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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT: Lease Stripping Transaction

This Field Service Advice responds to your memorandum dated March 10, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
B =

C =
D =

E =
F =
G =
H =
I =
J =
L =
M =
N =
O =

P =

Q	=
R	=
S	=
Law Firm	=
Period 1	=
Period 2	=
Period 3	=
Period 4	=
Period 5	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Year W	=
Year V	=
Amount 1	= $
Amount 2	= $
Amount 3	= $
Amount 4	= $
Amount 5	= $
Amount 6	= $
Amount 7	= $
Amount 8	= $
Amount 9	= $
Amount 10	= $
Amount 11	= $
Amount 12	= $
Amount 13	= $
Amount 14	= $
Amount 15	= $
Amount 16	= $
Amount 17	= $
Amount 18	= $
Amount 19	= $

Amount 20	= $
Amount 21	= $
Percentage 1	=
Percentage 2	=
Percentage 3	=
Percentage 4	=
Shares X	=
Shares Y	=
Shares Z	=

This case involves a lease-stripping transaction, where one party realizes rental income from property and another party or parties to the transaction claim deductions for rental expenses and/or depreciation on the equipment. In Notice 95-53, 1995-2 C.B. 334, the Service defined and described forms of lease-stripping transactions and the I.R.C. sections and doctrines that are applicable to such transactions. Notice 95-53 states that, depending upon the facts of the case, the Service may apply the following authorities to the transaction: sections 269, 382, 446(b), 482, 701 or 704, 7701(l), and the regulations of each section, and authorities that recharacterize certain assignments or accelerations of future payments as financings; assignment-of-income principles; the business-purpose doctrine; or the substance-over-form doctrines (including the step transaction and sham doctrines).

ISSUES:

(1)(a) Whether the lease stripping transactions at issue are sham transactions lacking business purpose and economic substance.

(1)(b) Whether the “Sham the Partner and/or Partnership” argument applies to this lease stripping transaction and would support disallowance of the taxpayer's claimed deductions for rental expenses

(2) Whether the purported sale of the rights to receive rental income by B to C should be recharacterized as a financing transaction.

(3)(a) Whether I.R.C. § 351 applies to the transfer of property from D to Taxpayer Company and from E to Taxpayer (collectively the “exchange”)

(3)(b) Whether the step transaction doctrine applies to the exchange.

(3)(c) Whether the built-in loss rules of the consolidated return regulations prevent Taxpayer from claiming the deductions arising from the exchange.

(3)(d) Whether section 269 applies to disallow the deductions claimed by Taxpayer as a result of the exchange.

CONCLUSIONS:

(1)(a) Additional factual development is necessary before we can determine whether the Service should apply the sham transaction theory to support the disallowance of the taxpayer's claimed deductions for rental expenses in the years at issue on the grounds that the lease-stripping transaction lacks economic substance; the parties did not have any business purpose for carrying out the transaction; and the parties entered into the transaction for tax avoidance purposes.

(1)(b) Additional factual development is necessary before we can determine whether the "Sham the Partner and/or Partnership" argument applies to this lease stripping transaction and would support disallowance of the Taxpayer's claimed deductions for rental expenses

(2) We do not have sufficient facts to determine that the transaction should be recharacterized as a financing. We recommend additional factual development.

(3)(a) Additional factual development is necessary before we can determine whether the lack of a business purpose should be asserted to disqualify the exchange under section 351. Please coordinate this issue with the National Office after the facts have been further developed.

(3)(b) Additional factual development is necessary before we can determine whether the step transaction doctrine applies to the exchange.

(3)(c) We do not have enough information to determine whether the built-in loss rules of the consolidated return regulations prevent Taxpayer from claiming the deductions arising from the exchange. Please coordinate this issue with the National Office after the facts have been further developed.

(3)(d) Section 269 does not apply to disallow the deductions claimed by Taxpayer as a result of the exchange.

FACTS:

We did not receive many of the relevant documents obtained by Examination until July 8, 1999. Additional facts need to be developed before we or District Counsel can provide Examination with a complete analysis of the facts. Accordingly, the focus of this Field Service Advice is on factual development.

Taxpayer participated in a transaction known as a “lease stripping transactions” involving numerous purchases and assignments of leased computer equipment.

On Date 2, F purchased IBM computer equipment. F financed this purchase through a loan from G in the amount of $Amount 1.

On Date 2, F leased the computer equipment to H. The lease to H was for Period 1. H was to pay $Amount 2 per month in rent. F secured its loan from G with a lien on the H equipment and the rights under the lease.

Thereafter, F transferred its interests in the H equipment to I. I financed the transaction through a loan from J and F in the principal amount of $Amount 3.

I subsequently transferred its rights to the H equipment, subject to various encumbrances, to L.

B, a limited partnership, was formed on Date 3, with D as its limited partner with a Percentage 1 interest and M as its general partner. D, a limited partnership, has two partners, M and N. On Date 4, M transferred its general partnership interest in B to O.

As of Date 5, the H computer equipment purportedly had an estimated economic life of Period 2 and a fair market value of $Amount 4.

On Date 5, L sold its rights in the H equipment to B in exchange for $Amount 5 in cash and a note for $Amount 6, for a total purchase price of $Amount 7.

On Date 5, B leased the equipment back to L for Period 3, from Date 5, until Date 9. L agreed to pay approximately $Amount 8 total in rent over this period. On the same day, B entered into a remarketing agreement with L pursuant to which L agreed to be B's exclusive agent to remarket the H equipment. B agreed to pay L’s direct out-of-pocket expenses and Percentage 4 of all net proceeds derived by B from any remarketing of the H equipment.

On Date 5, L assigned its rights under the remarketing agreement with B to F, and F assumed all of L’s obligations.

On Date 5, B sold the H equipment to P for $Amount 9 in cash and a promissory note in $Amount 10 for a total amount of $Amount 4.

On Date 5, P leased the equipment back to B for a six year period, from Date 5, to January 31, 1998. B agreed to pay approximately $Amount 11 total in rent over this period.

On Date 6, pursuant to the terms of the Lease Rental Purchase Agreement dated Date 6 (the “Rental Purchase Agreement”), B sold its rights to receive rental income from the H equipment to C, a lease factoring company. C agreed to pay cash to B and to assume one of B's obligations for a total payment amount of $Amount 12. B's Percentage 1 partner at this time, D, took its pro rata share of this income on its tax return for the tax year ending Date 7. D subsequently passed the majority of this amount through to its Percentage 1 partner, N, a corporation believed to be not subject to U.S. income tax. Law Firm, counsel for Q, in its tax opinion stated that B realized ordinary income on the sale of the rent receivables equal to the amount of cash received and the obligations assumed by C. The Law Firm opined that the sale of the rent receivables would be respected as a sale for federal income tax purposes. Whether this transaction is properly characterized as a sale or a financing transaction for federal income tax purposes is at issue.

On Date 7, D exchanged its limited partnership interest in B and its R equipment with Taxpayer for Shares X of voting common stock of Taxpayer. Taxpayer agreed to assume many of D's notes and obligations. The exchange by D of its interest in B with Taxpayer on Date 7 triggers deemed distributions and recontributions under section 708(b)(1)(B). B terminates, distributes its assets to its partners in proportion to their respective interests and immediately a new Partnership is formed. Taxpayer agreed to assume many of D's notes and obligations.

Law Firm determined in its tax opinion that B would be entitled to a deduction for rents paid or incurred under the H lease, pursuant to section 162(a)(3). They opined that B may deduct its rental payments because it had no title to or equity in the H equipment. On its tax return for the tax year ending Date 8, B indicated that it had $Amount 13 of rental expenses, Percentage 1 of which, $Amount 14, was allocated to Taxpayer. On its Year W tax return, B indicated that it had $Amount 15 of rental expenses, Percentage 1 of which, $Amount 16, was allocated to Taxpayer.

Taxpayer agreed to assume many of D's notes and obligations. More specifically, Taxpayer agreed to assume: (i) all of the obligations of D with respect to its limited partnership interest in B, including D’s obligation to contribute $Amount 17 to the capital of B, (ii) all of D’s obligations under the R notes ($Amount 18 in the aggregate), (iii) D’s obligation to pay the cash portion of the purchase price of the R equipment ($Amount 19) and (iv) $Amount 20 of D’s obligation to pay certain defined fees.

Simultaneously with the transfer by D, E contributed $Amount 21 to Taxpayer in exchange for Shares Y of the voting common stock of Taxpayer, for a total ownership of Shares Z. After these exchanges, E owned Percentage 2 of Taxpayer and D owned Percentage 3.

Subsequently, Taxpayer used the proceeds received from E to: (i) make its required capital contribution to B, (ii) pay the cash portion of the purchase price of the equipment assets and (iii) pay $Amount 20 of a fee (the remainder of that fee was paid by D out of the proceeds of the required capital contribution of its sole general partner of Q.

Law Firm determined in its tax opinion that B would be entitled to a deduction for rents paid or incurred under the H lease, pursuant to section 162(a)(3). They opined that B may deduct its rental payments because it had no title to or equity in the H equipment. On its tax return for the tax year ending Year V, B indicated that it had $Amount 13 of rental expenses, Percentage 1 of which, $Amount 14, was allocated to Taxpayer. On its Year W tax return, B indicated that it had $Amount 15 of rental expenses, Percentage 1 of which, $Amount 16, was allocated to Taxpayer.

ISSUE 1 - Sham Transaction

(1)(a) Whether the lease stripping transactions at issue are sham transactions lacking business purpose and economic substance?

CONCLUSION

(1)(a) Additional factual development is necessary before we can determine whether the Service should apply the sham transaction theory. If applied, the theory would support the disallowance of the taxpayer's claimed deductions for rental expenses in the years at issue on the grounds that the lease-stripping transaction lacks economic substance; the parties did not have any business purpose for carrying out the transaction; and the parties entered into the transaction for tax avoidance purposes.

LAW AND ANALYSIS

In Notice 95-53, 1995-2 C.B. 334, the Service discusses "lease strips" or "stripping transactions" and the tax consequences of these transactions. In this Notice, the Service announced that it may apply the substance-over-form-doctrines, including the sham transaction theory and the step transaction theory.

As to the sham transaction theory, generally, where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the transaction is not a sham and the Service should honor the allocation of rights and duties effectuated by the parties. To provide guidance in determining whether a transaction is a sham for tax purposes, courts have looked to: (1) whether the taxpayer had a business purposes for engaging in the transaction other than tax avoidance; and (2) whether the transaction had economic substance beyond the creation of tax benefits. Thus, both the taxpayer's subjective business motivation and the objective economic substance of the transactions are examined.

As stated above, additional factual development is required. If the fact show the following, then there is support for a finding that the transactions are sham transactions:: (1) A transaction which could reasonably be expected to be tax-neutral over its normal life expectancy was artificially divided into an income leg and a loss leg; (2) Recognition of income was accelerated by an entity which was effectively exempt from United State taxation; (3) The tax-exempt entity effectively exits from the transaction leaving the loss to be recognized by a US taxpayer in need of a tax shelter; (4) At no time is the US taxpayer exposed to any significant risk of economic loss as a result of the transaction, by the same token, at no time did the US taxpayer have a significant opportunity to earn an economic profit as a result of the transaction; and (5) the US taxpayer does not provide any detailed explanation of its tax-independent motivation for entering into the transaction.

If the facts show the transaction is a sham, we see no reason not to assert the sham transaction theory in this case. This theory is the Service's primary weapon in virtually all sale/leaseback cases.

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752(1975); Rice's Toyota World v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978). When a transaction is treated as a sham, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction.

The Service must show that the taxpayer was motivated by no substantial business purpose other than obtaining tax benefits and that the transaction did not have any economic substance. All of the facts and circumstances surrounding the transactions must be considered. No single factor will be determinative. Courts will respect the taxpayer's characterization of the transactions if there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped solely by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990).

Recently, the Service was successful in showing that a series of prearranged transactions involving the purchase and sale of debt instruments in an attempt to shift accelerated installment sale gain to a tax-neutral partner and manufacture a loss for another partner was a sham. ACM Partnership v. Commissioner, T.C.

Memo. 1997-115, 73 T.C.M. (CCH) 2189 (1997), aff'd in relevant part, rev'd in part, remanded, 157 F.3d 231 (3d Cir. 1998) cert denied, 1999 U.S. LEXIS 1899 (U.S. Mar. 22, 1999). In ACM Partnership, the Service argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance and lacking in economic reality.

In its opinion, the Tax Court said that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The Tax Court also stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transaction lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. 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. Similarly, in Rev. Rul 99-14, 1999-13 I.R.B. 3, the Service concluded that lease-in / lease-out ("LILO") transactions have no economic substance and therefore, determined that a U. S. taxpayer could not take deductions for rent or interest paid or incurred in connection with the transaction.

Even if the entire transaction is not a sham, that is, if the debts created were genuine, the transaction could still be rejected by the court. In Goldstein v. Commissioner, 364 F.2d 734, 742 (2d Cir. 1966), the court disallowed petitioner's deductions for interest paid in connection with a loan on the grounds that the transaction lacked any expectation of profit and was entered into by petitioner without any purpose except to obtain an interest deduction. See also, United States v. Wexler , 31 F. 3d 117, 125 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Lee v. Commissioner, 31 F. 3d 117, (2d. Cir.1998).

If the sham transaction theory applies in this case, it would disallow income expenses and deductions from the sale-leaseback. The transaction at issue in this case involves a series of sale-leasebacks each of which may have some business purpose, but when taken as a whole have no business purpose independent of tax considerations. As in ACM Partnership, the Taxpayer entered into the transaction for the sole purposes of avoiding taxes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

ISSUE 1 - Sham the Partner and /or Partnership

(1)(b) Whether the "Sham the Partner and/or Partnership" argument applies to this lease stripping transaction and would support disallowance of the taxpayer's claimed deductions for rental expenses

CONCLUSION

(1)(b) Additional factual development is necessary before we can determine whether the "Sham the Partner and/or Partnership" argument applies to this lease stripping transaction and would support disallowance of the Taxpayer's claimed deductions for rental expenses

LAW AND ANALYSIS:

In order for a federal tax law partnership to exist, the parties must, in good faith and with a business purpose, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise. The entities status under state law is not determinative for federal income tax purposes. Commissioner v. Tower, 327 U.S. 280, 287 (1946); Luna v. Commissioner, 42 T.C. 1067, 1077 (1964). The existence of a valid partnership depends on whether:

considering all of the facts—the agreement of the parties, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent–the parties in good faith and action with a business purpose intended to join together for the present conduct of an undertaking or enterprise. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); ASA Investering Partnership v. Commissioner, T.C. Memo. 1998-305, appeal filed, No. 98-1583 (D.C. Cir. Dec. 11, 1998); Rev. Rul. 82-61, 1982-1 C.B. 13.

Recently, the Service was successful in making this argument In ASA Investering. In that case, the primary issue considered by the Tax Court was whether Allied Signal, Allied Signal Investment Corporation, Barber Corporation N.V., and Dominguito Corporation, N.V. formed a valid partnership for federal income tax purposes. The Tax Court held that the corporations did not. In ASA Investering, the court disregarded the existence of Barber and Dominguito because the facts demonstrated that those entities were agents for ABN, the lender. Commissioner v. Bollinger, 485 U.S. 340 (1988). The court pointed out several relevant facts. First, both Barber and Dominguito were thinly capitalized shell corporations established for the sole purpose of engaging in the venture. Second, the parties treated ABN as the real participant in the venture and disregarded Barber's and Dominguito's respective corporate forms. As an example, AllliedSigned paid ABN directly for Barber's and Dominguito's participation in the venture. Third, Barber and Dominguito were mere conduits. ABN lent Barber and Dominguito the funds for their respective "capital contributions" and retained options that allowed ABN to purchase Barber's and Dominguito's shares for a de minimis amount. All of Barber's and Dominguito's profit from the transactions came back to ABN.

The court also concluded that because ASIC is AlliedSignal's wholly-owned subsidiary, AlliedSignal, not ASIC, is the relevant party. So for purposes of deciding the issue, the court also ignored the existence of ASIC. The court then considered whether AlliedSignal and ABN intended to join together in the present conduct of an enterprise.

The court pointed out the following facts as relevant to reaching its conclusion that AlliedSignal and ABM did not intend to join together in the present conduct of an enterprise. First, AlliedSignal and ABN had divergent business goals. AlliedSignal entered into the venture for the sole purpose of generating capital losses to shelter an anticipated capital gain. In pursuing this goal, AlliedSignal chose to ignore transaction costs, profit potential, and other fundamental business considerations. AlliedSignal focused solely on the potential tax benefits. In contrast, ABN entered into the venture for the sole purpose of receiving its specified return. This return was independent of the performance of ASA's investments (*e.g.*, the profitability of the LIBOR Notes) and the success of the venture (*i.e.*, whether AlliedSignal succeeded in generating capital losses). Further, ABN did not have any profit potential beyond its specified return and did not have any intention of being AlliedSignal's partner. In essence, the arrangement did not put all of the parties "in the same business boat," therefore, "they cannot get into the same boat merely to seek * * * [tax] benefits." Commissioner v. Culbertson, at 754.

In ASA Investerings, petitioner argued that ASA should be respected as a bona fide partnership because the purported partners carefully followed partnership formalities. The court stated that such formalities may have created a partnership facade, but the conduct of AlliedSignal and ABN demonstrates that the Bermuda Agreement, not the partnership agreement, governed their affairs.

The court concluded that the characteristics of AlliedSignal and ABN's relationship are contrary to the characteristics of a bona fide partnership. AlliedSignal and ABN had divergent, rather than common, interests. Moreover, they did not share in the venture's profit and losses and did not comply with their partnership agreement when it conflicted with the Bermuda Agreement. In conclusion, the court stated that AlliedSignal, ASIC, and ABN's agents, Barber and Dominguito, did not have the requisite intent to join together for the purpose of carrying on a partnership and sharing in the profits and losses therefrom. Instead, further analysis revealed that AlliedSignal and ABN had a debtor-creditor relationship. Having concluded that ABN is in substance a lender, the court held that Barber and Dominguito were not partners in ASA and that the appropriate amount of gain relating to the sale of the PPNs and loss relating to the sale of the LIBOR notes should be allocated between AlliedSignal and ASIC.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

ISSUE 2 - Sale vs. Financing

(2) Whether the purported sale of the rights to receive rental income by B to C should be recharacterized as a financing transaction?

CONCLUSION:

(2) We do not have sufficient facts to determine that the transaction should be recharacterized as a financing. We recommend additional factual development.

LAW AND ANALYSIS:

B and C have characterized the transfer of the rights to the rent receivables of the H equipment as a sale of these rights. By selling these rights on Date 6, B accelerated the rental income from the leasing transaction in the tax year ending on Date 7. Most of the income was passed through to N, a party believed to be not subject to US income tax. The taxpayer did not receive any of the accelerated rental income because it did not become a partner in B for another two weeks, until Date 7.

The effect of characterizing this transaction as a sale is that B would recognize any gain or loss from the sale of the rent receivables for federal income tax purposes under section 1001 on the date of the sale. Alternatively, if the transaction was a financing or secured financing, then B would not include the borrowed amounts in gross income. United States v. Centennial Savings Bank FSB, 499 U.S. 573, 582 (1991), 1991-2 C.B. 30. Rather, B would recognize the income when the rent was received or payable, pursuant to its usual method of accounting.

Whether a transaction is properly characterized for federal income tax purposes as a sale or a financing depends generally upon the substance of the transaction. Gregory v. Helvering, 293 U.S. 465, 470 (1935), XIV-1 C.B. 193. A transaction will be treated a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996).

Generally, courts examine a number of factors to determine whether a transaction is a sale or something else, such as a financing or a lease. The Tax Court in Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981), enumerated eight factors to consider when making the factual determination of whether a transaction is a sale or a financing:

(1) whether legal title passed;
(2) how the parties treated the transaction;
(3) whether an equity interest was acquired in the property;
(4) whether the seller was obligated to execute and deliver a deed and the buyer was obligated to make payments;
(5) whether the purchaser had a vested right to possession of the property;
(6) which party paid property taxes;
(7) which party bore the risk of loss or damage; and
(8) which party received profits from the operation and sale.

See also Levy v. Commissioner, 91 T.C. 838, 859-62 (1988).

The courts have generally focused on the risk of loss and treated a transaction as a sale when the assignee bears the risk that the anticipated income will not be paid, where the assignment involves the right to receive future income in exchange for consideration. Estate of Stranahan v. Commissioner, 472 F.2d 867, 870-71 (6th Cir. 1973). Conversely, when the assignee is certain that it will be fully repaid, that certainty is characteristic of a loan. Mapco Inc. v. United States, 556 F.2d 1107, 1110 (Ct.Cl. 1977).

Upon an analysis of the sale or financing factors set forth in Grodt & McKay applied to the facts of this case, it will be difficult to recharacterize the sale of the rent receivables by B into a financing because some of the facts in this case support characterization as a sale. Additional factual development is required to pursue this issue.

Pursuant to the terms of the Rental Purchase Agreement, the parties treated this transaction as a sale. The purchaser of the rent receivables, C, was obligated to make a payment in the amount of $Amount 12. The purchaser carried at least a portion of the risk of loss because it had the right, and the obligation, to collect the rent payments. Rental Purchase Agreement, ¶ 1.1. The purchaser had the right to receive payments of late charges, damages insurance payments, termination payments, loss payments or other accounts payable in lieu of or in addition to rent under any sublease, and all proceeds thereof.

Certain facts are not known and thus, do not support a recharacterization. It is not clear from the facts which party paid the sales, use, local, property or other tax. It is also not clear from the facts which party received “profits” from the sale of the rights to the rent receivables. We recommend additional factual development on these issues.

Some of the factors set forth by the court in Grodt & McKay are not relevant to the determination of whether there was a sale in this case. For example, whether legal title has passed, whether an equity interest was acquired in the property and whether the purchaser had a vested right to possession are not relevant because B sold the right to receive income, not the underlying property itself.

The assignee, C, did not appear to be guaranteed or certain that it would be repaid. Under Stranahan and Mapco, this lack of certainty is more indicative of a sale.

The rental expense deductions taken by the taxpayer pursuant to section 162 could be denied if the computer leases were neither used in the taxpayer’s trade or business nor held for the production of income. Any rental expense deductions taken pursuant to section 162 could be denied if the taxpayer had no intent to earn a profit. Portland Golf Club v. Commissioner, 497 U.S. 154, 169 (1990).

Additionally, depreciation deductions pursuant to section 167, if any, could be denied if the computer leases were neither used in the taxpayer's trade or business nor held for the production of income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:
[redacted]

[redacted]

[redacted]

[redacted]

ISSUE 3 - Corporate Issues

(3)(a) Whether section 351 applies to the transfer of property from D to Taxpayer and from E) to Taxpayer.

(3)(b) Whether the step transaction doctrine applies to the exchange.

(3)(c) Whether the built-in loss rules of the consolidated return regulations prevent Taxpayer from claiming the deductions arising from the exchange.

(3)(d) Whether section 269 applies to disallow the deductions claimed by Taxpayer as a result of the exchange.

CONCLUSIONS:

(3)(a) Additional factual development is necessary before we can determine whether the lack of a business purpose should be asserted to disqualify the exchange under section 351. Please coordinate this issue with the National Office after the facts have been further developed.

(3)(b) Additional factual development is necessary before we can determine whether the step transaction doctrine applies to the exchange.

(3)(c) We do not have enough information to determine whether the built-in loss rules of the consolidated return regulations prevent Taxpayer from claiming the deductions arising from the exchange. Please coordinate this issue with the National Office after the facts have been further developed.

(3)(d) Section 269 does not apply to disallow the deductions claimed by Taxpayer as a result of the exchange.

Subsequently, Taxpayer used the proceeds received from E to: (i) make its required capital contribution to B, (ii) pay the cash portion of the purchase price

Section 351 Issue

(3)(a) Whether section 351 applies to the transfer of property from D to Taxpayer and from E to Taxpayer.

Taxpayer argues that, on Date 5, the date B acquired certain leasehold interests and, on Date 6, the date B subsequently sold the right to the income therefrom (the “strip”), D was not subject to any binding contract with regard to the transfer of property to Taxpayer.

Taxpayer concedes that D did commit, prior to Date 5, to identify and offer leasehold positions for contribution to Taxpayer upon terms acceptable to D, E and Taxpayer. However, Taxpayer contends that such commitment, while it contained certain parameters, was of a general nature and was not specific as to such properties.

Accordingly, Taxpayer argues that, as of such dates, there was no certainty that D could transfer property to Taxpayer.

Taxpayer notes that because it used: (i) some of the cash that was contributed by E to fund the capital contribution to B and B used such cash, in substantial part, to fund its obligation to pay certain fees and (ii) the remainder of the cash that was contributed by E to pay the cash portion of the purchase price of the R equipment and a portion of the certain other fees, the Service may attempt to disregard the intended section 351 exchange and recharacterize it as a sale of the R equipment and D's limited partnership interest in B to Taxpayer.

In response, Taxpayer argues that: (i) each step in the exchange is described in section 351 and (ii) there was no plan by either E or D: (a) to dispose of the Taxpayer stock each received or (b) to engage in any subsequent corporate liquidation or reorganization. Thus, Taxpayer believes that this exchange falls outside the scope of Rev. Rul. 68-349, 1968-2 C.B.143, and Rev. Rul. 70-140, 1970-1 C.B. 73.

Further, Taxpayer argues that its assumption of obligations of D and utilization of funds contributed by E to satisfy the such obligations is more akin to the facts of Ungar v. Commissioner, 22 T.C.M. 766 (1963), in which the court found a valid section 351 exchange to have occurred. Therefore, the Taxpayer argues that the exchange should not be recharacterized as a sale.

In Ungar, as described by the Taxpayer, the taxpayer acquired a contract for the purchase of certain real property under favorable terms and contributed his interest in such contract to a corporation under his control, in exchange for securities in an amount equal to an earlier deposit made by the taxpayer under the terms of the contract with the balance of the purchase price to be funded by debt arranged by the taxpayer. Further, pursuant to the contract, an additional equity payment was due at closing on the property.

LAW AND ANALYSIS:

Generally, section 351 provides that investors do not recognize gain or loss if they transfer property to a corporation solely in exchange for its stock and if the transferors, as a group, are in control of the transferee corporation immediately after the exchange. For purposes of section 351, control is defined as ownership of 80 percent of the total combined voting power of all classes entitled to vote and 80 percent of the total number of shares of all other classes of stock of the transferee corporation (I.R.C. §§ 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. Subject to certain limitations, to determine control, a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction.

If section 351 applies to an exchange, under section 362(a)(1) the transferee corporation takes the same basis in the assets it received from the transferor as the transferor had in such assets increased by the amount of gain, if any, recognized to the transferor. Thus, if section 351 applies to the transfer of the property to Taxpayer, it appears Taxpayer will take the same basis in each such property as the transferors had.[1] Consequently, section 351 will not prevent Taxpayer from deducting the amounts claimed as depreciation.

On the other hand, if section 351 does not apply, the transfer of the property to Taxpayer is a taxable exchange under section 1001. Taxpayer still recognizes no gain or loss on the transaction under section 1032. However, Taxpayer determines the basis of the property it receives under section1012. Under Treas. Reg. § 1.1012-1(a), Taxpayer takes an aggregate basis in the property equal to the fair market value of the stock Taxpayer distributes in the exchange, which amount is substantially less than the transferors' aggregate basis in such property. Consequently, if section 351 does not apply, Taxpayer would not be able to deduct much of the amounts claimed as depreciation.

Rev. Rul. 68-349 and Rev. Rul. 70-140, cited by the Taxpayer, each apply the step transaction doctrine to deny the application of section 351 to a series of steps the purpose of which was to avoid recognizing gain. In this case, the Service is considering applying the step transaction doctrine to also deny the application of section 351. Thus, we do not agree that the transfer of property in this case is necessarily outside the scope of Rev. Rul. 68-349 and Rev. Rul. 70-140.

<u>Ungar v. Commissioner</u>, cited by the Taxpayer, is distinguishable. In that case, the Commissioner waited until he answered Ungar's petition to the Tax Court before raising the issue of whether Ungar had received stock and securities in a controlled corporation as compensation. Thus, the court held that the Commissioner had the burden of proof on this issue. The court further held that the Commissioner did not meet his burden. Instead, the court found as a fact that Ungar did not receive such stock and securities as compensation. Instead, the court held that Ungar received such stock and securities in a transaction qualifying under section 351. Because of the factual determination by the court, we believe there is little precedential value to the court's holding.

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1 Taxpayer will have a basis in the cash received from E equal to the face amount of such cash whether or not the transaction qualifies under section 351.

In this case, as noted above, E transferred cash to Taxpayer in exchange for stock. The cash was used by Taxpayer to either retire notes or pay fees. Thus, there may be an argument that E only transferred the cash through Taxpayer in order to structure the transaction so that Taxpayer could claim the losses, when in substance E could be deemed to have paid such amounts. In that case, of course, section 351 would not apply because the transaction would be recharacterized as a sale.

In order to assert this argument, the Service would essentially have to show that there was no business purpose for the purported section 351 exchange.

Courts have hinted at the concept of a business purpose requirement in section 351 repeatedly. Opinions discussing other section 351 issues often indicate that the taxpayer had a valid business purpose for the transaction in question. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in section 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). In Caruth, the court explains that section 351 is tied very closely to the reorganization provisions and reasons that the doctrines applicable there are equally valid for capital contributions. Under Caruth, the business purpose requirement for section 351 transactions appears to be the same as the business purpose requirement for acquisitive reorganizations. Generally, section 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS: [redacted]

Step Transaction Issue

(3)(b) Whether the step transaction doctrine applies to the exchange.

The Taxpayer notes that the Service could also attempt to challenge the Rental Purchase Agreement (involving the H Equipment) by arguing that it and the earlier purchase and sale/leaseback of the R equipment by B should be viewed as two integrated steps in a single transaction. As such, according to the Taxpayer, the two steps would be collapsed and treated as if occurring together, which could result in the Service not respecting the Rental Purchase Agreement or in B's recognition of income therefrom for Federal tax purposes.

The Taxpayer argues, however, that because: (i) B was not subject to any binding contract with regard to the sale of the lease rights involving L, (ii) there was no certainty that such rights could be sold, (iii) a period of time (albeit a short, but nevertheless material, period of time) passed between the sale/leaseback transactions, on the one hand, and the Rental Purchase Agreement, on the other hand, (iv) one B's motives was obtaining the benefits of the projected sublease revenues after the expiration of the I Lease, which motive is wholly independent of the Rental Purchase Agreement, and (v) the sale/leaseback transactions, on the one hand, and Rental Purchase Agreement, on the other hand, each had its own significant legal independence, therefore, the application of the step transaction doctrine to collapse the sale/leaseback transactions and the Rental Purchase Agreement would be inappropriate. See McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982). Cf. Packard v. Commissioner, 85 T.C. 397, 422 (1985).

LAW AND ANALYSIS:

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

The step transaction doctrine, as described above, allows the Service to argue that certain economically meaningless steps of a transaction can be collapsed or ignored. Thus, the issue is whether the step transaction doctrine can be applied in this case to eliminate economically meaningless steps.

Before we can comment on whether the step transaction doctrine applies in this case, we would need to know exactly how the field would recharacterize the lease-stripping transaction. In other words, we would need to know the specific steps that, in substance, occurred.

After you have provided this information, we would be happy to address the step transaction argument.

Consolidated Return Issue

(3)(c) Whether the built-in loss rules of the consolidated return regulations prevent Taxpayer from claiming the deductions arising from the exchange.

The Taxpayer notes that, although Taxpayer is properly a member of the S affiliated group, there is an issue of whether the losses to be generated by Taxpayer would be disallowed under the consolidated return regulations.

Taxpayer notes that under Treas. Reg. § 1.1502-15T(a),[2] the use of a built-in loss ("BIL") by a consolidated group is restricted. A BIL is defined by reference to the BIL rules of section 382(h)(2)(B), which limits utilization of a BIL in the case of a change of ownership of a corporation. Under Treas. Reg. § 1.1502-15T(b)(2)(i), an ownership change for BIL purposes can occur whenever assets and liabilities are acquired directly from the same transferor pursuant to the same plan.

A BIL under section 382(h)(2)(B) is generally a loss attributable to an asset resulting from the excess of adjusted basis in such asset over its fair market value. Examples include losses on disposition and excess depreciation and amortization and depletion.

According to the Taxpayer, in the exchange, as a result of section 351, Taxpayer is projected to realize losses from its allocable share of B's losses. However, such losses will be generated from rental deductions that relate to a period of time in the future and have not yet accrued or become contractually due. Therefore, the Taxpayer argues that the rental deductions should not constitute a BIL.

LAW AND ANALYSIS:

Treas. Reg. § 1.1502-15T(b)(1) provides that if a corporation has a net unrealized built-in loss under section 382(h)(3) (as modified by this section) on the day it becomes a member of the group (whether or not the group is a consolidated group), its deductions and losses are built-in losses under this section to the extent they are treated as recognized built-in losses under section 382(h)(2)(B) (as modified by this section).

Treas. Reg. § 1.1502-15T(b)(2)(i) provides that, solely for purposes of applying Treas. Reg. § 1.1502-15T(b)(1), the principles of Treas. Reg. § 1.1502-94T(c) apply with appropriate adjustments. For example, a corporation is treated as having an ownership change under section 382(g) on the day the corporation becomes a member of a group, and no other events (e.g., a subsequent ownership change under Section 382(g) while it is a member) are treated as causing an ownership change. In the case of an asset acquisition by a group, the assets and liabilities

[2] The temporary regulations do not apply unless S elects to have them apply to all open years. Treas. Reg. § 1.1502-15T(f)(2). For the sake of our analysis, we will assume they do. If this is incorrect, please contact us. Also, recently published Treas. Reg. § 1.1502-15 is not applicable. Treas. Reg. § 1.1502-15(h)(2).

acquired directly from the same transferor pursuant to the same plan are treated as the assets and liabilities of a corporation that becomes a member of the group (and has an ownership change) on the date of the acquisition.

Section 382(h)(2)(B) provides that the term “recognized built-in loss” means any loss recognized during the recognition period on the disposition of any asset except to the extent the new loss corporation establishes that: (i) such asset was not held by the old loss corporation immediately before the change date, or (ii) such loss exceeds the excess of: (I) the adjusted basis of such asset on the change date, over (II) the fair market value of such asset on such date. Such term (recognized built-in loss) includes any amount allowable as depreciation, amortization, or depletion for any period within the recognition period except to the extent the new loss corporation establishes that the amount so allowable is not attributable to the excess described in section 382(h)(2)(B)(ii).

Treas. Reg. § 1.1502-15T limits the use of built-in losses by members of a consolidated group. Built-in losses are defined in section 382(h)(2)(B), as modified by Treas. Reg. § 1.1502-15T. We do not have enough information to determine whether Treas. Reg. § 1.1502-15T prevents Taxpayer from claiming the deductions arising from the exchange.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

[redacted] . [redacted]

Section 269 <u>Issue</u>

(3)(d)Whether section 269 applies to disallow the deductions claimed by E as a result of the exchange.

Taxpayer argues that section 269 does not apply because E did not acquire control of Taxpayer in the exchange. In Date 10, S formed Taxpayer. As noted above, S also owns all of the stock of E. In Period 4, Taxpayer transferred all of its assets, and associated liabilities, to S. In Period 5, prior to the current transaction, S transferred all of the stock of Taxpayer to E. Taxpayer argues that at all times since its formation either S or E has owned at least Percentage 2 of the stock of Taxpayer. Therefore, Taxpayer argues that section 269 does not apply because E did not acquire control of Taxpayer in the exchange. The Taxpayer notes that the Service may contend that S’s prior ownership of Taxpayer should be disregarded because the Period 4 transaction should be treated as having terminated Taxpayer’s corporate identity so that E can be viewed as having acquired

Percentage2 of a newly formed corporation. However, the Taxpayer further notes that the acquisition of control requirement section 269(a)(1) was not satisfied under similar circumstances. The Challenger, Inc. v. Commissioner, 23 T.C.M. 2096 (1964). Therefore, the Taxpayer believes that such a contention would fail here.

The Taxpayer also argues that section 269(a)(2) would not apply because Taxpayer did not acquire its property from a corporation.

LAW AND ANALYSIS:

Section 269(a) authorizes the Service to disallow any deduction or other allowance if (1) any person or persons directly or indirectly acquire control of a corporation or (2) any corporation acquires property from an unrelated corporation in a transaction in which the basis of the property carries over, and, in either case, the principal purpose for the acquisition is to evade or avoid Federal income tax by securing the benefit of a deduction or other allowance that such person or corporation would not otherwise enjoy.

The Taxpayer is correct that section 269 does not apply. Section 269(a)(1) does not apply because S cannot be treated as acquiring the stock of a corporation, Taxpayer, that it already owns when all that occurred was that the stock of E was transferred down the chain. See The Challenger, Inc., supra.

The Taxpayer is also correct that section 269(a)(2) does not apply because Taxpayer acquired its property from a partnership, not a corporation.

If you have any questions, please contact (202) 622-2830.

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