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Release Date: 2/23/2001  
October 24, 2000  
CC: PSI:1

MEMORANDUM FOR District Counsel - Upstate New York District, Buffalo  
Attn: Halvor Adams  
FROM: Associate Chief Counsel (Passthroughs and Special Industries), CC: PSI:1  
SUBJECT: Lease Strip  

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LEGEND

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**ISSUES**

As set forth in the memorandum submitted to the National Office, the issues in this case are as follows:

1. Should this transaction be characterized as a sham for tax purposes and disregarded?

2. Is this a valid partnership for tax purposes?
3. If it is a valid tax partnership, do the special allocations meet the substantial economic effect rule found in §1.704-1(b)(2)(iii)(a)?

4. Is section 482 applicable to reallocate partnership income away from the two foreign partners and back to A?

5. Should the foreign investors be considered lenders rather than partners?

6. Should accuracy-related penalties for negligence and/or substantial valuation misstatement be asserted under section 6662?

We note at the outset that we present numerous values in this Field Service Advice. However, all of the numbers used were provided from materials which were submitted by the taxpayer in this case, and our use of these numbers is purely for illustrative purposes and should not be construed as the National Office’s opinion that any of the values are accurate or appropriate.

CONCLUSIONS

Several legal theories should be explored in developing this case. We conclude that all of the theories you presented in your memorandum should be considered.

In short, we believe that “sham” arguments should be developed and argued as the primary argument in this case. There is a strong basis to conclude that the sham transaction theory or sham partnership theory can prevail because the formation of the partnership and allocation scheme was undertaken solely for tax purposes. We also conclude that there is a strong basis to conclude that the allocations set forth and carried out from the Operating Agreement, in the context of all the facts and circumstances, can be shown to lack substantial economic effect. There is also a strong basis to conclude that section 482 applies in the facts of this case to reallocate income to clearly reflect the taxpayer’s income. There is also a basis to argue that the foreign investors are more appropriately viewed as lenders rather than investors. Finally, we believe that penalties should be asserted regardless of the legal theory used.

FACTS

A. In General

A is a corporation organized under the laws of State1. A is the lessor in N1 leverage leases of . The leverage leases cover N2 total which are leased to various commercial businesses. B and C are wholly owned
subsidiaries of A and were organized under the laws of State1. D is also a wholly owned subsidiary of A and was formed under the laws of Country1. A, B, C, and D were part of a consolidated group for the years in issue and are sometimes referred to herein as the “A consolidated group.”

In the early years of the leveraged leases, an affiliate of A recognized a significant amount of depreciation for tax purposes which permitted A to defer recognition of taxable income attributable to the rental income being received from the . From an accounting perspective, the deferred income tax was tracked and recorded as “deferred tax liability” on A’s books and represented the approximate amount of tax liability that A would incur in future years as a result of the various lease positions.

The subject to the leveraged leases had been fully depreciated for tax purposes by Year1. However, it was estimated that the lease contracts would produce rental income of $ee through Year10. The rental income was expected to be offset by approximately $ff in interest expense, resulting in taxable income of approximately $gg. If taxed at 35 percent, a tax liability of approximately $hh would have been incurred.

B. Promoting the transaction to A

In the spring of Year1, Promoter presented A a partnership structure that encompassed the contribution by A of a portfolio of older vintage leased and an equity contribution of cash by unrelated investors. The partnership would be accomplished by the formation of a limited liability company by A, its affiliates, and unrelated investors. The idea behind the structure was to have certain unrelated investors involved in the transaction who would be allocated the income that A was anticipating as a lessor in the latter years of the various lease positions it held.

Pursuant to a summary of the transaction which was prepared by Promoter, the unrelated investors would not be subject to United States corporate regular income tax on their distributive share of the partnership’s taxable income. In fact, it was anticipated that the investors would be located in a jurisdiction that had a tax treaty with the United States which precluded the imposition of U.S. withholding tax on the investors’ distributive share of the partnership’s income. Further, the investors would be indemnified against United States tax liabilities, but not indemnified against taxes imposed by their home jurisdiction. After identifying the appropriate and refining the structure, the transaction was undertaken.

C. Formation of LLC
On D1, Articles of Organization were filed for LLC with the Secretary of State and an initial operating agreement was executed with respect to LLC. Pursuant to the initial operating agreement, the original members of LLC were B, C, and D. Upon the formation of LLC, A contributed to B certain and liabilities which B then contributed to LLC. Included were the N1 leveraged lease positions which covered N2 leased to various companies. The agreed upon value for the was $a, plus accrued rents of $b, subject to nonrecourse debt of $c. We note that the wholesale and retail values for the were $d and $e, respectively. The net value of the contributed by B to LLC was $f. In addition, B contributed cash in the amount of $g. C and D also contributed cash to LLC. An approximation of the parties respective contributions and ownership interests upon formation of LLC is as follows:

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<tr>
<th></th>
<th>B</th>
<th>C</th>
<th>D</th>
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<tbody>
<tr>
<td>Accrued rents</td>
<td>$a</td>
<td>$b</td>
<td>(c)</td>
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<tr>
<td>Nonrecourse debt</td>
<td>(c)</td>
<td></td>
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<tr>
<td>Net contribution</td>
<td>$f</td>
<td></td>
<td></td>
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<tr>
<td>Cash</td>
<td>$g</td>
<td>$h</td>
<td>$i</td>
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<tr>
<td>Total original contribution</td>
<td>$i</td>
<td>$h</td>
<td>$i</td>
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</table>

Original ownership percent | a%      | b%      | c%

D. Admission of foreign investors to LLC

On D2, LLC’s Articles of Organization were amended and an Amended and Restated Operating Agreement of LLC (Operating Agreement) was executed, pursuant to which two new members, F1 and F2, were admitted to LLC and the name of LLC was changed. F1 and F2 (collectively referred to as the “Investors” or “foreign investors”), are entities that were organized under the laws of Country. When F1 and F2 entered as members, D withdrew as a member.

The admission of the new members was accomplished by a series of transactions involving the pre-existing members of LLC. The details of the transactions were set forth in an investment agreement (“Investment Agreement”) executed on D2 by B, C, D, F1, F2, and LLC. First, C sold its interest to F1 and F2, each purchasing one-half of C’s interest. F1 and F2 each paid $k plus accrued earnings to date for their portions of C’s interest. F1 and F2 then each contributed $l to LLC. Second, D sold its entire interest in LLC to C for $i. C then contributed an additional $m to LLC. At the end of D2, the members of LLC were B, C, F1, and F2. B and C were Class B members of LLC possessing the voting rights and managerial powers over LLC. F1 and F2 were Class A owners who lacked managerial powers and
only possessed voting rights in the event of default by the partnership. Pursuant to the Investment Agreement, F1 and F2 were admitted to LLC as substituted members.

The initial contributions, sale of interests and ownership of LLC can be summarized as follows.

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<tr>
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<th>C</th>
<th>D</th>
<th>F1</th>
<th>F2</th>
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<tr>
<td><strong>Initial contribution</strong></td>
<td>$i</td>
<td>$h</td>
<td>$i</td>
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<tr>
<td><strong>Income to D2</strong></td>
<td></td>
<td></td>
<td></td>
<td>$i</td>
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<tr>
<td><strong>Cash withdrawn</strong></td>
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<td>$n</td>
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<tr>
<td><strong>Balance D2</strong></td>
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<td>$s</td>
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<td><strong>Sale of C’s interest</strong></td>
<td>($r)</td>
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<tr>
<td><strong>Sale of D’s interest</strong></td>
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<td>($s)</td>
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<tr>
<td><strong>Additional capital contribution</strong></td>
<td></td>
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<td>$l</td>
<td>$l</td>
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<td><strong>Cash withdrawn</strong></td>
<td></td>
<td></td>
<td></td>
<td>($v)</td>
<td>($v)</td>
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<tr>
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<td><strong>Ending capital account</strong></td>
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<td><strong>Ownership percentage</strong></td>
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<td>c%</td>
<td>0</td>
<td>e%</td>
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LLC Sub is a State1 corporation and a wholly owned subsidiary of LLC. On D1, LLC invested cash in the amount of $bb in LLC Sub. On D2, LLC invested an additional $cc in LLC Sub which represented the cash received from F1 and F2. LLC Sub invested the money received from LLC in A commercial paper.

Under the Investment Agreement, C paid each of the Investors a fee of $dd. The fee is referred to as a transaction fee and is characterized as an inducement for F1 and F2 to join LLC.

E. Management and Administration of LLC

Pursuant to the Operating Agreement, there were three managers of LLC, one of which was the General Manager. The managers were selected by the Class B

\[1\] Note that section 2.3(d) of the Operating Agreement provides that after F1 and F2 each make their additional contribution, the ownership percentages are f%, and c%, for B and C, respectively, and g% each for F1 and F2. Further, the ownership percentages listed in the Operating Agreement correspond to the percentages listed as each respective partner’s interest in the capital of LLC as set forth on the Schedule K-1’s issued to each of the partners for Years1 through Year4. B’s and C’s ownership interest in the capital of LLC for Year5 and Year6, as set forth on the respective Schedule K-1’s, differs slightly from the capital interest percentages reported on the Schedule K-1’s for those members for Year1 through Year4.
members of LLC (B and C), and the Class A members were not involved in the process.

Pursuant to section 1.4 of the Operating Agreement, LLC’s principal place of business is in Country3, and its General Manager was a resident of that country. However, LLC lists an address in Country4 on all of its tax returns.

According to various summaries and the Operating Agreement, LLC was to maintain three bank accounts. The accounts were to be located in Country1, Country3, and Country4. LLC was to receive the rental payments from the various leases, and make payments on its indebtedness through its account in Country1. Also, LLC was to fund the accounts in Country3 and Country4 from its account in Country1. The accounts in Country3 and Country4 appear to exist solely to pay the expenses of LLC’s operations in those countries.

F. Indemnification Agreement

On D2, F1 and F2 each entered into a Tax Indemnification Agreement (“Indemnification Agreement”) with B and LLC. Pursuant to section 3 of the Indemnification Agreement, B agreed to indemnify F1 or F2 for any tax that F1 or F2 was required to pay to any U.S., State, or Local government with respect to F1’s or F2’s income from LLC, or with respect to distributions made by LLC. B agreed to indemnify F1 or F2 on an after-tax or “grossed-up” basis, meaning that F1 or F2 would receive indemnification payments in amounts equal to any such tax it was required to pay, plus payments to allow them to pay any taxes imposed on the receipt of the first indemnifying payment. Section 5 of the Indemnification Agreement provides certain exclusions to B’s obligation to indemnify F1 or F2. These exclusions, however, are largely limited to circumstances where F1 or F2 has acted inconsistently with the position that each is excepted from taxation on its LLC income in the United States. A summary of the terms that were to be included in the Indemnification Agreement accurately states that B would indemnify the Investors if and to the extent the Investors became subject to U.S. tax other than by reason of (i) their own “specified” acts or misrepresentations, or (ii) changes in United States tax law (including treaties).

F1 and F2 were required to represent that they intended to participate as members in LLC for the purpose of making an economic profit from the transactions entered into by LLC.

G. Projections for carrying out the transaction

According to projections prepared by Promoter, the Investors were scheduled to receive an annual cash distribution in a planned amount. If there were no defaults under the leases of the original leased , LLC would have available cash flow
to make the annual distribution each year. To the extent the available cash flow was inadequate, LLC was permitted to borrow from LLC Sub in order to fund the annual distribution. LLC was not required to make the annual distribution even if the available cash flow was adequate. However, in the event that the annual distribution was not made within ten business days after the end of a fiscal year, the Investors had the right to cause LLC to be liquidated.

According to all projections and estimates, it was expected that LLC would have sufficient profits available to allocate to the Investors and cover the Investors annual distributions. In addition, LLC was also expected to have gain from disposition of the original leased which would be allocated, in part, to the Investors.

LLC was not permitted to distribute available cash flow other than in satisfaction of the annual distribution. However, LLC was permitted to contribute any available cash flow in excess of the annual distribution to LLC Sub.

H. Operating Agreement Allocations and Liquidation rights. 2

1. Allocation of Profits and Losses

Operating profits were to be allocated h% to the Investors (allocated equally between them) and c% each to B and C. Operating losses were to first offset certain prior operating profit and disposition gain allocations and then were to be allocated h% to the Investors and c% to B and c% to C until the Investors had been allocated cumulative net book losses equal to $ll (taking into account certain disposition gains and losses and operating losses allocated to the Investors). Then, operating losses were to be allocated i% to B and C and c% to the Investors until the capital accounts of B and C were reduced to zero. Any further operating losses would be allocated to the Investors until their capital accounts were equal to zero. Finally, any remaining operating losses would be allocated to B.

In a summary which Promoter prepared describing the general allocation scheme set forth above, it was stated:

2 The allocation scheme described in the text for operating losses, and disposition gains and losses has been simplified. The recitation in the text is taken from a “Summary of Terms and Conditions of Company Operating Agreement” (“Summary”) prepared by Promoter on or around D1. We note that in the Summary, certain allocations are described for D and no allocations are described for C. However, the Operating Agreement appears to provide for the same allocations to C and not for D. Accordingly, the description in the text uses the general language from the Summary and substitutes C for D where appropriate.
By moving the management and decision making activities, and finance and accounting activities with respect to the N2 assets out of the U.S. to the LLC, the taxable income of these assets is also transferred from the U.S. and is now assessed as taxable income of the Members of the LLC.

The effect of the above income allocations in the LLC is to shift approx. $ii million of taxable income, which, but for this transaction would have been assessed against [A], to [F1 and F2].

As a consequence of the above, a reduction in [the A] deferred tax liability of $rr was made in Year1 and a further $ss reduction in the deferred tax liability will be booked for the years Year2-Year8.

2. Allocation of gain or loss from disposition of

Disposition gain (i.e., gains from sale, disposition or deemed disposition due to "marking to market") was first to be allocated to offset certain prior operating loss and disposition loss allocations. Then, disposition gain would be allocated j% to the Investors, k% to B and c% to C until the Investors had been allocated cumulative disposition gain equal to $mm. The balance of any disposition gain would be allocated c% to the Investors, h% to B, and c% to C.

Disposition loss was first to be allocated to offset certain prior disposition gain allocations. Next, disposition loss was to be allocated j% to the Investors and k% to B and c% to C until the Investors had been allocated cumulative net book losses equal to $mm. Next, disposition losses were to be allocated i% to B and C (in proportion to their relative positive capital account balances) and c% to the Investors until the capital account balances of B and C were zero. Next, disposition losses were to be allocated to the Investors until their capital account balances were equal to zero. Any remaining disposition loss was to be allocated to B.

3. Liquidation rights

The Investors had the right to cause LLC to be liquidated on D5, in which event they would receive a cash payment from LLC equal to their capital account at that time. Also, at the time LLC was liquidated, LLC would pay the Investors a guaranteed payment. The guaranteed payment from LLC to the Investors was equal to the difference between the amount of the aggregate profits and losses that were allocated to the Investors which were less than a target amount. The obligation to make the guaranteed payments was backed ultimately by the credit of A. The guaranteed payment was designed to ensure that the profits allocated to the Investors were
sufficient to provide in “all-in” cash-on-cash return to each equity investor of at least $k\%$ per annum.

Despite the intent to provide each equity investor with a return of at least $k\%$ per annum, certain loss allocation rules could cause the equity investor’s return to be less than $k\%$ even after taking into account the guaranteed payments. First, to the extent operating losses or disposition losses exceeded $\$jj$, the additional $c\%$ of losses allocated to the Investors would not be taken into account in calculating the equity investor’s guaranteed payments. Consequently, the Investors’ return would be less than $k\%$ to the extent of any such losses. Second, losses allocated to the Investors to the extent of their capital accounts which could occur once the capital accounts of the LLC partners were reduced to zero would also not be taken into account in calculating the Investors’ guaranteed payments. The second level of loss allocations would be reached in a catastrophic loss scenario where LLC had experienced losses that completely wiped out the capital accounts of both B and C, which amounted to over $\$kk$. However, LLC carried insurance in amounts believed to be adequate to protect against any such catastrophic loss.

In lieu of liquidating LLC, B could purchase the Investors’ interest in LLC for a cash purchase price equal to the Investors’ capital account plus the guaranteed payment the equity investor would have been entitled to receive if LLC had been liquidated.

I. Operations of LLC - maintenance of capital accounts

LLC maintained a capital account for each member of LLC. A member’s capital account was increased by the cash and fair market value of property contributed to LLC by the member and the book income allocated to the member. A member’s capital account was decreased by the cash and the fair market value of property distributed to the member, as well as book losses allocated to the member. According to the financial statements provided by taxpayer, the partners’ respective capital accounts$^3$ for the years that F1 and F2 were in the partnership, were as follows:

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<th>Statement of Capital Accounts</th>
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<tr>
<td>B</td>
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<tr>
<td>$\text{Capital Account 12/31/Year1}$</td>
</tr>
<tr>
<td>$\text{Allocation of Income for year}$</td>
</tr>
</tbody>
</table>

$^3$ While the LLC Operating Agreement required that the partners’ capital accounts be maintained in accordance with the regulations under §1.704-1(b)(2)(iv), we are uncertain that the capital account reconciliation provided in the financial statements was prepared with the aforementioned regulation in mind.
The disposition gain allocated to F1 and F2 in Year6 is the “mark to market” gain on the assets in LLC and LLC Sub as of the date of the sale by F1 and F2 of their interests in LLC. The total “mark to market” gain was $abl, $abm of which was presumably allocated between B and C. The agreed fair market value of the assets in LLC for purposes of determining the “mark to market” gain was $abn and the agreed fair market value in the stock of LLC Sub was $abo. The book basis used in the calculation of the “mark to market” gain was $abp for the assets in LLC and $abq for the stock of LLC Sub.

J. Year6 Buyout of F1 and F2

From the documentation submitted by the taxpayer, there appears to have been some changes in the tax laws of Country2 that caused F1 and F2 to seek greater indemnification from B beginning in Year6. This increased indemnification was agreed to in an amendment to the Indemnification Agreement executed by each party. The amendment was effective as of D6. It appears that because the increased indemnification obligation was not originally bargained for, B decided to purchase the interests of F1 and F2. B gave notice of its intention to purchase F1’s and F2’s interest on D7, and actually closed the purchase on D8. The actual purchase by B was accomplished through two newly formed subsidiaries, E and F. The purchase price was paid in two installments. The calculation of the purchase price was as follows:

<table>
<thead>
<tr>
<th>Disposition gain (loss) allocated</th>
<th>$zz</th>
<th>$aaa</th>
<th>$aab</th>
<th>$aab</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>($aad)</td>
<td>$aae</td>
<td>$aaf</td>
<td>$aag</td>
</tr>
<tr>
<td>Property</td>
<td></td>
<td>($aac)</td>
<td></td>
<td>($aac)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Account 12/31/Year2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of Income for year</td>
</tr>
<tr>
<td>Disposition gain (loss) allocated</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Property</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Account 12/31/Year3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of Income for year</td>
</tr>
<tr>
<td>Disposition gain (loss) allocated</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Property</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Account 12/31/Year4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of Income for year</td>
</tr>
<tr>
<td>Disposition gain (loss) allocated</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Property</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Account 12/31/Year5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of Income for year</td>
</tr>
<tr>
<td>Disposition gain (loss) allocated</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Property</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Account 12/31/Year6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mark to market gain (loss) allocated</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Property</td>
</tr>
</tbody>
</table>

---

\(^4\) The disposition gain allocated to F1 and F2 in Year6 is the “mark to market” gain on the assets in LLC and LLC Sub as of the date of the sale by F1 and F2 of their interests in LLC. The total “mark to market” gain was $abl, $abm of which was presumably allocated between B and C. The agreed fair market value of the assets in LLC for purposes of determining the “mark to market” gain was $abn and the agreed fair market value in the stock of LLC Sub was $abo. The book basis used in the calculation of the “mark to market” gain was $abp for the assets in LLC and $abq for the stock of LLC Sub.
K. Disposition of by LLC

In Year2 and Year3, LLC distributed N3 to B. The fair market value of the distributed in each year was $aad and $aao, respectively. No gain or loss was recognized upon the distribution of the for tax purposes, however, LLC “marked to market” the distributed just prior to their distribution, which resulted in book gains and losses. As a result of LLC’s adjustments, LLC recognized a $aca book gain in Year2 and a $acb book loss in Year3. In Year3 and Year4, LLC sold N4 to unrelated parties. These sales resulted in a taxable gain and book loss in each year. LLC recognized a taxable gain of $acc in Year3 and a taxable gain of $acd in Year4. LLC’s combined book loss on the sales in Year3 and Year4 was $ace. The book losses for each year from LLC’s disposition of was allocated as follows:

<table>
<thead>
<tr>
<th>Book Gain (Loss)</th>
<th>B</th>
<th>C</th>
<th>F1</th>
<th>F2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year2</td>
<td>$aca</td>
<td>$zz</td>
<td>$aaa</td>
<td>$aab</td>
</tr>
<tr>
<td>Year3</td>
<td>($acf)</td>
<td>($aaj)</td>
<td>($ak)</td>
<td>($aai)</td>
</tr>
<tr>
<td>Year4</td>
<td>($acg)</td>
<td>($aau)</td>
<td>($av)</td>
<td>($aw)</td>
</tr>
</tbody>
</table>

A. Estimated and actual economic results.

Promoter completed an executive summary of the entire transaction for the purpose of promoting the transaction to the Investors. The summary estimates the probable economic results for the Investors as follows:

If no cumulative disposition gain or disposition loss was allocated to the equity investors, their capital accounts would be approximately $nn on D5 and their return would be l%. If the equity investors were allocated

5 Premium paid for increased tax liability of F1 and F2 in Country2 in Year6. Presumably this payment was made as a result of the amended Indemnification Agreement.

6 Taxpayer represents that the taxable gain was allocated entirely to B, while the book loss was allocated in accordance with the Operating Agreement.
Note that in the materials submitted to the National Office there were at least two different estimates of the anticipated results from the operations of LLC. However, the estimates did not differ significantly in the values presented. We have taken the above estimates from the projections prepared by Promoter on or around D2.

In marketing the partnership arrangement, Promoter set forth the anticipated allocations of book income and taxable income, as well as cash distributions that were to be made to the respective partners of LLC. The chart below compares Promoter’s estimates with the actual allocations and distributions that were made.

<table>
<thead>
<tr>
<th>Year End</th>
<th>Estimated Cash Distributions</th>
<th>Actual Cash Distributions</th>
<th>Estimated Book Income</th>
<th>Actual Book Income</th>
<th>Estimated Taxable Income</th>
<th>Actual Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year1</td>
<td>$ach</td>
<td>$aci</td>
<td>$acj</td>
<td>$ack</td>
<td>$acl</td>
<td>$acm</td>
</tr>
<tr>
<td>Year2</td>
<td>$acn</td>
<td>$acn</td>
<td>$aco</td>
<td>$acp</td>
<td>$acq</td>
<td>$acr</td>
</tr>
<tr>
<td>Year3</td>
<td>$acs</td>
<td>$acs</td>
<td>$act</td>
<td>$acu</td>
<td>$acv</td>
<td>$acw</td>
</tr>
<tr>
<td>Year4</td>
<td>$acx</td>
<td>$acy</td>
<td>$acz</td>
<td>$ada</td>
<td>$adb</td>
<td>$adc</td>
</tr>
<tr>
<td>Year5</td>
<td>$add</td>
<td>$add</td>
<td>$ade</td>
<td>$adf</td>
<td>$adg</td>
<td>$adh</td>
</tr>
<tr>
<td>Year6</td>
<td>$adi</td>
<td>–</td>
<td>$adj</td>
<td>$adk</td>
<td>$adl</td>
<td>$adm</td>
</tr>
<tr>
<td>Year7</td>
<td>$adn</td>
<td></td>
<td>$ado</td>
<td>$adp</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year8</td>
<td>$adq</td>
<td></td>
<td>$adr</td>
<td>$adp</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year9</td>
<td>$adt</td>
<td></td>
<td>$adt</td>
<td>$adu</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year10</td>
<td>$adv</td>
<td></td>
<td>$adv</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In a schedule prepared early in Year8, the following amounts were set forth as the balance of the deferred tax liability account as of the time LLC was formed, as well as the current year deferred tax benefit that accrued during each year that F1 and F2 were members in LLC.

Deferred Tax liability account

Benefit on Formation $adz

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Note that in the materials submitted to the National Office there were at least two different estimates of the anticipated results from the operations of LLC. However, the estimates did not differ significantly in the values presented. We have taken the above estimates from the projections prepared by Promoter on or around D2.

Figures for estimated and actual cash distributions are with respect to F1 and F2. The actual cash distribution figures are taken from the Schedule K-1 issued to F1 and F2 for a particular year.

Each year’s figures are taken from the respective Form 1065, Partnership Return of Income, filed by LLC for the year. Only the tax returns for Year1 through Year6 were available. Figures include “Guaranteed Payments” made to B and C.
Current Year Benefit

<table>
<thead>
<tr>
<th>Year</th>
<th>19</th>
<th>20</th>
<th>20</th>
<th>20</th>
<th>20</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$a_{ea}$</td>
<td>$a_{eb}$</td>
<td>$a_{ec}$</td>
<td>$a_{ed}$</td>
<td>$a_{ee}$</td>
<td>$a_{ef}$</td>
</tr>
</tbody>
</table>

Impact of F1 and F2 departing ($a_{eg}$)
Total benefit $a_{eh}$

M. Activities of LLC Sub

As stated above, LLC Sub received substantial cash contributions from LLC. Initially, and as contemplated, a substantial part of its total assets were invested in securities. However, in Year2, and Year3, LLC Sub acquired several. LLC Sub acquired N7 in Year2 and N8 in Year3. The basis for depreciation in the acquired in Year2 and Year3 were $a_{ei}$ and $a_{ej}$, respectively. In Year6, LLC Sub acquired an additional N9 with a depreciable basis of $a_{ek}$. Upon acquiring the in Year2, LLC Sub appears to have leased the. The details of its leasing arrangements is not set forth in the materials submitted to the National Office. A summary of LLC Sub's gross rents from its leasing activities, its total assets, its investment in securities, and the depreciable basis for its is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>19</th>
<th>20</th>
<th>20</th>
<th>20</th>
<th>20</th>
<th>20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Rents</td>
<td>–</td>
<td>$a_{el}$</td>
<td>$a_{em}$</td>
<td>$a_{en}$</td>
<td>$a_{en}$</td>
<td>$a_{eo}$</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$a_{ep}$</td>
<td>$a_{eq}$</td>
<td>$a_{er}$</td>
<td>$a_{es}$</td>
<td>$a_{et}$</td>
<td>$a_{eu}$</td>
</tr>
<tr>
<td>Investment in securities</td>
<td>$a_{ev}$</td>
<td>$a_{ew}$</td>
<td>$a_{ex}$</td>
<td>$a_{ey}$</td>
<td>$a_{ez}$</td>
<td>$a_{fa}$</td>
</tr>
<tr>
<td>Basis of depreciable</td>
<td>–</td>
<td>$a_{ei}$</td>
<td>$a_{fb}$</td>
<td>$a_{fb}$</td>
<td>$a_{fb}$</td>
<td>$a_{fc}$</td>
</tr>
</tbody>
</table>

Approximately six months after the purchase of the Investors' interests in LLC on D8, approximately g% of the stock of LLC Sub was distributed to B.

N. Miscellaneous matters

LLC and LLC Sub were to own only "Permitted Assets." The definition of "permitted asset" with respect to LLC was set forth in the Operating Agreement, in relevant part, as follows:
1. Securities with remaining maturities of no longer than ninety days or securities that are floating rate demand obligations or floating rate commercial paper;

2. Cash and cash equivalents;

3. Original leased assets

4. Stock of LLC Sub; and

5. Replacement leased assets which are contributed to or acquired by the company to replace an original leased asset with respect to which there has been a default under the lease or a similar event.

LLC and LLC Sub were to maintain in the aggregate core financial assets with aggregate mark-to-market values at least equal to the Investors’ unreturned investment in LLC plus k% per annum (compounded annually) on the average daily balance of the unreturned investment. Core financial assets consist of securities with remaining maturities no longer than 90 days, securities that are floating rate demand obligations and commercial paper, cash and cash equivalents.

C was obligated to make additional contributions to LLC if and to the extent necessary to ensure that its interest in LLC’s capital did not fall below c%. B was obligated to make additional cash contributions in amounts equal to any tax indemnity payments required to be made by LLC to the Investors and could have to make additional contributions of replacement leased assets and cash to the extent necessary to satisfy certain obligations under the Operating Agreement. B and C also were obligated to make additional capital contributions to eliminate the deficit balance, if any, in their respective capital accounts upon the liquidation of LLC.

The Investors were only obligated to make additional contributions to LLC to the extent necessary to eliminate the deficit balance, if any, in their capital accounts upon liquidation of LLC.

**Question 1.** Should this transaction be characterized as a sham for tax purposes and disregarded?

**LAW:**

*Sham transaction theory*

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.
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. Frank Lyon Co. v. U.S., 435 U.S. 561 (1978); Rice’s Toyota World v. Commissioner, 752 F. 2d 89, 92 (4th Cir. 1985). In short, a court will look for facts that suggest that the taxpayer was not motivated by a substantial business purpose other than obtaining tax benefits.

The sham approach hinges on all of the facts and circumstances surrounding the transactions involved. No single factor will be determinative. 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 (1978); ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), aff’g in relevant part T.C. Memo 1997-115; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Rice’s Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985), aff’g in part 81 T.C. 184 (1983); Compaq v. Commissioner, 113 T.C. 214 (1999); UPS of Am. v. Commissioner, T.C. Memo. 1999-268; Winn-Dixie v. Commissioner, 113 T.C. 254 (1999).

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 transactions when the facts, when viewed as a whole, have no economic substance.

ANALYSIS:

In this case, A entered into a transaction primarily for tax purposes. No projections of pre-tax profit and loss were made in contemplation of the transaction. It appears that the identity of the foreign investors was meaningless to A because A was only concerned with shifting income to a tax indifferent partner. The Service should argue that LLC’s allocations were motivated by tax avoidance purposes and had no valid business purpose. The formation of the partnership and the allocations pursuant to the Operating Agreement did not have economic substance and were not compelled or encouraged by business or regulatory realities. The stream of income from the , the cash distributions to F1 and F2, and the ultimate savings in terms of tax dollars could be approximated with virtual certainty. The Investors’ capital contributions were invested in short-term securities which generated a return which
was less than the return that was to be paid to the them. This fact suggests that the motivation for having the Investors involved was so that A could obtain certain tax benefits. In short, the formation of LLC was not imbued with tax-independent considerations, and was shaped primarily by tax avoidance features that have meaningless labels attached.

**Question2.** Is this a valid partnership for tax purposes?

**LAW:**

Section 7701(a)(2) defines a partnership as a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation. Although the definition set forth in the Code is quite broad, not every purported joint undertaking gives rise to a partnership for federal tax purposes.

In order for a federal tax law partnership to exist, the parties must, in good faith and with a business purpose, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise. The entity's status under state law is not determinative for federal income tax purposes. Commissioner v. Tower, 327 U.S. 280, 287 (1946). The existence of a valid partnership depends on all of the facts, including, 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 the parties' true intent. The analysis of these facts show whether 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 Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g T.C. Memo. 1998-305.

In ASA Investerings, the Tax Court first disregarded several parties as mere agents in determining whether the parties had formed a valid partnership. T.C. Memo. 1998-305. In reaching its conclusion that the remaining parties did not intend to join together in the present conduct of an enterprise, the court found that the parties had divergent business goals. The Tax Court's opinion was affirmed by the Court of Appeals for the District of Columbia. ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000). Although the appellate court wrote that parties with different business goals are not precluded from having the intent required to form a
partnership, the court affirmed the Tax Court’s holding that the arrangement between the parties was not a valid partnership, in part because “[a] partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership.” Id. At 515. The appellate court rejected the taxpayer’s argument that the test for whether a partnership is valid differs from the test for whether a transaction’s form should be respected, writing that “whether the ‘sham’ be in the entity or the transaction…the absence of a nontax business purpose is fatal.” Id. At 512.

**ANALYSIS:**

Based upon the documents submitted to the National Office, it appears to us that the participation of F1 and F2 as partners in LLC, taken as a whole, has no business purpose independent of tax considerations and should be disregarded. Once one ignores F1 and F2, all that is left is a partnership between B and C.

F1 and F2 were guaranteed an approximate k% return on the capital they contributed to LLC despite the fact that their capital was invested in assets generating a much lower return. F1 and F2 were indemnified against any taxes assessed in the United States resulting from their participation in LLC. All projections suggested that F1 and F2 would achieve their return and the circumstances under which they would not appear to be remote and, in part, covered by insurance. F1 and F2 appear to have borne no risk of loss in this transaction. F1 and F2 were not involved in the management of LLC, nor in choosing the managers of LLC. They simply contributed their capital, received their cash distributions, and were allocated income they would not have to pay tax on. Also, even if the foreign investors were required to pay tax in the United States, they would be paid for that as well. Furthermore, pursuant to the Operating Agreement, if F1 or F2 did not receive the expected cash distributions, they were entitled to force a liquidation of LLC or have their interests purchased. In sum then, they didn’t participate in management, paid no tax on the income allocated to them, and received a guaranteed return. Although they represented to have joined LLC for the purpose of making a profit in the joint undertaking, the facts suggest otherwise.

LLC was formed as a conduit through which A attempted to avoid current taxation on the income generated from leases. It appears that the purported economic benefits were contrived in an effort to give the transaction economic substance. However, the transaction was driven solely by the tax benefits available to A. Therefore, a valid partnership was not formed and the A consolidated group should be allocated all of the taxable income generated by the leases.

No evidence has been made available to suggest that A considered the transaction from a pre-tax profit perspective. In fact, A has stated that it only considered the after-tax perspective of the transaction. Further, it is clear from the
promotional materials that the central theme of the entire structure was to shift taxable income to tax indifferent parties, while retaining ultimate control over the LLC.

LLC may argue that a profit objective or economic benefit is not necessary for a valid partnership to be recognized for tax purposes. In Vanderschraaf v. Commissioner, T.C. Memo 1997-306, the court concluded that a decision that a partnership activity does not constitute a trade or business, has no economic substance, or lacks a profit objective is not equivalent to a holding that the investors intended to create an entity other than a partnership. Thus, a financial operation or venture is still treated as a partnership under section 761(a) even though the underlying activity of the partnership lacked a profit objective under section 183. However, the court recognized that a financial operation or venture is a prerequisite for the creation of a valid partnership.

Although A’s affiliates, B, C, and D, and F1 and F2 may have intended to create a partnership, they did not intend to engage in and, in fact, did not engage in a joint financial operation or venture. Instead, they intended to use the partnership solely as a tax avoidance vehicle with F1 and F2 getting a fixed return on their investment and A retaining the leasing activity through its affiliate B. Thus, the Service should argue that a valid partnership was not formed.

Case Development, Hazards and Other Considerations
Question 3. - If it is a valid partnership, do the special allocations meet the substantial economic effect rule found in section 1.704-1(b)(2)(iii)(a)?

We believe that the special allocations did not have substantial economic effect and therefore the items of income and deduction which were specially allocated would need to be reallocated in accordance with the partners’ interests in the partnership. The underlying premise of such an argument is that the special allocations put no partner in a worse after-tax economic position than without the special allocations while at the same time enhancing at least one partner’s after-tax position.
Section 704(b)

Section 704(b) provides that a partner’s distributive share of income, gain, loss, deduction, or credit shall be determined in accordance with the partner’s interest in the partnership (PIP), (determined by taking into account all facts and circumstances), if:

1. the partnership agreement does not provide as to the partner’s distributive share of income, gain, loss, deduction, or credit; or

2. the allocation to a partner under the agreement of income, gain, loss, deduction, or credit does not have substantial economic effect.

Section 1.704-1(b)(1)(i) provides that if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit to a partner, there are three ways in which the allocation will be respected under section 704(b). First, the allocation can have substantial economic effect in accordance with §1.704-1(b)(2). Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner’s interest in the partnership (§1.704-1(b)(3)). Third, the allocation can be deemed to be in accordance with the partner’s interest in the partnership pursuant to the special rules in §1.704-1(b)(4). To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit to a partner does not have substantial economic effect, is not in accordance with the partner’s interest in the partnership, and is not deemed to be in accordance with the partner’s interest in the partnership, such income, gain, loss, deduction, or credit will be reallocated in accordance with the partner’s interest in the partnership (§1.704-1(b)(3)).

1. Substantial economic effect.

To have substantial economic effect, partnership allocations must reflect the actual division of income or loss among the partners when viewed from the standpoint of economic, rather than tax, consequences. Goldfine v. Commissioner, 80 T.C. 843 (1983). Section 1.704-1(b)(2)(i) provides that the determination of whether an allocation of income, gain, loss, or deduction to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect within the meaning of §1.704-1(b)(2)(ii). Second, the economic effect of the allocation must be substantial within the meaning of §1.704-1(b)(2)(iii).

2. Economic Effect
For a partnership’s allocations to have economic effect, the partnership agreement generally must meet three mechanical requirements §1.704-1(b)(2)(ii)(b) (the “safe-harbor” test). The partnership agreement must provide: 1) for the determination and maintenance of the partners’ capital accounts in accordance with the rules of §1.704-1(b)(2)(iv); 2) that upon the liquidation of the partnership (or of any partner’s interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after making all capital account adjustments of the partnership taxable year during which such liquidation occurs; and 3) if a partner has a deficit balance in the partner’s capital account following the liquidation of the partner’s interest in the partnership, the partner is unconditionally obligated to restore the amount of the deficit. If a partnership satisfies each of these requirements, its allocations are generally treated as having economic effect for tax purposes.

Section 1.704-1(b)(2)(ii)(i) provides that allocations that do not meet the “safe-harbor” requirements of §1.704-1(b)(2)(ii)(b) will nevertheless be deemed to have economic effect if, as of the end of each taxable year, a liquidation of the partnership at the end of such taxable year (or at the end of any future year) would produce the same economic results to the partners as would occur if the requirements of §1.704-1(b)(2)(ii)(b) had been satisfied, regardless of the economic performance of the partnership.

Section 1.704-1(b)(2)(ii)(a) provides that in order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. In other words, if there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

3. Substantiality

Section 1.704-1(b)(2)(iii) provides that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.

Section 1.704-1(b)(2)(iii) further provides that the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement:

(1) The after-tax economic consequences of at least one partner, may in present value terms, be enhanced compared to such consequences if the allocation was not contained in the partnership agreement; and
(2) There is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation was not contained in the partnership agreement.

In determining the after-tax economic benefit or detriment to a partner, the tax consequences that result from the interaction of the allocation with the partner’s tax attributes that are unrelated to the partnership will be taken into account. Examples 5 and 9 of §1.704-1(b)(5) specifically take into account differing tax brackets of the partners, and situations in which one or more partners will not be subject to tax on income derived from a partnership because of NOL carryforwards.

4. Partner’s Interest in the Partnership (PIP)

If the Service is successful in arguing that LLC’s allocations did not have economic effect or that the economic effect of the allocations was not substantial, the allocations of income, and depreciation must be reallocated according to the partners’ interests in the partnership.

A partner’s interest in the partnership and the partner’s interest in any particular item of partnership income, gain, or loss are generally determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. Section 1.704-1(b)(3) sets forth a presumption that all partners have equal interests in the partnership, determined on a per capita basis. Therefore, in this case, B, C, F1, F2 are each presumed to each have a 25% interest in LLC.

Either the taxpayer or the Service may rebut this presumption by establishing facts and circumstances which show that the partners’ interests in the partnership were not equal. Any and all facts relating to the partners’ underlying economic agreement will affect the determination of a partner’s interest in the partnership. Section 1.704-1(b)(3)(ii) provides that the following facts and circumstances are ordinarily taken into account for purposes of determining PIP or a partner’s interest in any particular item of income, gain, or loss:

- the partners’ relative contributions to the partnership;
- the partners’ interests in the economic profits and losses (if different than that in taxable income and loss);
- the interests of the partners in cash flow and other non-liquidating distributions; and
- the rights of the partners to distributions of capital upon liquidation.

ANALYSIS:
It appears LLC was formed primarily to permit the shifting of lease income for tax purposes from B and C to F1 and F2, foreign entities exempt from U.S. taxation, and thus, to separate the economic consequences of the lease income from its tax consequences. Although F1 and F2 were allocated partnership income for tax purposes, their book accounts were structured so that F1 and F2 were entitled only to a predetermined amount on liquidation of the partnership measured by the balance in their book capital accounts. Because of the depreciation on LLC’s assets for book purposes, F1’s and F2’s book capital accounts, to which they would be entitled on liquidation, was rising much slower than their tax capital accounts. On the liquidation or redemption of F1’s and F2’s partnership interest F1 and F2 were entitled only to the amount in their book capital accounts, even though they had reported most of the taxable income generated from the partnership.

In short, by contributing zero-basis, income-generating assets to a partnership, the A consolidated group attempted to shift the current tax liability for the income stream to other partners. F1 and F2 were apparently willing to participate in this deal because they were exempt from U.S. taxation on the income and because they were guaranteed a certain return on their investment in the partnership. In addition, A, through its affiliated subsidiary, B, maintained the residual ownership of the relationship. Therefore, at the expiration of the leases, B would receive the lease assets from the partnership. B would be liable for any taxable gain on the disposition of those assets, just as it would have if it had never entered into the partnership. The partnership simply allowed the A consolidated group to shift the tax liability for the income stream to a tax-exempt entity. Because the lease generated a predictable stream of income for B, it was possible to calculate with reasonable accuracy the tax and economic effects of the transaction.

As we said earlier, for a partnership’s allocations to have economic effect, the partnership agreement generally must meet three mechanical requirements of §1.704-1(b)(2)(ii)(b) (the “safe-harbor” test). In this case, LLC’s operating agreement (the “Agreement”) must provide for the determination and maintenance of the partners’ capital accounts in accordance with the specific rules of §1.704-1(b)(2)(iv). The Operating Agreement provides, in general, that a partner’s capital account is to be 1) credited with the partner’s capital contributions, the partner’s distributive share of partnership profits and gains, and any partnership liabilities assumed by the partner; and 2) debited for the amount of cash and basis of property distributed to the partner, the partner’s distributive share of partnership losses, and the amount of any liabilities of the partner assumed by LLC. The Agreement provides that these provisions are intended to comply with the requirements of §1.704-1(b) and 1.704-2 and are to be interpreted and applied in a manner consistent with these regulations. Further, the Operating Agreement provides that distributions in liquidation of LLC be made in accordance with the positive capital account balances of the members and that a partner with a negative capital account upon liquidation is unconditionally obligated to
restore such deficit. Accordingly, it appears that the allocations dictated by LLC’s Operating Agreement were intended to meet the “safe harbor” requirements of §1.704-1(b)(2)(ii)(b).

However, even if the Operating Agreement contains the necessary language set forth in §1.704-1(b)(2)(ii), if the capital accounts were not maintained consistent with the regulations, an argument should be made that the “safe harbor” for economic effect was not met. Further, even if it is determined that the “safe harbor” is met, we believe that the allocations may be disallowed by the fundamental principles underlying the economic effect requirement. As we said earlier, if there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden. LLC’s allocations are designed to shift the taxable income to F1 and F2. However, F1’s and F2’s ability to withdraw capital from the partnership appears to be limited to a predetermined amount which does not correspond with the taxable income it reported. Although F1 and F2 are allocated taxable income, F1 and F2 will never receive the economic benefit that corresponds to that allocation. Therefore, it appears that the allocation of taxable income to F1 and F2 does not have economic effect.

Furthermore, even if LLC is able to demonstrate that its allocations satisfy the “safe harbor” requirements of §1.704-1(b)(2)(ii), the economic effect of the allocations must still be substantial under §1.704-1(b)(2)(iii). With this in mind, we believe that the economic effect of the allocations from LLC are not substantial because, from an after-tax perspective (taking into account present value considerations), no partner was in an economic position which was worse than they would have been without the allocations, and, the A consolidated group appears to have been in a better economic situation than they would have been without the allocations. The foreign partners were not subject to taxation in the United States. In the absence of the special allocations, they would have likely been entitled to allocations corresponding closely to their relative capital contributions. Although the foreign partners failed to receive a substantial portion of the taxable income which was allocated to them, it appears that they are better off than they would have been had there been no special allocations. Further, it is rather clear from all of the projections and memoranda leading up to the formation of LLC, that the entire structure was conceived and executed primarily to achieve tax benefits for the A consolidated group. Without the special allocations, the A consolidated group would have been allocated substantially more of the rental income and incurred a tax liability which was much greater than that which was incurred with the allocations. These facts support the argument that the economic effect of LLC’s allocations were not substantial.

If the Service is successful in arguing that economic effect of LLC’s allocations was not substantial, the allocations of income and depreciation must be reallocated according to the partners’ interest in the partnership. In this case, the underlying
economic arrangement between the parties was outlined in the promotional materials and the formation documents. F1 and F2 each contributed only g% percent of LLC’s capital and were guaranteed an annual return on their investment in LLC of approximately k% until Year8. Despite collectively contributing only n% percent of LLC’s capital, F1 and F2 were allocated h% percent of LLC’s taxable income for which F1 and F2 apparently had no tax liability. B, C, and D, on the other hand, collectively contributed o% of LLC’s capital, and received less than p% of its taxable income, and B was able to retain the residual ownership of the . Arguably, F1’s and F2’s collective interest in the partnership is only n%, F1’s and F2’s collective capital contribution.

Furthermore, the determination of a partner’s interest in a partnership is an item-by-item determination. B’s interest in the leased and lease income may be greater than B’s overall PIP. The Service may be able to argue that F1’s and F2’s interests in LLC or in the partnership items generated from the leased , equals the amount that gives F1 and F2 the required return on their capital contribution. This is the amount that guarantees the k% return to F1 and F2 and represents all that F1 and F2 are entitled to on liquidation of their partnership interests.

Case Development, Hazards and Other Considerations
Question 4. Is section 482 applicable to reallocate partnership income away from the two foreign partners and back to A?

Because of the manner in which certain penalties are set forth in section 6662, as well as Question 6 as set forth in your request for advice, the above question raises two issues which we address below. Those questions are: 1) Whether section 482 may apply to reallocate income under leases, that were contributed to a partnership, to the contributing partner who sustained the deductions attributable to the leased properties, in lieu of the allocation under the partnership agreement of the bulk of such income to tax-indifferent foreign partners; and 2) If section 482 applies, whether the accuracy-related penalty for substantial valuation misstatement under section 6662(e)(1)(B) may be asserted.

The plain language of the statute and case law would support the applicability of section 482 to clearly reflect the taxpayer's income. Further, we consider the better view to be that the section 6662(e)(1)(B) transactional and net adjustment penalties are limited by the terms of the statute, as elaborated by the legislative history and regulations, to above-threshold “adjustments under section 482 in the price for any property or services (or for the use of property).” Under this view, transfer pricing adjustments to which the penalties apply would be distinguished from non-transfer pricing adjustments under section 482, such as this case's adjustments to avoid tax attribute mismatches as the result of nonrecognition transactions, to which the penalties do not apply.

LAW AND ANALYSIS

A. Section 482 - In General

Section 482 provides:

In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses if he determines that such distribution, apportionment, or allocation is necessary in
order to prevent evasion of taxes or clearly to reflect the income of any of such
organizations, trades, or businesses.\footnote{11}

The purpose of section 482 is “to prevent evasion [of taxes] (by the shifting of profits . . . and other methods frequently employed for the purpose of “milking”), and in order to arrive at their true tax liability.” S. Rep. No. 960, 70th Cong., 1st Sess. (1928), reprinted in 1939-1 (Part 2) C.B. 409, 426. The scope and applicability of section 482 is broad and is not necessarily limited to cases of “improper accounting” or cases of “fraudulent, colorable, or sham transaction[s].” Section 1.482-1(f)(1)(i). In other words, section 482 may apply even when a taxpayer’s actions inadvertently result in an inaccurate reflection of income. See §1.482-1(f)(1). In Your Host, Inc. v. Commissioner, 58 T.C. 10, 24 (1972), aff’d, 489 F.2d 957 (2d Cir. 1973), the court explained that

if there has been an actual shifting of income, purity of purpose and the
presence of sound business reasons for forming multiple corporations are no
defense under section 482. In short, section 482 does not deal with motivation
and purpose . . . but with economic reality. (Emphasis added.)

The policy that underlies section 482 concerns economic reality and true tax
liability rather than technical conformity within statutory or regulatory parameters.

B. Requirements and Applicability of Section 482

1. Two or More Organizations

The first requirement for applying section 482 is that the taxes or income of two
“organizations, trades, or businesses” be involved. These terms are defined very
broadly in the regulations. Section 1.482-1(i)(1) and (2). For example, section 482
can be applied to reallocate income from a partnership to a corporate partner of the
partnership. See, e.g., Aladdin Industries, Inc. v. Commissioner, T.C. Memo. 1981-245. Section 482 also permits reallocation of income among corporate partners. Rodebaugh v. Commissioner, T.C. Memo. 1974-36, aff’d, 518 F.2d 73 (6th Cir. 1975). The fact pattern presented in this case meets the multiple “organizations, trades, or businesses” requirement of section 482.

2. Common Ownership or Control

\footnote{11 For purposes of section 482, the term “evasion of taxes” is synonymous with
“tax avoidance.” Foster v. Commissioner, 80 T.C. 34, 157-158 (1983).}
The second requirement for applying section 482 to a transaction is that the transaction involve two or more entities “owned or controlled” by the same interests. This control requirement is, like the first requirement, construed very broadly. Section 1.482-1(i)(4). Any kind of control whether direct or indirect and whether or not legally enforceable satisfies the control requirement. Id. In addition, arbitrary shifting of income or deductions raises a presumption of control. Id.; see also Notice 95-53 (treating parties to a transaction as “controlled . . . by the same interests” if they act in concert with the common goal of arbitrarily shifting income or deductions between transferor and transferee).

In this case, A owned 100% of the two domestic partners. Those two partners, B and C, held all managerial power within the partnership. They also held virtually all voting power. The control of the partnership by the domestic partners and, thus, by A satisfies the broad meaning of “ownership and control” in section 482. See also Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419-420 (4th Cir. 1966) (standing for the proposition that management control of an entity, rather than legal ownership interests, drives section 482 and may constitute “actual and effective control”).

Moreover, an arbitrary shifting of virtually all partnership rental income to the two foreign partners would raise a presumption of control with respect to the partnership. §1.482-1(i)(4). By using the partnership agreement to shift the A consolidated group’s rental income to the partnership – and specifically to the foreign partners – the parties worked in concert to shift h% of the future income to the tax-exempt foreign partners. This cooperation among the entities indicates control under §1.482-1(i)(4) and Notice 95-53, 1995-2 C.B. at 335. See also South Texas Rice Warehouse Co. v. Commissioner, 43 T.C. 540 (1965) (holding that when individual shareholders and partners of multiple corporations and partnerships carefully structured their equity interests to avoid statutory control requirements, their common design and their actions in concert nonetheless constituted section 482 control).

A controlled the partnership through its subsidiaries. In addition, an arbitrary shifting of rental income would raise a presumption of control among the various partners. Under either approach, the control requirement of section 482 has been met.

3. Clear Reflection or Evasion of Taxes Prongs - Nonrecognition Transactions

The third requirement for application of section 482 is an IRS determination that a reallocation is necessary to prevent evasion of taxes or clearly to reflect the income of any of the entities involved in the transaction. Such a determination will be upheld unless the taxpayer proves that the determination is arbitrary, capricious, or unreasonable. See, e.g., Liberty Loan Corp. v. U.S., 498 F.2d 225 (8th Cir.), cert. denied, 419 U.S. 1089 (1973) (providing an extensive analysis of the issue); see also
On remand, the Claims Court held that the taxpayer did have a tax avoidance motive and, thus, allowed the application of section 482. Ruddick, supra, 3 Cl. Ct. 61 (1983), aff’d, 732 F.2d 168 (Fed. Cir. 1984) (mem. op.).

Transfer pricing adjustments are made to conform the consideration – that is, the transfer price – in transactions between controlled taxpayers to what the consideration would be in a comparable transaction between uncontrolled taxpayers in comparable circumstances at arm’s length. See §1.482-1(b)(arm’s length standard). For transfer pricing adjustments, the Commissioner may proceed under the clear reflection prong and need not establish a tax avoidance motive as a predicate. Section 1.482-1(f)(1)(i).

The statute is broad, and the case law and the regulations have long extended the application of section 482 beyond the realm of transfer pricing, in particular, to rectify misallocations of tax attributes that may arise in connection with nonrecognition transactions. See National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir.), cert. denied, 320 U.S. 794 (1943) (reallocating loss to transferor when one corporation transferred property with a built-in loss to another corporation in a section 351 nonrecognition transfer and the transferee sold the property for a loss); Section 1.482-1(f)(1)(iii)(A) and (B) (expressly adopting the rule of National Securities and permitting application of section 482 to nonrecognition transactions when necessary to prevent the avoidance of taxes or clearly reflect income).

Nevertheless, the case law has been sensitive to an apparent tension that exists between the clear reflection prong of section 482 and nonrecognition provisions, since the latter contemplate to some degree an alteration of what otherwise would be the recognition of income and deductions. See Ruddick Corp. v. United States, 643 F.2d 747, 751 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff’d without op., 732 F.2d 168 (Fed. Cir. 1984). In Ruddick, the U.S. Claims Court refused to apply section 482 to a section 311 distribution in the absence of a tax avoidance purpose. 643 F.2d at 752. The court reasoned that section 482 should not automatically override the income distortion that is built into, and anticipated by, a nonrecognition provision. Id.

Some case law arguably may circumscribe the latitude the Service has to assert section 482 to overcome the results of a nonrecognition transaction. See Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1114-1125 (1985), aff’d in part and rev’d in part, 856 F.2d 855, 861-868 (7th Cir. 1988). Under this view, the Service may generally have to invoke the evasion of taxes prong and establish that the purpose of a nonrecognition transfer is tax avoidance in order to make a section 482 adjustment.

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12 On remand, the Claims Court held that the taxpayer did have a tax avoidance motive and, thus, allowed the application of section 482. Ruddick, supra, 3 Cl. Ct. 61 (1983), aff’d, 732 F.2d 168 (Fed. Cir. 1984) (mem. op.).
Eli Lilly does carve out a line of cases in which the Service may still proceed under the clear reflection prong, without showing a tax avoidance motive, in order to apply section 482 to correct an artificial separation of income from the expenses of earning the income by means of a nonrecognition transaction, but the boundaries of that exception are uncertain. Accord, Ruddick, supra, 643 F.2d at 753 (permits the use of section 482 even when tax avoidance is not involved if the nonrecognition transaction results in an "outright distortion or violation of the basic precepts" that related "expenses and income should ordinarily be matched").

The principal authorities cited in Eli Lilly for application of the clear reflection prong of section 482 to adjust the results of a nonrecognition transfer consist of two similar cases in which a taxpayer, without any tax avoidance purpose, mismatched its income and deductions in a single year. In both Rooney v. United States, 305 F.2d 681, 682 (9th Cir. 1963) and Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), rev’g, 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952), individuals engaged in a farming business incurred expenses planting crops, deducted those expenses on their individual returns, and then transferred all of the assets of that business – including the planted crops – to a new corporation. In so doing, the taxpayers benefitted from deductions and then shifted the related future income in the form of planted crops to another entity. Both cases held that section 482 applied to allow reallocation of the income away from the new corporations and back to the individuals and their businesses that had benefitted from the related expense deductions.

In Eli Lilly, the taxpayer incurred research and development ("R&D") expenses which it had deducted and recovered in 1966 before transferring the resulting manufacturing intangibles to a Puerto Rican subsidiary for production of income in 1971, 1972, and 1973. The Tax Court and the Seventh Circuit refused to uphold reallocations of income based on a broad, non-transfer pricing theory that effectively would have nullified the section 351 nonrecognition transfer of the manufacturing intangibles to the Puerto Rican subsidiary. 84 T.C. at 1125; 856 F.2d at 863. The requisite tax avoidance purpose was not found for applying the evasion of taxes prong to override the nonrecognition transfer under section 482. Further, the facts were found not to fall within the exception for applying the clear reflection prong under the Rooney and Central Cuba Sugar line of cases. 84 T.C. at 1122; 856 F.2d at 863. The Tax Court pointed out that both Rooney, supra, and Central Cuba Sugar, supra, involved mismatching of income and deductions within a single year. 84 T.C. at 1122. By contrast, Eli Lilly’s R&D expenses that gave rise to the income producing intangibles were “too remote in time to be matched with the income earned by [the subsidiary] during the years in issue.” Id. at 1125. Although the court was careful to note that it did not intend for its decision to imply that the applicability of section 482 is limited to events occurring within a one-year period, it did not elaborate upon the
circumstances in which a multiple year application might be possible absent a tax avoidance motive. See id. at 1125 n.63.

Several other cases should also be noted. In Foster v. Commissioner, 80 T.C. 34 (1983), aff’d in relevant part, 756 F.2d 1430 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986), a partnership incurred expenses developing land for sale, but the partners deducted those expenses against their individual incomes. The partnership then transferred the land to corporations in section 351 nonrecognition exchanges to shift the related income and minimize tax liability. 756 F.2d at 1433. Agreeing with the Tax Court that the transferred properties were “highly appreciated” and “pregnant with income,” the Ninth Circuit held that the transfers had no business function and that their purpose was tax avoidance. Id. at 1433 and 1436. Accord, Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987) (distribution of two tracts of partnership land to partners prior to donation and sale). See also Southern Bancorporation v. Commissioner, 67 T.C. 1022 (1977) (reallocating gain from sale of bonds from parent to subsidiary when subsidiary invested in the bonds but distributed the appreciated bonds to its parent which enjoyed more favorable tax treatment on disposition); Ballentine Motor Co., Inc. v. Commissioner, 39 T.C. 348, 349 (1962), aff’d, 321 F.2d 796 (4th Cir. 1963) (reallocating income from inventory sales when profitable commonly-owned businesses transferred their inventory title to an unprofitable commonly-owned business until its net operating loss carryover was exhausted); Spicer Theatre, Inc. v. Commissioner, 44 T.C. 198 (1964), aff’d, 346 F.2d 704 (6th Cir. 1965) (reaching the same result as the Ballentine court where a profitable theater business leased its theaters to a commonly-owned, insolvent, and dormant corporation for two years to offset anticipated theater profits against the dormant corporation’s NOL carryover).

In the instant case, B’s contribution of the leasing assets to the partnership was a nonrecognition transfer under section 721. Compliance with the partnership allocation rules under section 704 would not shield the A consolidated group per se from scrutiny under section 482. Section 1.704-1(b)(1)(iii) (stating that an allocation respected under section 704 may still be reallocated under section 482 as well as other remedial provisions).

The instant facts constitute circumstances for the application of the clear reflection of income prong to remedy a mismatch in income and deductions as the result of a nonrecognition transfer, notwithstanding that, like Eli Lilly, the mismatch occurred over an extended period of many years. Eli Lilly could be distinguished on the basis that it was not possible on the facts of that case to match up expenses and attributable income over the multi-year period. By contrast, the A consolidated group and the foreign partners knew with precision how much income the leased properties would generate yearly. Moreover, the plain language of the statute supports
application of section 482 in this case by authorizing adjustments necessary to clearly reflect income.

C. Section 6662(e) Penalty in Section 482 Context

1. Section 6662(e)(1)(B) in General

In certain circumstances, a taxpayer may be penalized in an amount equal to 20% of a portion of an underpayment of tax required to be shown on a return. Section 6662(a). The penalty applies to underpayments that are attributable to, among other things, a “substantial valuation misstatement under chapter 1.” Sections 6662(b)(3) and (e).

A substantial valuation misstatement may exist if section 482 applies to a transaction, and the price claimed on a return for property, services, or use of property is at least 200% greater or at most 50% less than the correct price determined under section 482. Section 6662(e)(1)(B)(i). The penalty for this kind of substantial valuation misstatement is known as a “transactional penalty.” Section 1.6662-6(a)(1). The definition of transactional penalty in the regulations echoes the statutory definition and repeatedly refers to prices. Section 1.6662-6(b)(1).

A substantial valuation misstatement may also exist if “the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10% of the taxpayer’s gross receipts.” Section 6662(e)(1)(B)(ii). A net section 482 transfer price adjustment is the net increase in taxable income in a taxable year as a result of section 482 adjustments in the price of property, services, or use of property. Section 6662(e)(3)(A). The net section 482 transfer price adjustment is defined in the regulations as the net increase in taxable income resulting from “allocations under section 482 . . . .” Section 1.6662-6(c)(1). This regulatory definition does not fully echo the language in sections 6662(e)(1)(B)(ii) and (3)(A), because it omits references

13 Please note that section 6662(e)(1)(A) describes a third substantial valuation misstatement that is not tied to section 482 applicability and which this analysis does not address.

14 The full definition of §1.6662-6(c)(1) is as follows:

the sum of all increases in the taxable income of a taxpayer for a taxable year resulting from allocations under section 482 (determined without regard to any amount carried to such taxable year from another taxable year) less any decreases in taxable income attributable to collateral adjustments as described in §1.482-1(g).
to transfer prices. The 20% penalty for this kind of substantial valuation misstatement is known as the “net adjustment penalty.” Section 1.6662-6(a)(1).

When determining the net section 482 transfer price adjustment, portions of any net increase in taxable income may be excluded from the calculation if the taxpayer (1) meets the specific pricing method and documentation requirements under section 6662(e)(3)(B)(i); (2) meets the unspecified pricing method and documentation requirements under section 6662(e)(3)(B)(ii); or (3) satisfies the terms of transactions solely between foreign corporations under section 6662(e)(3)(B)(iii). See also §1.6662-6(d)(2)-(4), for descriptions of these requirements.

The section 6662(a) 20% penalty may be imposed on a taxpayer if either the transactional penalty requirements or the net adjustment penalty requirements have been met. A de minimis rule provides that no penalty for substantial valuation misstatement is imposed unless the amount of the underpayment exceeds $5,000 or $10,000 in the case of a corporation other than an S corporation or a section 542 personal holding company. Section 6662(e)(2).

2. Gross Valuation Misstatement

A “gross valuation misstatement” in the section 482 context is a substantial valuation misstatement under section 6662(e)(1)(B) but determined by substituting the values 400%, 25%, $20 million, and 20% for the values 200%, 50%, $5 million, and 10%, respectively. Section 6662(h)(2)(A). If there is a gross valuation misstatement under section 6662(h), then the 20% penalty under section 6662(a) is increased to 40%. Section 6662(h)(1).

3. Reasonable Cause and Good Faith Exception

The penalty is not imposed on any portion of an underpayment if the taxpayer shows reasonable cause for the underpayment and demonstrates that it acted in good faith with respect to the underpayment. Sections 6664(c)(1) and 6664(a). See §1.6664-4 for guidance in determining reasonable cause and good faith in the context of section 6662 penalties. Whereas the reasonable cause and good faith exception potentially applies to all transactional penalties, the exception applies to a net adjustment penalty only if one of the above-mentioned three requirements under section 6662(e)(3)(B) has been met. Section 6662(e)(3)(D). In other words, if a taxpayer does not satisfy section 6662(e)(3)(B) with respect to a possible net adjustment penalty, the taxpayer cannot qualify for the reasonable cause and good faith exception.

15 See also INTL-21-91, 1993-1 C.B. 846, 849 (Prop. Reg. §1.6662-5(j)(2)(i) defining “net section 482 transfer price adjustment” as “the net increase in the taxable income of a taxpayer for a taxable year that results from all section 482 allocations”).
faith exception. See also §1.6662-6(c)(6). Furthermore, the regulations provide that
a taxpayer that meets the documentation requirements will be treated as establishing
reasonable cause and good faith for purposes of excusing the transactional penalty.
Section 1.6662-6(b)(3). See also §1.6662-6(f) for rules coordinating the transactional
and net adjustment penalties as well as substantial valuation misstatements and gross
valuation misstatements.

4. Timing Issues

As noted, the taxable years in this matter are Year1 through Year6

The Omnibus Budget Reconciliation Act of 1993 (“OBRA”) made several
amendments to the structure of section 6662(e) and section 6662(h), principal among
which were the addition of the documentation requirements under the net adjustment
changes took effect in tax years beginning after 1993. Therefore, the rules for the
section 6662(e)(1)(B) penalties described above apply to certain taxable years

For taxable years beginning before 1994, the threshold for triggering a net
adjustment penalty is $10 million rather than the current threshold of $5 million or 10%
of the taxpayer’s gross receipts. Id. at section 13236(a) (amending section
6662(e)(1)(B)(ii)). Therefore, the trigger for a net adjustment penalty for taxable years
beginning in 1993 and earlier is a $10 million adjustment.

Accordingly, the reference in section 6662(h) to the net adjustment penalty
threshold changed in 1994. Id. at section 13236(d). Therefore, for 1993 and prior
taxable years, a gross valuation misstatement can exist with respect to a net
adjustment penalty only by substituting $20 million for $10 million when making a
determination of the section 6662(e)(1)(B)(ii) amount.

Section 1.6664-4 which provides special guidance for the determination of
reasonable cause and good faith in the case of section 6662 penalties applies to
the technical guidance in §1.6664-4 does not apply to returns due on or before
September 1, 1995. The Treasury Department considers the proposed regulations
published on January 21, 1993 at INTL-21-91, 1993-1 C.B. 846, to be a reasonable
interpretation of section 6662(e) for taxable years ending after November 5, 1990, but

The 1994 amendments brought two other changes to the penalty regime. The
details of the pricing method and documentation exception in section 6662(e)(3)(B)
with respect to net section 482 transfer pricing adjustment calculations changed
slightly. OBRA at section 13236(b). Also, the provision under section 6662(e)(3)(D)
that the reasonable cause and good faith exception would not apply to a net
adjustment penalty unless one of the three requirements of section 6662(e)(3)(B) is
met was added to section 6662(e) in 1994. Id. at section 13236(c). Therefore, for
taxable years beginning prior to 1994 but after November 5, 1990, the reasonable
cause and good faith exception is equally applicable to both transactional penalties
and net adjustment penalties regardless of whether a taxpayer complies with the
requirements of section 6662(e)(3)(B).

The rules under §1.6662-6 are effective February 9, 1996. Section 1.6662-6(g).
However, a taxpayer may elect to apply this section to all open taxable years beginning
after December 31, 1993.

5. Meaning of “Transfer Pricing” in the Context of Section 6662(e)(1)(B)

Both the transactional penalty and the net adjustment penalty are expressly tied
under the statutory language to “the price for any property or services (or for the use
of property).” Sections 6662(e)(1)(B)(i) and (ii) as well as (e)(3)(A). The term “price”
is not defined in section 6662 or in the accompanying regulations. Terms used in
§1.6662-6 that are identical to terms used in the section 482 regulations have the
meaning given in the section 482 regulations. Section 1.6662-6(a)(3). The term
“price” is not defined in the section 482 regulations, which speak instead in terms of
the “results” of, or “amount charged” in, controlled and uncontrolled transactions. See
§1.482-1 et seq. The clear sense that emerges is that “price” refers to the
consideration charged in various types of transactions for services, sales, licenses, etc.
and does not apply to a mismatching of tax attributes as occurred in the present case.

Throughout the method and documentation requirements of section
6662(e)(3)(B), the statute refers expressly and repeatedly to “price” and “pricing
methods.” The repeated references to transfer prices throughout section 6662(e)
does not define in section 6662 or in the accompanying regulations. The term “price”
is not defined in the section 482 regulations, which speak instead in terms of
the “results” or “amount charged” in, controlled and uncontrolled transactions. See
§1.482-1 et seq. The clear sense that emerges is that “price” refers to the
consideration charged in various types of transactions for services, sales, licenses, etc.
and does not apply to a mismatching of tax attributes as occurred in the present case.

The House Conference Report on the 1990 OBRA describes the “net section
482 transfer price adjustment” as the “net increase in taxable income for a taxable year
that results from all adjustments under section 482 in the transfer price of any property
or services.” H.R. Rep. No. 964, 101st Cong., 2d Sess. 1075 (1990), reprinted in,
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1991-2 C.B. 560, 579. The Report also states that the term “price” should “be broadly interpreted to encompass consideration of all kinds that may be adjusted by the IRS under section 482, including but not limited to purchase prices, fees for services, royalties, interest, and rents.” 1991-2 C.B. at 580.

Although the section 6662(e)(1)(B)(ii) net adjustment penalty is determined with respect to a “net section 482 transfer price adjustment,” the regulations refer only to a “net section 482 adjustment.” Section 1.6662-6(c)(1). The regulations describe a net section 482 adjustment as “the sum of all increases in the taxable income of a taxpayer for a taxable year resulting from allocations under section 482 . . . .”Id. The phrase “allocations under section 482” in §1.6662-6(c)(1) may refer to the broad scope of section 482 adjustments, including those relating to mismatches in tax attributes arising from nonrecognition transfers. See, e.g., §§1.482-1(a)(2) and (f)(1)(iii). Under this view, the references to “price” and “transfer price” in section 6662(e) would indicate that mere section 482 applicability – rather than a transfer pricing distortion – is a prerequisite for a section 6662(e) penalty. We do not consider this argument persuasive. See also 1994-1 C.B. 298, 299 (preamble to §1.6662-6 commingling the language of the statute and the regulation); Staff of House Comm. On Ways and Means, H.R. Con. Res. 64, 103rd Cong. (Comm. Print 1993) (freely using the term “net section 482 adjustment” intermittently in its discussion of the “net section 482 transfer pricing penalty”); I.R.M. section 120.1.5.9.3 (2000) (echoing the House Conference Report’s definition of “price”).

We consider the better view to be that the section 6662(e)(1)(B) transactional and net adjustment penalties are limited by the terms of the statute, as elaborated by the legislative history and regulations, to above-threshold “adjustments under section 482 in the price for any property or services (or for the use of property).” Under this view, transfer pricing adjustments to which the penalties apply would be distinguished from other non-transfer pricing adjustments under section 482, specifically in this case adjustments to avoid tax attribute mismatches as the result of nonrecognition transactions, to which the penalties do not apply.

Therefore, it is our view that the penalties under section 6662(e)(1)(B) do not apply to the mismatching of income and deductions in this matter, even though section 482 provides the Service with an alternative basis for reallocating those items.

Case Development, Hazards and Other Considerations
Question 5. Should the foreign investors be considered lenders rather than partners?

**LAW AND ANALYSIS**

As an alternative to arguing that the formation of the partnership or its allocation structure was a sham, the Service may wish to argue that F1 and F2 were not true partners in the partnership. F1 and F2 will be respected as partners for federal tax purposes if F1 and F2 had a good faith intent to engage in joint investment activities and share the profits and losses from those activities as co-proprietors with B, and C. All objective indicia of F1’s and F2’s intent will be taken into account, including: 1) the partnership agreement; 2) the conduct of F1 and F2 in executing the terms of the agreement; 3) F1’s and F2’s participation in the management and operation of LLC’s business activities; 4) how independent third parties dealing with F1 and F2 viewed F1 and F2 (e.g., as a partner or lender); 5) the parties’ respective capital and service contributions; 6) F1’s and F2’s relative control over LLC’s income and capital, and its rights to withdraw assets from LLC; and 7) any other factors throwing light on the true intent of F1 and F2. See Commissioner v. Culbertson, 337 U.S. 733 (1949); Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).

We believe that the facts need to be developed with respect to the argument that F1 and F2 were lenders rather than equity participants in the partnership.

Despite the Investors’ representation that they entered into LLC for the purpose of engaging in a profit the facts and circumstances of the entire partnership structure must be considered. F1 and F2 were essentially guaranteed a minimum return on their investment in LLC. F1 and F2 were not involved in the management of LLC. They were indemnified against tax imposed in the United States. Despite taxpayers’ arguments that F1 and F2 were sought out because they were genuinely interested in an investment in older vintage, the fact remains that F1 and F2 were not involved in the management of LLC, they obtained a guaranteed return on their investment of approximately k%, they were indemnified against U.S. tax, and they exited the partnership structure when A’s cost of maintaining them as a participant in the transaction became too costly because of the indemnification they would need to be paid on an ongoing basis because of increased tax rates in Country2. The facts as established so far support an argument that F1 and F2 did not intend to engage in joint activities with A’s affiliates through a partnership. F1’s and F2’s capital contributions were invested in short-term securities which generated a return which was less than the return that was to be paid to the Investors and which carried little risk. This fact suggests that the motivation for having the Investors involved was so that A could obtain certain tax benefits. Despite taxpayer’s arguments to the contrary,
A did not intend to make a profit from the use of the Investors’ capital, the use of their capital was merely incidental to the larger partnership allocation scheme. B’s contributed assets generated a predetermined stream of income which was collected by LLC and allocated to the partners so that F1 and F2 earned a predetermined return on its capital contribution. A, through its affiliate B, retained the residual value on the assets it contributed.

The Investors’ capital was never truly at risk in a joint venture with A’s affiliates. F1’s and F2’s status in the transaction was more akin to a lender who expected a debt-like return on its investment rather than a true tax owner imbued with the benefits and burdens of ownership. Therefore, the Service should argue that, although LLC was a partnership, F1 and F2 were never partners in the partnership.

Case Development, Hazards and Other Considerations
Question 6. Should accuracy-related penalties for negligence and/or substantial valuation misstatement be asserted under section 6662?

LAW AND ANALYSIS:

The substantial valuation misstatement penalty under section 6662(e)(1)(B) has been discussed, and concluded to be inapplicable, under Question 4. The remainder of the discussion hereafter concerns the accuracy-related penalty for negligence.

Negligence

In pertinent part, section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to negligence.

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonably care in the preparation of a tax return. See section 6662(c) and §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 Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff’d, 43 T.C. 168 (1964).

Section 1.6662-3(b)(1)(ii) provides 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 which would seem to a reasonable and prudent person to be “too good to be true” under the circumstances.

In Compaq v. Commissioner, 113 T.C. 214 (1999), the Service argued that Compaq was liable for the accuracy-related penalty because Compaq disregarded the economic substance of the transaction. The court in Compaq agreed with the Service’s position and asserted the accuracy-related penalty for negligence because
Compaq “failed to investigate the details of the transaction, the entity it was investing in, the parties it was doing business with, or the cash-flow implications of the transaction.”

In United Parcel Services of America, Inc. v. Commissioner, T.C. Memo. 1999-268, the court affirmed the negligence penalty against United Parcel Services (UPS) because UPS was a sophisticated taxpayer that was engaged in an ongoing sham transaction devoid of economic substance during the year at issue.

If you find that Taxpayer engaged in a transaction that lacked economic substance and that the tax benefits claimed would have seemed, to a reasonable and prudent person, to be “too good to be true,” then you may conclude that Taxpayer was negligent in its tax treatment of the lease stripping transaction under any of the suggested theories for increasing Taxpayer’s taxable income.

Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, for each year at issue the Service can either assert the accuracy-related penalty for negligence or the accuracy-related penalty for a substantial valuation misstatement (if applicable), but not both. See DHL Corp. v. Commissioner, T.C. Memo. 1998-461, where the Service alternatively determined that either the 40-percent gross valuation misstatement penalty under section 6662(h) or the 20-percent negligence penalty under section 6662(b) was applicable.

Reasonable Cause

Section 6664(c)(1) of the Code provides that the accuracy-related penalty does not apply with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. 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. See §1.6664-4(c)(1)(i). In most circumstances, the National Office does not make decisions on whether reasonable cause, due diligence, or good faith exist under subtitle F. Instead such decisions are left to the Commissioner and the Service’s personnel. However, we have provided the following law that may be used to help determine if Taxpayer can avoid the accuracy-related penalty because of reasonable cause.

Generally, a taxpayer may avoid liability of the accuracy-related penalty if there is reasonable reliance on a competent professional tax advisor and the taxpayer acted in good faith. See §1.6664-(b)(1). However, reliance on advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. See §1.6664-4(b)(1); Boyle v. United States, 469 U.S. 241 (1985). Reliance on an advisor can only be used by a taxpayer for reasonable cause if the following requirements are
met: 1) the advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances and 2) the advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.  See §1.6664-4(c)(1).

Reliance on professional advice, standing alone, is not a defense to negligence but rather a factor to be considered.  In order to establish reasonable cause, it must be shown that the reliance on the tax professional was reasonable.  Freytag v. Commissioner, 89 T.C. 849, (1987) aff’d, 904 F.2d 1011 (5th Cir. 1990); Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994); and Addington v. United States, 205 F.3d 54 (2d Cir. 2000).  For example, in Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988), the taxpayer’s reliance on the accountant’s advice was improper because the accountant did not know anything firsthand about the tax shelter.  Therefore, reasonable cause relief was denied.

CAVEAT:

This advice is limited to the particular facts of this case and does not represent a final statement of the Service’s position.  It may not be used, cited or relied on as precedent.  This Field Service Advice has set forth many values.  The values set forth were provided in large part by the taxpayer and should not be construed as the National Office’s opinion that the values are accurate or appropriate.  The Field should undertake its own independent verification of the values used.

If you have any questions, please call David J. Sotos at (202) 622-3050.

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