



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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
MEMORANDUM FOR ASSOCIATE AREA COUNSEL, CHICAGO CC:CHI:LMSB:1

FROM: Chief, CC:INTL:Br3

SUBJECT:
This Chief Counsel Advice responds to your memorandum dated June 19, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Deconsolidated =
TSub =
Bank =
FB1 =
FB2 =
FB3 =
Law Firm =
Country A =
Year 1 =
Year 2 =
Date 1 =
Date 2 =
Date 3 =

=
=

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Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Amount 8	=
Amount 9	=
Amount 10	=
Amount 11	=
Amount 12	=
Amount 13	=
x percent	=

ISSUES

1. Whether mirror sale-leaseback transactions between two domestic subsidiaries of the taxpayer and two foreign subsidiaries of a foreign bank followed by a like-kind exchange that returned title to the leased properties to Taxpayer's controlled group lacked economic substance and therefore should be disregarded for federal income tax purposes.
2. Alternatively, whether section 482 applies to reallocate income and deductions from the transactions.
3. If the foreign source rental income created in the foreign property sale-leaseback is not disregarded, whether such income is properly characterized as general limitation income or passive income for foreign tax credit limitation purposes.
4. Whether the accuracy-related penalty under section 6662(a) should be asserted.

CONCLUSIONS

1. The transactions at issue lacked economic substance and a nontax business purpose and therefore should be disregarded for federal income tax purposes.

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2. Alternatively, based on the facts presented, section 482 applies to reallocate rental income and expense and depreciation deductions between the members of Taxpayer's controlled group that participated in the transactions.
3. If not disregarded, the facts provided suggest the rental income should be characterized as passive income.
4. The facts of this case present a reasonable basis for asserting the section 6662(a) penalty.

FACTS

Taxpayer is a domestic corporation that is the controlling parent of Deconsolidated, a domestic subsidiary that was deconsolidated from Taxpayer on Date 1 and filed a separate return. Because Deconsolidated had foreign tax credit carryforwards of Amount 1 that were to expire unused in Year 1, Taxpayer contacted Law Firm to explore methods to utilize these expiring credits and on Date 2, signed a confidentiality agreement with Law Firm. Five months later, Taxpayer and Bank, a Country A bank, began to negotiate the terms of the transaction, and on Date 3, Taxpayer signed a confidentiality agreement with and agreed to pay fees to Bank.

Briefly, the transaction at issue involved mirror sale-leasebacks between two domestic subsidiaries of Taxpayer, Deconsolidated and Tsub (a member of Taxpayer's consolidated group), and two Country A corporations, FB1 and FB2, that were indirectly owned by Bank.¹ The transaction generated offsetting cashflows and an economic loss to Taxpayer when transaction costs are taken into account. As a result of the transaction, Deconsolidated claimed U.S. source depreciation deductions, reported foreign source rental income, and used the expiring credits to eliminate U.S. tax on such income, and Taxpayer claimed U.S. source rental expense deductions.²

1. Foreign property sale-leaseback transaction

On Date 4, Deconsolidated purchased used computer equipment located in Country A from FB1 for Amount 2 and immediately leased back the same equipment to FB1. The three-year lease agreement provided for monthly rent payments, which

¹ FB1 and FB2 were subsidiaries of FB3, a Country A corporation, of which Bank owns x percent.

² We understand that in Year 2, the same parties engaged in a similar transaction involving the steps described in this Field Service Advice. To the extent that the two transactions are substantially similar, our analysis of and conclusions concerning the Year 1 transaction would also apply to the Year 2 transaction.

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over the three-year period totaled Amount 3. The agreement contained an option for FB1 to prepay the lease by making a lump sum payment of Amount 4.

2. U.S. property sale-leaseback transaction

On Date 5, the day after the first sale-leaseback, FB2 purchased used computer equipment located in the United States from TSub for Amount 5 and immediately leased back the same equipment to TSub. It appears that all of the assets purportedly sold by TSub were acquired by TSub in Year 1 and sold at cost or nearly at cost to FB2. The three-year lease agreement provided for monthly rent payments, which over the three-year period totaled Amount 6. The agreement contained an option for TSub to prepay the lease by making a lump sum payment of Amount 7.

3. Prepayment of rent

A week after the second sale-leaseback transaction, on Date 6, TSub exercised its option to prepay the lease on the U.S. property and paid FB2 Amount 7. Thus, the net cash impact of the transaction on TSub was a positive cash flow of Amount 8 (Amount 5 sales price less Amount 7 of prepaid rent). Simultaneously, FB1 exercised its option to prepay the lease on the foreign property and paid Deconsolidated Amount 4. Thus, the net cash impact of the transaction on Deconsolidated was a negative cash flow of Amount 8 (Amount 4 prepaid rent minus Amount 2 sales price), which exactly offset Tsub's positive cash flow on the U.S. sale-leaseback.

We understand that, except for fees paid to Bank, it is unclear whether any cash payments between Taxpayer's subsidiaries and Bank's subsidiaries in fact were made or whether they were merely book journal entries. Taxpayer has apparently not provided any documentation demonstrating that wire transfers between TSub and FB2's bank accounts were actually made.

4. Like-kind exchange

On Date 7, approximately three months after the rent prepayments on the purported sale-leaseback transactions, Deconsolidated and FB2 entered into a transaction where Deconsolidated exchanged the Country A equipment originally owned by FB1 (title to which was now in Deconsolidated's hands) for the U.S. equipment originally owned by TSub (title to which was now in FB2's hands). As a result, title to the equipment sold by TSub was returned to Taxpayer's controlled group, and title to the equipment sold by FB1 was returned to the Bank's group. This transaction purportedly qualified as a tax-free like-kind exchange under section 1031. It also operated to restore the characterization of the equipment owned by the Taxpayer's group as assets producing U.S. source income, so that

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depreciation expenses on the equipment would reduce U.S. rather than foreign source income for foreign tax credit limitation purposes.

5. Reported U.S. tax consequences

As a result of the transaction, Taxpayer claimed rental deductions totaling Amount 7 against its U.S. source income over the three-year life of the lease, beginning in Year 1. Taxpayer also claimed in Year 1 a deduction of Amount 10 for professional fee expenses (although for book purposes TSub accrued Amount 9). Taxpayer did not report any income tax consequences attributable to TSub's purported equipment sale to FB2 until questioned on audit, at which time Taxpayer prepared a revised Form 4797, reporting gross receipts on the sale of Amount 5 resulting in a nominal loss of Amount 13.

On a separate return for Year 1, Deconsolidated reported foreign source general limitation rental income of Amount 4 and claimed foreign tax credits of Amount 12, which offset the U.S. tax on the foreign source income. (Amount 1 of the claimed credits were carryforward credits due to expire unused in Year 1.) Deconsolidated also claimed depreciation deductions on the U.S. equipment. As a result of the purported section 1031 exchange, it took a substituted basis in the U.S. equipment, resulting in an increased depreciation basis of Amount 11. The exchange also operated to restore the U.S. source of the income produced by the equipment owned by Deconsolidated so that depreciation expenses on the equipment would not reduce foreign source income for foreign tax credit limitation purposes.

LAW AND ANALYSIS

A. Taxpayer's transaction should be disregarded for federal income tax purposes because it had no real, practical economic effect and had no business purpose.

1. The economic substance doctrine generally

To be respected for federal income tax purposes, a transaction must have economic substance separate and apart from the benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits which were not intended by Congress by means of a transaction that serves no economic purpose, the doctrine of economic substance applies to deny the taxpayer the tax benefits of the transaction. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); Saba Partnership v. Commissioner, T.C. Memo.

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1999-359; ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999). In determining whether a transaction has economic substance, the transaction must be viewed as a whole, and each step is relevant. ACM Partnership, 157 F.3d at 247.

Generally, the inquiry into the economic substance of a transaction looks to the objective economic substance of the transaction and the subjective business purpose behind the transaction. Id.; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). These two inquiries do not constitute a rigid two-step test, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

The phrasing of the objective test has varied among the courts. For example, the Tax Court in ACM Partnership articulated the objective test as follows:

...the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.

ACM Partnership, 73 T.C.M. at 2217 (citations omitted). While the specific articulation of the objective test has differed among the courts, the fundamental principle is that a transaction must have real and practical economic effects other than the creation of income tax benefits in order to satisfy the objective aspect of the economic substance analysis. See, e.g., ACM Partnership, 157 F.3d at 248-252; Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989); Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir.), cert. denied, 488 U.S. 824 (1988).

Although, like the objective test, the courts have set forth various articulations of the subjective test, the common thread is whether the transaction has a business purpose other than obtaining tax benefits. See, e.g., Yosha v. Commissioner, 861 F.2d at 501 (“Judges can’t peer into people’s minds or ‘weigh’ motives.... Rather, the usual approach is to focus the analysis on whether any non-tax goals or functions were or plausibly could have been served by the action.”); Rice’s Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (whether

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“the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering in the transaction”).

2. Taxpayer’s transaction had no net effect on taxpayer’s economic position except for the creation of tax benefits.

Taxpayer had no possibility of a positive economic return because the transaction was designed to, and in fact did, create perfectly offsetting cash flows (before transaction costs). See Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 223 (1999), appeal pending, No. 00-60648 (5th Cir. Argued Sept. 5, 2001); compare IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001), rehearing denied (Oct. 1, 2001), rev’ing 1999 U.S. Dist. LEXIS 22610, 84 A.F.T.R.2d (RIA) 6445 (N.D. Iowa 1999). TSub received a net cash inflow of Amount 8 from TSub's sale-leaseback transaction. This positive cash flow, however, was precisely offset by the net cash outflow of Amount 8 from Deconsolidated's sale-leaseback transaction. The cash flow analysis set forth below demonstrates that without taking tax benefits into consideration, the Taxpayer group could never recover its transaction costs and that an economic loss was a mathematical certainty.

Deconsolidated's equipment purchase	(Amount 2)	
Rent prepayment by FB1	<u>Amount 4</u>	
net cash from Deconsolidated's transaction		(Amount 8)
TSub's sale of equipment to FB2	Amount 5	
Rent prepayment by TSub	<u>(Amount 7)</u>	
net cash from TSub's transaction		<u>Amount 8</u>
Offsetting cash flows		0
Less transaction costs		<u>(Amount 9)</u>
NET ECONOMIC LOSS		<u>(Amount 9)</u>

An economic loss was assured because every aspect of the transaction was prearranged to produce that result. See Compaq, 113 T.C. at 219 (“Every aspect of [Compaq’s] ADR transaction was deliberately predetermined and designed by [Compaq and the promoter] to yield a specific result and to eliminate all economic risks and influences from outside market forces on the purchases and sales in the ADR transaction.”). Bank and Law Firm fixed the purchase and sale prices and rent prepayment terms of the sale-leaseback transactions so that the net cash flow received by the Taxpayer group would exactly equal the net cash flow paid by the

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Taxpayer group.³ A number of documents indicate that Taxpayer knew that the transaction would produce this result. First, an internally generated spreadsheet titled “Consolidated Cash Flows” clearly showed that, excluding transaction costs, “cash in” amounts and “cash out” amounts netted to zero. Second, a Date 8 draft memorandum (apparently drafted by Bank employees) included an annex that was later faxed to Taxpayer. This annex explicitly stated that “[t]he agreement between [Bank] and [Taxpayer] planned a netting,” indicating that both parties understood that the transaction’s cash flows would offset each other. Finally, a Date 9 memorandum faxed by Bank to Taxpayer showed a consolidated cash flow analysis with a net cash flow to Bank of zero.

In addition to offsetting cash flows, the transaction involved circular transfers of title to the equipment. The Bank group’s economic position, namely ownership of FB1’s equipment, was the same before and after the transaction. Similarly, ownership of TSub’s equipment was returned to Deconsolidated, which was controlled by the Taxpayer group. Thus, excluding transaction costs, the overall transaction did not significantly alter Taxpayer and Bank’s economic positions. See Merryman v. Commissioner, 873 F.2d 879, 882 (5th Cir. 1989) (“money flowed back and forth but the economic positions of the parties were not altered”); Lynch v. Commissioner, 267 F.2d 867, 871-72 (2d Cir. 1959) (lack of significant change between parties’ economic positions before and after a transaction is evidence of sham).

The only “profit” to the Taxpayer group was attributable to the claimed tax benefits. By transferring title of U.S. equipment originally owned by TSub to FB2 and then to Deconsolidated, the transaction effectively shifted U.S. source depreciation deductions on that equipment from TSub to Deconsolidated. The transaction also created offsetting cash flows in the form of purchase and sale transactions generating rental income and expense. Although the rent prepayment constituted foreign source rental income that increased Deconsolidated’s pre-credit U.S. tax liability, Deconsolidated treated it as general limitation income so that the carryforward foreign tax credits eliminated that incremental U.S. tax liability. Had the Taxpayer group not been subject to U.S. tax, Taxpayer and Deconsolidated would not have entered into the transaction. This is because the Taxpayer group, without the ability to claim rental deductions against U.S. source income coupled with foreign source rental income shielded from U.S. tax with expiring foreign tax

³ As further indicia of the noneconomic nature of the transaction, it appears that the purchase and sale prices of the equipment, as well as the two rent prepayments, were not arm’s length amounts. The amount of the TSub’s rent prepayment was not an arm’s length amount because it was only slightly less than the aggregate amount that TSub was obligated to pay over the three-year term of the lease. The same is true for FB1’s rent prepayment to Deconsolidated.

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credit carryforwards, would have suffered an economic loss equivalent to transaction costs.

3. Taxpayer had no business purpose for entering into the transaction.

The objective facts surrounding the transaction belie Taxpayer's assertion that its business purpose was to earn a higher investment return than Deconsolidated was currently achieving. All of the facts presented indicate that the sole objective of the transaction was to generate offsetting cash flows, where depreciation deductions would be transferred from TSub to Deconsolidated, TSub's rent prepayment would generate U.S. source rental deductions, and foreign source rental income would be sheltered by expiring foreign tax credits. Taxpayer was aware that Deconsolidated had substantial carryover foreign tax credits that would expire unused in Year 1 and contacted Law Firm that year to discuss ways to utilize the expiring credits. After negotiations with Bank, on Date 10, we understand that Taxpayer's chief financial officer presented the transaction at issue to Taxpayer's management committee. According to the presentation, which was entitled "Utilization of Foreign Tax Credits," "[w]e have pursued various strategies to utilize the excess foreign tax credits, and recommend entering into a Sale/Leaseback of Computer Equipment...[which] converts expiring FTC's to a Depreciation Deduction."

Taxpayer performed a cash flow analysis of the transaction. As discussed above, an internally generated spreadsheet titled "Consolidated Cash Flows" clearly shows that, without taking into account tax benefits and transaction costs, "cash in" amounts and "cash out" amounts netted to zero. Taxpayer also received at least two documents from Bank clearly indicating that the cash flows from the transaction would offset each other. The first was an annex faxed by Bank to Taxpayer, which explicitly stated that "[t]he agreement between [Bank] and [Taxpayer] planned a netting," and the second was a Date 9 memorandum faxed by Bank to Taxpayer, showing a consolidated cash flow analysis with a net cash flow to Bank of zero. We believe that a reasonable businessperson analyzing the spreadsheet and other documents would conclude that the transaction generates an economic loss equivalent to transaction costs, and that an economic loss of this nature would have no non-tax utility to a business.

The structure of the transaction and Taxpayer's involvement in the transaction indicate that Taxpayer was not motivated by a business purpose but solely by tax considerations.

- a. Taxpayer was not exposed to any economic risk because every aspect of the transaction was prearranged to not only produce a net cash flow of zero (excluding transaction costs) but also to avoid subjecting Taxpayer to economic risk. See Compaq v. Commissioner, 113 T.C. at

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223-24. The risk that Bank's subsidiaries would fail to execute the transaction properly was minimal since TSub was not obligated to make its rent prepayment to FB2 until FB1 made its rent prepayment to Deconsolidated. Thus, Taxpayer's only real risk arising from an improper execution of the transaction was a tax risk. This is further supported by promotional materials prepared by Bank that stated if Deconsolidated failed to complete the last leg of the overall transaction, the exchange of the equipment, Taxpayer would "(1) lose [approximately Amount 1] of foreign tax credits and [approximately Amount 8] of fees and expenses paid to [Bank] and its own outside advisers."

- b. Taxpayer was aware that Amount 1 of Deconsolidated's foreign tax credits would expire in Year 1 and had considered various methods of utilizing those credits. Not coincidentally, the pre-credit U.S. tax on the rent prepayment received by Deconsolidated correlated closely to the amount of its expiring foreign tax credits. Where the timing of a transaction is of overriding importance and is keyed to tax consequences or particular tax years, a transaction can be found to lack economic substance. See Sheldon v. Commissioner, 94 T.C. 738, 766, 769 (1990) (tax-determined timing of transaction is indicia of sham); Glass v. Commissioner, 87 T.C. 1087, 1174 (1986) (same).
- c. The transaction was planned and executed by Taxpayer's tax personnel.
- d. Taxpayer apparently did not follow its established equipment procurement procedures when it entered into the transaction at issue. We understand that Deconsolidated purchased and leased back from FB1 equipment for which Deconsolidated had neither analyzed nor obtained from an independent source a review, appraisal, or other study as to the equipment's residual value. Deconsolidated did nothing with respect to FB1's equipment except immediately lease it back to FB1.
- e. Taxpayer had no intention of entering into a bona fide purchase of FB1's equipment or bona fide sale of TSub's equipment, as evidenced by the like-kind exchange that followed the sale-leaseback transactions approximately three months later.
- f. TSub failed to report its Year 1 asset sale of Amount 5 until questioned on audit, although it did deduct the related professional fees. We also understand that there is a lack of documentation supporting actual cash wire transfers between TSub and FB1's accounts (besides payment of transaction fees), as opposed to strictly book transactions.

The consequence of treating the transaction at issue as an economic (or factual) sham is to "unwind" the transaction, *i.e.*, title (which Deconsolidated held as a result of the purported section 1031 exchange) to the U.S. equipment would be

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returned to TSub, the entity that originally owned the equipment. Accordingly, the following adjustments should be made to Taxpayer's return: (1) disallow the rental deductions over the three-year life of the lease, beginning in Year 1; (2) disallow the deduction for professional fee expenses in Year 1; (3) disallow the small loss reported on revised Form 4797; and (4) offset the disallowed deductions by U.S. source depreciation deductions, since TSub is treated as retaining ownership of the U.S. equipment. With respect to Deconsolidated, treating the transaction as a sham should result in the disallowance of all items reported in connection with the transaction, which are the U.S. source depreciation deductions, foreign source rental income, and foreign tax credits. We recommend that you coordinate with the team examining Deconsolidated's Year 1 and Year 2 returns to ensure that these issues are resolved consistently.

B. Alternative position to disregarding the transaction for tax purposes

An alternative to unwinding the sham transaction is to view the Taxpayer and its consolidated group as the party to the two sale-leaseback transactions and disregard the participation of Deconsolidated. This recharacterization of the transaction is based on the fact that Deconsolidated's participation in the transaction lacked economic substance. First, it only held temporary and bare legal title to FB1's equipment as a result of Deconsolidated's "purchase" of the equipment. Deconsolidated never enjoyed the economic benefits or burdens of ownership because it immediately leased the equipment back to FB1 and approximately three months after the purchase, returned title to the Bank group. Second, Deconsolidated did not economically receive the rent prepayment from the Bank group because the prepayment was apparently applied in partial satisfaction of the "purchase price" due for the property, and it has not been established that Deconsolidated ever paid the difference. Third, Deconsolidated's ownership of TSub's equipment, like its ownership of FB1's equipment, was in title only, since TSub continued to use the equipment. It appears that the only effect of its brief ownership of the Country A equipment and titular ownership of the residual interest in TSub's equipment was Deconsolidated's claimed tax benefits in the form of foreign tax credits and U.S. depreciation deductions.

The consequence of disregarding Deconsolidated's role in the transaction is to treat Taxpayer as the entity that economically earned the foreign source rental income and was entitled to the depreciation deductions associated with ownership of the U.S. equipment. Under this alternative analysis, Taxpayer would be required to report on its consolidated return all of the items related to the transaction, *i.e.*, the foreign source rental income, U.S. source rental deductions, and U.S. source depreciation deductions.

This result could be reached by applying section 482 to Taxpayer, TSub, and Deconsolidated. In order to apply, section 482 provides that the transaction must

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be between two or more organizations, trades, or businesses owned or controlled by the same interests. If section 482 applies, the Secretary is given the authority to allocate gross income, deductions, credits, or allowances among two or more organizations, trades or businesses, if he determines that such allocation is necessary, in order to prevent the evasion of taxes or to clearly reflect income. I.R.C. § 482. Section 482 provides, in relevant part, as follows:

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

In the instant case, there is common ownership among Taxpayer, TSub, and Deconsolidated. Thus, control exists for purposes of allocating income and deductions among these members of the controlled group. See Treas. Reg. §1.482-1(i).

Section 482 overlaps with the case law relating to economic substance and sham doctrines by allowing the Service, in certain instances, to disregard contractual terms and agreements and to recharacterize a transaction. See Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1), -1(d)(3)(ii)(C) ex. 3, -1(f)(2)(ii), -2(a)(1)(ii)(B), -2(a)(3), -4(f)(3)(ii)(A). However, the section 482 regulations expand upon case law principles and provide additional guidance in specific areas. Specifically, they provide:

The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties.... If the contractual terms are inconsistent with economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B). The regulations also provide that the Service's authority to make allocations under section 482 "is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances." Treas. Reg. § 1.482-1(f)(1)(i).

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Deconsolidated's role in the transaction appears to be inconsistent with the transaction's substance (if the transaction is not disregarded in its entirety) in that Deconsolidated only held title to equipment that was continuously used by the original owners of the equipment, as discussed above. Accordingly, it would be appropriate to disregard the transaction's contractual terms concerning Deconsolidated and reallocate the foreign source rental income and U.S. depreciation deductions from Deconsolidated to TSub. See GAC Produce Co., Inc., v. Commissioner, T.C. Memo. 1999-134 (applying section 482 to prohibit shifting of sales income among related companies where an unrelated purchaser "acted in concert" with the related companies to shift income among the related companies). In this case, FB1 and FB2 acted as facilitators to shift income and deductions between Deconsolidated and TSub.

C. Treatment of foreign source rental income

If the transaction is not disregarded as a sham transaction, the issue arises whether the foreign source rental income from the sale-leaseback of the Country A equipment should be treated as general limitation or passive income for purposes of section 904. Treas. Reg. §1.904-4(b)(2)(i) provides that passive income does not include any rents or royalties that are received from an unrelated person and derived in the active conduct of a trade or business under the principles of section 954(c)(2)(A) and the regulations thereunder. Treas. Reg. §1.904-4(b)(2)(ii) provides that rents derived by a United States person are considered derived in the active conduct of a trade or business for purposes of section 904 if the requirements of section 954(c)(2)(A) are met by one or more corporations that are members of the recipient's affiliated group. Temp. Reg. §4.954-2(b)(5) applies to Year 1, the year at issue. It provides:

Whether or not rents or royalties are derived in the active conduct of a trade or business is to be determined from the facts and circumstances of each case; but see paragraph (c) or (d) of this section for specific cases in which rents or royalties will be considered for purposes of this paragraph to be derived in the active conduct of a trade or business.

Treas. Reg. §4.954-2(b)(5).

Section 4.954-2(c)(1) identifies four exceptions where rents will be considered to be derived in the active conduct of a trade or business. Based on the facts provided, it appears that the foreign source rental income attributed to TSub would not qualify as active business income under the regulations. Therefore, in the event the transaction is not disregarded as a sham and the foreign source rental income is allocated to TSub, it should be treated as passive income.⁴

⁴ Similarly, even if the transaction were respected and the foreign source rental income were considered to be income of Deconsolidated, the facts provided indicate

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D. Negligence penalty

I.R.C. section 6662(a) imposes an addition to tax in an amount equal to 20 percent of an underpayment of tax required to be shown on a tax return. Section 6662(b) specifies the portion of underpayment to which this penalty applies and includes an underpayment attributable to negligence or disregard of rules or regulations. Underpayment is defined as the difference between the taxpayer's correct tax liability and the sum of the amount(s) shown on the return and as previously assessed, plus rebates. Section 6664(a). We understand that the underpayment for which you propose to apply the accuracy-related penalty is the amount of the deficiency attributable to the transaction at issue, and that this underpayment was due to negligence or disregard of rules or regulations.

Negligence is defined by section 6662(c) as including any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return, and the term "disregard" includes any careless, reckless, or intentional disregard of rules or regulations. Treas. Reg. §1.6662-3(b)(1), (b)(2). Section 6664(c)(1) and Treas. Reg. §1.6662-4(a) provide an exception to the accuracy-related penalty if the taxpayer shows that there was reasonable cause for, and the taxpayer acted in good faith with respect to, the underpayment. Whether a taxpayer acted with reasonable cause and in good faith depends on all pertinent facts and circumstances. Treas. Reg. §1.6662-4(b)(1). The most important factor is the extent of the taxpayer's effort to compute the proper tax liability for the year. Id.

Taxpayer knowingly engaged in a transaction that had no economic substance or business purpose and was designed solely to reduce its U.S. income tax liability for Year 1. As discussed above in section A, it is well established that transactions lack economic substance and are solely motivated by tax benefits are disregarded for tax purposes. To claim tax benefits under the circumstances of the transaction at issue is negligent because Taxpayer disregarded the well-established principles of the economic substance doctrine and neither had reasonable cause for its return position for the transaction nor acted in good faith with respect to such item. See Compaq, 113 T.C. at 226-27 (imposing negligence penalty on taxpayer that engaged in economic sham). Taxpayer was fully aware of Deconsolidated's expiring foreign tax credit situation and considered the transaction at issue as a way to utilize these expiring credits by creating tax-sheltered foreign source rental income that was effectively offset by U.S. source rental deductions. Taxpayer's tax department was not merely consulted about the tax consequences of the transaction but in fact planned and executed the transaction.

that the rental income would be passive income to Deconsolidated, so that the claimed carryforward general limitation foreign tax credits should be disallowed.

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Based on the facts presented, Taxpayer did not perform a thorough investigation into the economic validity of the transaction, and Taxpayer did not make a reasonable attempt to determine the tax bona fides of this transaction. Taxpayer's cash flow analysis would have alerted a reasonable businessperson of the questionable economic nature of the transaction, but Taxpayer apparently chose to ignore the cash flow analysis. The objective facts surrounding this transaction, its structure, and its results clearly support the conclusion that the transaction was solely tax-motivated. Under these circumstances, Taxpayer's disinterest and disregard for the details of this transaction constitute negligence.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We recommend further development of the following facts

[REDACTED]

[REDACTED]

With respect to the treatment of the foreign source rental income from the Year 1 sale-leaseback transaction between Deconsolidated and FB1, Taxpayer may argue that the rental income qualifies for active treatment under the fourth regulatory exception, which applies to rents from leasing "property which is leased as a result of the performance of marketing functions by such lessor if the lessor ... maintains and operates an organization ... which is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and which is substantial in relation to the amount of rents derived from the leasing of such property." See Treas. Reg. §4.954-2(c)(1)(iv). If the income is imputed to Tsub, under §1.904-4(b)(2)(ii) this test is satisfied if it is met by any member of Taxpayer's affiliated group. Similarly, if the rent is treated as income of Deconsolidated, the test could be satisfied by any member of Deconsolidated's group. [REDACTED]

[REDACTED]

Taxpayer may argue that even if it failed to meet any of the regulatory exceptions, the rents were nevertheless derived in the active conduct of a trade or business because it satisfied the facts and circumstances test provided in §4.954-2(b)(5). [REDACTED]

[REDACTED]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 622-3850 if you have any questions.

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