



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

OFFICE OF  
CHIEF COUNSEL

May 15, 2002

Number: **200235005**  
Release Date: 8/30/2002  
UILC: 351.00-00

CC:CORP  
TL-N-215-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR Michael Wilder  
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FROM: ALFRED C. BISHOP, JR.  
Chief, CC:CORP:6

SUBJECT: Qualification of Transaction as a § 351 Exchange in  
Taxpayer Lease Stripping Case

LEGEND

Taxpayer =  
B =  
C =  
D =  
E =  
F =  
Bank A =  
Bank B =  
Bank C =  
Country 1 =

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n1 =

n2 =

n3 =

n4 =

n5 =

\$n6 =

\$n7 =

\$n8 =

\$n9 =

n10 =

n11 =

\$n12 =

p1% =

p2% =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

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This Chief Counsel Advice responds to your request for our opinion on the characterization of certain transactions in the above-referenced case. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

**ISSUE:**

Does the purported § 351 transaction involving F, Taxpayer and D qualify as a § 351 exchange?

**FACTS:**

Pursuant to its regular business, B, a subsidiary of C had leased certain computer equipment to certain corporations who were the end users of such equipment ("User Leases"). The typical User Lease conveyed several items of computer equipment. Each of the User Leases was negotiated at arm's length and contained commercially reasonable terms and conditions.

The User Lease dates varied with the earliest lease commencing in Year 1. As of Date 4, the remaining lease terms of the User Leases ranged from n1 to n2 months, and the average remaining term on the User Leases was approximately n3 months.

**First Step**

On Date 1, pursuant to a Master lease, B leased the computer equipment, subject to the existing User Leases, to D, a Country 1 limited liability company with foreign members. The Master Lease includes the identical equipment contained in the User Lease. The remaining lease terms of the equipment included in the Master Lease vary from n4 months to n5 months.

**Second Step**

On Date 2, pursuant to an Agreement of Sublease, D then subleased the equipment, subject to the Master Lease and the User Leases, to E. E was a partnership formed for the purpose of acquiring a leasehold interest in a tax shelter transaction.

D, pursuant to a notice delivered under the Sublease, required E to prepay p1% of the present value of the rentals due to E under the User Leases or approximately \$n6. In order to make such a prepayment, E borrowed approximately \$n7 from

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Bank A. Because D is a foreign LLC with foreign members, the prepayment income is not taxable in the U.S.

D was required by the Master Lease to use any prepayment of rent received under a Sublease either to prepay rent due under the Master Lease or procure a third party guaranty securing payment of the portion of the master lease rent corresponding to the prepaid Sublease rent.

D used the prepayment to purchase a short-term U.S. Treasury Bill, due to mature in Date 5, and used the Treasury Bill to secure a guaranty issued by Bank B. For providing the guaranty, D granted a security interest in the U.S. Treasury Bill as collateral security to secure its obligations and agreed to deposit the proceeds of the U.S. Treasury Bill upon maturity (\$n8) in an account maintained at Bank C. The Bank C account was not available for use by D for any purpose except to make Master Lease rental payments to B. Pursuant to this Agreement, D directed Bank C to periodically pay B the portion of the Master Lease rent corresponding to the prepaid Sublease rent.

### **Third Step**

According to a summary of the transaction stated in an Taxpayer office memorandum dated Date 3, Taxpayer contributed approximately \$n9 to a subsidiary of Taxpayer, which turned out to be F, in exchange for n10 shares of F's Class A preferred stock plus additional shares of F's common stock. Per the Exchange Agreement dated Date 4, D assigned its interest in the Master Lease, the Sublease, the Bank B Guaranty, a U.S. Treasury Bill, and the prepaid rent to F (i.e. F takes over D's interest in the Bank C account) in return for n11 shares of Class B non voting preferred stock of F, valued at \$n12. (F, Taxpayer and D treated this exchange as qualifying for non-recognition under IRC § 351.) As a result of this exchange, F was entitled to receive rents for "(i) the unpaid p2% of the sublease rents for the periods of the User leases, (ii) the period of the sublease from the end of the User Leases to the end of the sublease, and (iii) the re-lease of the equipment after the expiration of the sublease.

Taxpayer then attempted to take tax deductions for rent as the payments to B were made from the bank account.

### **LAW & ANALYSIS**

#### **A. § 351 and the Business Purpose Requirement**

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§ 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.

In addition to the statutory requirements transferors must satisfy, the Courts have indicated there is a business purpose requirement in § 351. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in section 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). Generally, section 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191. Whether a valid business purpose underlies a transaction whereby a taxpayer purportedly acquires ownership of an asset with an inflated basis traceable to a lease stripping transaction is a factual issue.

#### B. Application of Business Purpose Requirement to these Facts

The purported § 351 transaction involving F, Taxpayer and D does not qualify as a §351 exchange. In the purported § 351 transaction involving the contribution of the leasehold interest to F, there was no objective business purpose. Rather, the sole purpose of the transactions was the creation of tax benefits.

Taxpayer's expert determined that Taxpayer reasonably expected to realize an economic profit on the transaction while simultaneously realizing significant tax savings.

However, the Service's expert determined that participation in the transaction would have resulted in Taxpayer's suffering a net economic loss, meaning that Taxpayer had no possibility of realizing an economic profit from this transaction. Therefore, the only benefit to Taxpayer would be the significant tax savings.

#### **CONCLUSION:**

There exists an unresolved conflict as to whether or not Taxpayer had a possibility of realizing an economic profit from the purported § 351 transaction at the time it entered the transaction. Accordingly, Taxpayer has failed to demonstrate a valid business purpose for entering into the purported § 351 transaction .

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The projections performed for Taxpayer show that Taxpayer had a possibility of realizing an economic profit from the transaction. However, projections calculated on behalf of the Service indicate that no such possibility existed. Therefore, because Taxpayer has failed to substantiate a valid business purpose for entering into the purported § 351 transaction, the transaction does not qualify as a § 351 exchange.

In the instant case, the failure of the transaction to qualify as a § 351 has no bearing on whether or not the Taxpayer is entitled to the rental deductions that it claims. Thus, the above conclusion does not support an adjustment in the immediate case.

However, our conclusion that the transaction here does not qualify as a § 351 exchange will have bearing on the later disposition of the stock D received in the purported § 351 transaction.

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 if you have any further questions.