

Office of Chief Counsel
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Memorandum

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to: Associate Area Counsel (Phoenix)
(Large & Mid-Size Business)

attn: Rick V. Hosler

from: Robert M. Brown

Associate Chief Counsel
(Income Tax & Accounting)

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Corp A =

Corp B =

Corp E =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

\$A =

\$B =

\$C =

This Chief Counsel Advice responds to your request for our assistance in the above-captioned case. Chief Counsel Advice is open to public inspection pursuant to the provisions of § 6110(i) of the Internal Revenue Code. The provisions of § 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Section 6110(i)(3)(B) also authorizes the Service to delete information that is protected from disclosure before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Chief Counsel Advice is authorized to make such deletions and to make the redacted document available for public inspection. Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of an unredacted version of this document to the taxpayer or their representative. The recipient of this document may share an unredacted version only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Chief Counsel Advice.

ISSUE

What is Corp A's adjusted basis in three promissory notes received by Corp A under the terms of a Sale and Assignment Agreement executed by Corp B and Corp A?

CONCLUSION

Corp A's adjusted basis in three promissory notes received by Corp A under the terms of a Sale and Assignment Agreement is equal to the \$C given by Corp A to Corp B, plus the value of the obligations assumed by Corp A to make lease payments under the Master Leases for the Date 1 to Date 2 period. Corp A's basis in the notes does not include the payment obligations that it assumed from Corp B for the Date 2 to Date 4 period that only the Master Leases are in effect.

FACTS

In Year 1, Corp A, an accrual basis taxpayer, sold stock in one of its subsidiaries, resulting in a consolidated capital loss. In the year the capital loss would have expired, Corp A entered into a number of transactions designed to generate capital gains, one of which is described below.

Step 1. Three limited partnerships (Owners) owned certain equipment leased to various Users under numerous lease agreements (User Leases). The User Leases began on Date 1 and ended on various dates, the latest of which is Date 2.

Step 2. On Date 3, Owners and Corp B entered into three Master Leases under which Corp B acquired the Owners' lessor rights to the equipment for a period beginning Date 1 and ending on various dates the latest of which is Date 4. In exchange for the lessor rights, Corp B was required to make lease payments to Owners for the entire Master Lease period (the Master Lease obligations). The Master Leases provide that if Corp B assigns its Master Lease obligations, Corp B's assignee must prepay the lease payments under the Master Lease (accelerated lease payments), which amounts to a payment of \$A. Further, as part of the agreement between Owners and Corp B, Owners assigned all of their rights and obligations under the User Leases to Corp B.

Step 3. On Date 5, Corp B sold its rights to receive the lease payments from the Users under the User Leases to Corp E. Although the User Lease payments were stripped, Corp B was still obligated to pay to Owners the required lease payments during the User Lease period (and beyond). In exchange for the lease payments, Corp B received three promissory notes from Corp E (the Corp E notes) with an aggregate face amount of \$B.

Step 4. On Date 6, Corp A and Corp B entered into a Sale and Assignment Agreement. Under the Sale and Assignment Agreement, Corp A acquired from Corp B:

- (1) the right to use the equipment covered by the Master Leases after the expiration of the User Leases (i.e. from Date 2 to Date 4), and
- (2) the Corp E notes.

In exchange for the Date 2 to Date 4 leasehold rights and the Corp E notes, Corp B acquired from Corp A:

- (1) \$C, and
- (2) the assumption by Corp A of Corp B's Master Lease obligations, which, because Corp A was Corp B's assignee, was a \$A accelerated lease payment due on Date 7 (see step 2).

Step 5. Date 8, Corp E paid Corp A \$B in satisfaction of the Corp E notes.

Step 6. Date 8, Date 9, and Date 10, Corp A made accelerated lease payments under the Master Leases to Corp B.

LAW AND ANALYSIS

As an initial matter, we conclude that no basis should be assigned to Corp A's leasehold rights under the Master Leases (i.e., Corp A's right to use the Master Lease property from Date 2 to Date 4). Corp A simply assumed Corp B's obligation to make payments under the Master Leases for the period Corp A is entitled to use the property (the period after the User Leases expire until the Master Leases expire). Consequently, Corp A does not get basis with respect to the payment obligations that it assumed from Corp B for the period that only the Master Leases are in effect. With respect to this aspect of the transaction, Corp A acquired a leasehold interest in the equipment from Date 2 to Date 4 in exchange for assuming Corp B's leasehold obligations attributable to Date 2 to Date 4. The below analysis addresses, therefore, whether the other obligations assumed by Corp A are included in the basis of the Corp E notes.

While both the field and Corp A agree that the \$C Corp A paid to Corp B is included in the basis of the Corp E notes, the parties disagree as to the treatment of the assumption by Corp A of Corp B's obligation to make lease payments under the Master Leases during the period Date 1 to Date 2 that both the User Leases and the Master Leases are in effect (the overlap period). The field argues that these overlap-period liabilities assumed by Corp A arise out of the provision of property to Corp A, with the result that Corp A gets a current basis in the Corp E notes attributable to the liability assumption. To the contrary, Corp A argues that the liability arises out of the use of property by Corp A, with the result that Corp A gets a deferred basis in the Corp E notes attributable to the liability assumption.

Section 1012 of the Code provides, in general, that the basis of property shall be the cost of such property. Section 1.1012-1(a) of the Income Tax Regulations provides that the cost of property is the amount paid for property in cash or other property.

Part of the cost of property, and thus an amount also included in the basis of such property, is any liability incurred, including a liability of the seller assumed by the taxpayer as consideration for the property, to purchase the property. *Crane v. Commissioner*, 331 U.S. 1 (1947); *Stackhouse v. U.S.*, 441 F.2d 465, 467 (5th Cir. 1970); *Bertoli v. Commissioner*, 103 T.C. 501 (1994).

Section 1.461-1(a)(2) provides generally that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. The Internal Revenue Service made clear in the preamble to the final regulations implementing § 461(h) that

the economic performance rules must be satisfied in determining whether an item is taken into account in computing basis. Preamble to T.D. 8408, 57 Fed. Reg. 12411 (Apr. 10, 1992) [1992-1 C.B. 155, 156]. See also § 1.446-1(c)(1)(ii)(B) (amounts a taxpayer expends must be incurred before being taken into account in computing basis). Thus, an assumed liability is only to be included in the adjusted basis of property if the all-events test is met and economic performance has occurred with respect to the assumed liability.

In the instant case, all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy. The issue, therefore, is when economic performance with respect to the overlap-period obligations that Corp A assumed is satisfied, which is when such obligations are taken into account in computing basis.

Section 461(h)(2) provides rules as to when economic performance occurs, which depends on the type of liability. Section 461(h)(2)(A)(ii) provides that if the liability of the taxpayer arises out of the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property. See also § 1.461-4(d)(2) and (6). Section 461(h)(2)(A)(iii) provides that if the liability of the taxpayer arises out of the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property. See also § 1.461-4(d)(3). Section 461(h)(2)(D) and § 1.461-4(g)(7) provide that if the liability in question does not arise out of one of the enumerated situations described in § 461(h) and the regulations thereunder, then economic performance occurs as payment is made to the person to whom the liability is owed.

The characterization of the liability assumed by Corp A in the instant case depends on a close examination of the facts. We view the liability either as having arisen out of the provision to Corp A of property or, because the liability is not covered by any of the enumerated situations described in § 461(h) and the regulations thereunder, a payment liability. In either case, Corp A gets current basis in the Corp E notes attributable to the assumption by Corp A of Corp B's obligation to make lease payments for the overlap period of the Master Leases.

During the overlap period, we reasonably could view the liability of Corp A to make payments under the Master Leases as having arisen from the provision to Corp A of property by Corp B, specifically the Corp E notes. Under this view, pursuant to § 461(h)(2)(A)(ii), Corp A satisfied the economic performance requirement when Corp B provided the Corp E notes to Corp A.

Corp A argues that the liability assumed by Corp A is a use liability under § 461(h)(2)(A)(iii). During the overlap period, however, Corp A did not have the use of the property in question (the equipment). During that period, Users had use of the equipment. Moreover, the lease payments payable by the Users for the use of the property had been stripped and were payable to Corp E, not Corp A. Therefore, the liability assumed by Corp A cannot be characterized as a use liability. Furthermore, if

not viewed as a liability arising out of the provision of property to Corp A under § 461(h)(2)(A)(ii) and because it is not a use liability, then the liability would be an “other liability” (or payment liability) not characterized as a liability described in § 461(h) or the regulations thereunder. In that case, § 1.461-4(g)(7) provides that economic performance occurs as Corp A makes payments in satisfaction of the liability to Owners, the party to which the liability is owed. Here, Corp A made accelerated lease payments under the Master Leases to Owners at the time it received the Corp E notes.

In summary, regardless of whether the overlap-period liabilities assumed by Corp A are viewed as having arisen from the provision of property to Corp A or as a payment liability, they should be included in the adjusted basis of the Corp E notes. When Corp E paid Corp A in satisfaction of the Corp E notes, Corp A’s basis in the Corp E notes included the \$C and the value of the liabilities assumed by Corp A to make lease payments under the Master Leases for the overlap period.

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