. § 1.701-2(c) does not create a presumption that a partnership was (or was not) used in such a manner.

The transactions here are subject to re-characterization under Treas. Reg. § 1.701-2, based on the following factors:

First, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. If the transactions were respected for federal tax purposes, K would be allocated capital losses (resulting from transactions in which K did not sustain a corresponding economic loss), which K would use to offset capital gains. Accordingly, any purported business purpose for the transactions is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes.

Second, the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. If B and K had conducted the activities directly rather than through J partnership, B would have sold the D preferred stock directly to K rather than contributing the D preferred stock to J partnership. Upon the sale of the preferred stock to K, B would have recognized a tax loss. K would have taken a cost basis in the preferred stock equal to the fair market value of the preferred stock. Upon the subsequent sale of the preferred stock at fair market value, K would not have recognized a capital loss, which it claimed through the partnership. Conducting the activities through J partnership allowed K to claim capital losses, which it used to offset capital gains. Because B and K conducted the activities through J partnership, K's aggregate federal tax liability was substantially less than it would have been if B and K had dealt directly.

Third, the present value of the partners' aggregate federal tax liability is substantially less than would be the case if the purportedly separate transactions that were designed to achieve a particular end result are integrated and treated as steps in a single transaction. As discussed above, the present value of K's federal tax liability was substantially less than would be the case if the transactions were integrated into a direct sale of B's D preferred stock to K. It was contemplated that B, whose J partnership interest was necessary to allocate the purported built-in loss in the preferred stock to K, would hold the interest for a transitory period, until the sale to K.

Accordingly, the Service may conclude that the contribution by B of the D preferred stock to J partnership, and the subsequent sale of the J partnership interest to K, were in substance a sale by B of the D preferred stock to K and a subsequent contribution by K of the D preferred stock to J partnership.

It is very likely that a court would hold that a principal purpose for the transaction at issue was to substantially reduce the present value of the partners' aggregate federal tax liability. It is also highly likely that a court would hold that there is no substantial business purpose for the transaction because any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. Therefore, the Commissioner should be able to recast the transaction.

Taxpayers are expected to argue that the transaction at issue more closely resembles Treas. Reg. § 1.701-2(d) example 9 than Treas. Reg. § 1.701-2(d) example 8. However, as stated above, it is highly likely that the court will find that there is not a substantial business purpose for the transaction. Accordingly, without a substantial business purpose, the court should not find that the transaction is contemplated by § 754.

In summary, in order to recast a transaction under the partnership anti-abuse rule, (1) a principal purpose of the transaction must have been to substantially reduce the present value of the partners' aggregate federal tax liability and (2) this reduction must be inconsistent with the intent of Subchapter K. As it is likely that the government would be able to establish both of these factors, it is expected that a court would uphold the Commissioner's right to apply the anti-abuse rule to recast the transaction.

Appeals will evaluate the strength of this argument based on the facts of the case.

C. PENALTIES

The Compliance CIP addresses the applicability of the Accuracy-related penalty under § 6662 and the fraud penalty under § 6663 to underpayments attributable to losses reported from inflated basis assets from lease stripping transactions. Whether penalties apply to such underpayments must be determined on a case-by-case basis based upon the application of the legal standard for the penalty (as set forth in the Discussion section of this guideline) to the specific facts and circumstances of each case.

The Accuracy-related penalty has been sustained in the tax shelter area. In Nicole Rose Corp. v. Commissioner, supra, petitioner argued that penalties did not apply because it had reasonably relied on qualified advisors concerning an issue of first impression. The court rejected that argument finding that the scheme was so clear and obvious that the participation of professionals could not shelter petitioners from the penalties. Similarly, in Long Term Capital Holdings v. United States, supra, the court held that a taxpayer had failed to demonstrate that it had relied reasonably and in good faith on advice from a large law firm. Id. at 205-11. The appeals court agreed that the record provided ample support for the district court's finding that Long-Term knew that the advice relied on assumptions that were false and that it was unreasonable for the law firm to rely on the assumptions when a reasonably diligent review of the pertinent facts and circumstances would have revealed them to be false. See also Neonatology Associates P.A. v. Commissioner, supra; CMA Consolidated, Inc. v. Commissioner, supra.

Negligence or Disregard of Rules or Regulations

Appeals believes that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. If the facts establish that losses are reported from inflated basis assets that are traceable to lease stripping transactions that lack economic substance, then the Accuracy-related penalty attributable to negligence may be applicable if there was no reasonable attempt to ascertain the correctness of the claimed losses or deductions. Taxpayers who point solely to the opinions of the promoter of the transaction, or a law firm or similar entity associated with the promoter for purposes of the transaction, should not be viewed as having made a reasonable attempt to ascertain the correctness of the income exclusion. In these cases, no concession of the penalty is warranted.

Taxpayers participating in or filing returns claiming tax benefits from inflated basis assets that are traceable to lease stripping transactions any significant element of which was entered into or undertaken after the issuance of Notice 95-53 on October 13, 1995 (superseded by Notice 2003-55) arguably took positions contrary to a notice and would be subject to an Accuracy-related penalty for disregarding a rule. See Treas. Reg. § 1.6662-3(b)(2) (defining rules or regulations to include notices other than notices of proposed rulemaking). For losses reported from inflated basis assets from lease stripping transactions predating the issuance of Notice 95-53, a taxpayer could be liable for the negligence penalty based upon a failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return.

If in any of the above situations a taxpayer can point to an analysis of the tax consequences of the transaction prepared by an independent professional tax advisor that supports its position, or its own contemporaneous analysis where the taxpayer had sufficient knowledge to reasonably believe that it could conduct such an analysis, the taxpayer may have made a reasonable attempt to properly report the transaction. In such cases, the penalty should be settled on an intermediate basis.

Substantial Understatement

Appeals believes that the transactions at issue will meet the definition of a tax shelter, and that the taxpayers will lack substantial authority for their positions. Accordingly, the Accuracy-related penalty will apply in most cases based on a substantial understatement of income tax.

Generally, if a taxpayer is unwilling to produce a copy of its opinion letter, the taxpayer should not be relieved from penalty consideration. Moreover, an opinion letter prepared by a promoter should not be accorded significant weight. Neonatology Associates P.A. v. Commissioner, 115 T.C. at 98-100 (reasoning that while good faith reliance on professional advice may establish reasonable cause, "reliance may be unreasonable when it is placed upon insiders, executives, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about.") In addition, if the taxpayer did not receive the opinion letter until after the return was filed, the taxpayer could not have reasonably relied on the opinion and thus should not be relieved from penalties. See Long Term Capital Holdings v. United States, supra at 208.

In Long Term Capital Holdings, supra, the court concluded that a legal opinion did not provide a taxpayer with reasonable cause where (1) the taxpayer did not receive the written opinion prior to filing its tax return, and the record did not establish the taxpayer's receipt of an earlier oral opinion upon which it would have been reasonable for the taxpayer to rely; (2) the opinion was based upon unreasonable assumptions; (3) the opinion did not adequately analyze the applicable law; and (4) the taxpayer's partners did not adequately review the opinion to determine whether it would be reasonable to rely on it. In addition, the court concluded that the taxpayer's lack of good faith was evidenced by its decision to attempt to conceal the losses reported from the transaction by netting them against gains on its returns. The appeals court agreed with these conclusions.

On December 30, 2003, Treasury and the Service amended the § 6664 regulations to provide that the failure to disclose a reportable transaction, on Form 8886, "Reportable Transaction Disclosure Statement," is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under § 6011. See Treas. Reg. § 1.6664-4(d). While this amendment applies to returns filed after December 31, 2002, with respect to

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transactions entered into on or after January 1, 2003, the logic of this provision applies to reportable transactions occurring prior to that effective date. Failure to comply with the disclosure provisions of the law is a strong indication of bad faith. See Long Term Capital Holdings v. United States, supra at 211-12.

Appeals believes that litigation hazards with respect to the applicability of the Accuracy-related penalty based on a substantial understatement of income tax relate to the facts of each case and development of the issue by the Government.

In determining whether a penalty applies the following factors are relevant: the sophistication of the taxpayer; whether the taxpayer obtained an outside opinion; the contents of any outside opinion; the timing of the receipt of the opinion in relation to the filing of the tax return; whether the opinion was given by an advisor connected with the promotion or promoter in contrast to the taxpayer’s regular advisor; whether the promoter arranged for the opinion; the contents of the opinion; and any efforts to conceal the transaction, mislead the Service, or fail to cooperate in the examination of the transaction. If any of these factors are present then they should be considered in connection with the assertion or settlement of the penalty raised.

Substantial or Gross Valuation Misstatement

Appeals believes that where an Inflated Basis Tax Shelter involves a loss reported from an asset with a reported basis of 200 percent or more of the correct amount, an Accuracy-related penalty for a substantial or gross valuation misstatement will apply. In Long Term Capital Holdings, supra, the court upheld the 40% gross valuation misstatement penalty as well as the 20% substantial understatement penalty. See also CMA Consolidated, Inc. v. Commissioner, supra (sustaining the 40% penalty for gross valuation misstatement on underpayment attributable to the disallowance of note disposition losses related to lease strip transaction).

Fraud

If facts are present establishing that a taxpayer attempted to conceal or mislead, such as by deliberately mislabeling an item, incorrectly reporting the relevant facts, or reporting an item so as to reduce the likelihood that it would be identified for examination, it may support the imposition of a penalty for fraud. Spies v. United States, 317 U.S. 492, 499 (1943). Similarly, implausible or inconsistent explanations of behavior are an indicia of fraud. Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980).

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If one or more of the foregoing facts are present, then the fraud penalty may be applicable.

Appeals will consider the appropriateness of the proposed fraud penalty on the facts of the case.