OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

This Field Service Advice responds to your memorandum dated November 10, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND</u>:

Taxpayer =
B =
C = .
D =
E =

F =
G =
H =

Law Firm 1	=
Law Firm 2	=
Nationality	=
Country	=
Period 1	=
Period 2	=
Period 3	=
Period 4	=
Period 5	=
Period 6	=
Period 7	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Year W	=
Year X	=
Year Y	=
Year Z	=
Amount 1	= $
Amount 2	= $
Amount 3	= $
Amount 4	= $
Amount 5	= $
Amount 6	= $
Amount 7	= $
Amount 8	= $
Amount 9	= $
Amount 10	= $
Amount 11	= $

Amount 12	= $
Amount 13	= $
Amount 14	= $
Amount 15	= $
Amount 16	= $
Amount 17	= $
Amount 18	= $
Amount 19	= $
Amount 20	= $
Amount 21	= $
Amount 22	= $
Percentage 1	=
Percentage 2	=
Percentage 3	=
Percentage 4	=
Percentage 5	=
Months X	=
Months Y	=
Months Z	=
Credit Rating	=
Forms	=

ISSUES:

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

(2) Whether the step transaction doctrine applies to the lease stripping transactions at issue.

(3) What is the proper characterization of D's purchase of the lease receivables?

(4) Whether the Service should challenge the depreciation deductions attributable to the lease stripping transactions under section 167.

(5) Whether section 482 applies to the taxpayer and other parties to the lease- stripping transactions at issue, and if so, what are the consequences of applying section 482.

CONCLUSIONS:

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

(2) The Service should not assert the step transaction.

(3) More facts need to be developed before a determination may be made regarding how to characterize the transaction and whether the sale vs. financing argument applies in this case.

(4)

(5) From the facts provided, we conclude that section 482 may apply to Taxpayer and the other parties (collectively, the "participants") to the transaction. Because the participants acted in concert pursuant to a common plan to arbitrarily shift income and deductions, the participants will be treated as members of the same controlled group for purposes of section 482.

FACTS:

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

We understand that Taxpayer entered into two lease-stripping transactions and that the two transactions are factually very close. Based on the information provided to us, the following is a summary of the first transaction, which is described more fully in the request for field service advice. These are the facts that Taxpayer's purport happened and are reported as such without validating the facts.

The initial participants to the transaction were C, a U.S. corporation engaged in the business of computer equipment leasing, and B. We understand that B is a resident

and citizen of Country, had spent fewer than 183 days each year in the United States, did not conduct any business in the United States, and did not have a permanent establishment in the United States. B was apparently experienced in computer leasing and operated a consulting company focusing on "cross-border tax structures."

Step 1. Purchase of the Equipment

On Date 1, B purchased computer equipment from C for Amount 1. The equipment was subject to pre-existing user leases between third parties and C, as well as liens of financial institutions securing nonrecourse loans entered into by C. The third-party lessees paid rent directly to the financial institutions holding the liens. C did not transfer any rights with respect to these user leases, *e.g.,* the right to receive third-party rents, to B. Also, during the terms of the third-party leases, the third parties were permitted to sublease or relocate the equipment without B's consent.

To finance the purchase, B borrowed Amount 2 from the E, and borrowed the remainder of the purchase price from C in the form of Amount 3 of recourse installment notes and Amount 4 of nonrecourse balloon notes. The E loan was secured by the equipment; if B defaulted, E' recourse was limited to the equipment and to third-party rents. The loan and was payable approximately 3 ½ years after the purchase. However, any transfer of B's interest in the equipment prior to the loan's due date would accelerate the payment of principal and interest under the loan.

Unless B obtained C's consent, he was prohibited from selling or assigning his interest in the equipment and from leasing the equipment to any party except C. Although he was permitted to sell his right to receive rents under a lease, if such sale occurred prior to the maturity of the installment notes, the notes would be accelerated and all principal and interest would become immediately payable. Additionally, all proceeds from such a sale were required to first be used as prepayment of principal and accrued interest on the installment notes.

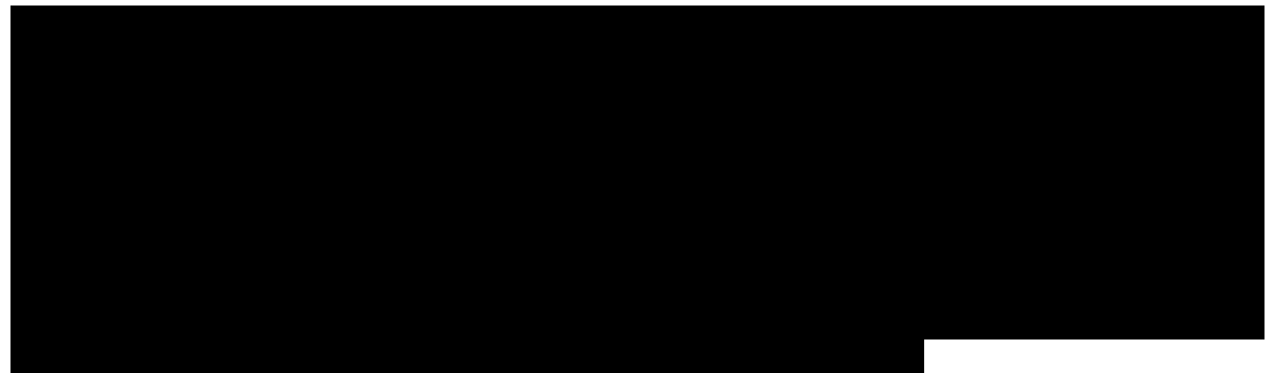
Step 2. Leaseback of the Equipment

On Date 1, simultaneously with the purchase, B leased back the equipment to C for a maximum term of approximately four years. The terms of the lease (and we assume the sales documents) were expressly conditioned on B's anticipated ability to sell or assign his right to receive rent under the lease. The lease terms provided that C had the option of purchasing the equipment at the end of the lease for its fair market value at such time. He also had the option of terminating the lease between Period 1 (Period 2) (the "early termination date") and reacquiring the equipment for the greater of its fair market value or the balance outstanding on the balloon note, plus an early termination fee.

Because the equipment was subject to pre-existing user leases, neither C nor B actually used the equipment, and C's rights under the sale and leaseback agreements were subject to the rights of the third-party lessees. B could not interrupt the third-party lessees' use of the equipment unless C and the third parties obligated to pay rent to C both defaulted. C, which had managed the third-party leases prior to the sale to B, continued to do so after the sale. Under the terms of the lease, B was not responsible to C for the maintenance, repair, or servicing of the equipment. Further, as required by the lease, C promised to indemnify him for any claims or losses from any action by C or third-party lessee.

Step 3. <u>Sale of the Lease Receivable</u>

Two weeks after the sale-leaseback, on Date 2, B sold the right to receive certain rents in lump sum to D, a U.S. bank, for Amount 3 (the "Lease Receivable"). Under the terms of the sale agreement, C would pay rent directly to D instead of B, until one day before the early termination date (Period 2) or when C prepaid all rent due, whichever occurred earlier. After such time, D agreed to reconvey to B its right to receive rent from C. D was solely responsible for demanding and collecting these payments; B was under no obligation to take such action. D had no security interest in the equipment and no recourse against B. D's recourse was limited to C.



The sale of the lease receivable triggered the acceleration of the installment notes, and B was required to use the Amount 3 sale proceeds to pay off the Amount 3 installment

notes as required by the terms of the notes and the security agreement. D directly wired the proceeds to C's account.

The Purchase Agreement provides, at 4, that:

> 2. Purchase and Sale of Undivided Lease Interests
>
> Subject to the terms of this Agreement, on the Closing Date Seller hereby sells, assigns, transfers and conveys to Purchaser, and Purchaser hereby purchases and acquires from Seller, an undivided interest of Percentage1 in the Purchased Lease (the 'Undivided Lease Interest') for the Purchase Price, subject to the provisions contained in Sections 3 and 4 below. Such sale shall be absolute and without recourse against Seller, except for the warranties and agreements on the part of Seller expressly set forth hereunder.

Thus, the Purchase Agreement purports to be a sale of the interests in the leases.

The Purchase Agreement, at 4, states that:

> 3. Agreement to Reconvey
>
> Purchaser and seller hereby agree that, ... upon ... a prepayment of rent ... or one Business Day prior to the Early Termination Date.... Purchaser shall reconvey, transfer and assign to Seller all of Purchaser's right, title and interest in and to the Undivided Lease Interest with respect to the applicable Category of Equipment, except for the Designated Rights and Identified Payments, free and clear of all leases and liens other than Permitted Liens, and (ii) if any amounts become due and payable by the Lessee other than amounts constituting Designated Rights or Identified Payments, in consideration of the mutual covenants contained herein, Purchaser shall immediately reconvey, transfer and assign to Seller all of Purchaser's right, title and interest in and to the right to receive any such amount free and clear of all leases and liens other than Permitted Liens (such rights, title and interests to be reconveyed ... being hereinafter collectively referred to as the "Reconveyed Rights").

C was the lessee on the leases.

The Designated Rights, defined in the Purchase Agreement, at 2, mean: the right to demand, collect, sue for, receive and retain (including, without limitation, all rights of Seller to require prepayment of the Percentage of Rent upon an Event of Default ...) the Percentage of payments of Rent and any prepayments thereof, together with interest on overdue payments thereof as provided in the Lease. . . and (ii) all rights of Seller to receive the Casualty Value with respect to each Unit of Equipment ... but shall not include any interest in the Equipment of any other rights under the Lease.

D agreed that it would have no claim or recourse against B "with respect to certain Designated Rights or Identified Payments or such failure of Lessee to pay Rent or any other amounts pursuant to the terms of the Lease." Purchase Agreement, at 5.

The parties also agreed, in the Purchase Agreement, at 9, that:

> there are or there may be from time to time other purchasers of undivided percentage interests in the Purchased Lease (other than the Undivided Lease Interest). Notwithstanding the foregoing, Purchaser shall have the right, subject to Section 4 hereof, to exercise individually all power, rights and remedies under this Agreement against Seller as if there were no other purchasers, and Purchaser acknowledges and agrees that each other purchaser may from time to time be granted by Seller the same right under its agreement with respect to such other purchaser's purchase of its undivided percentage interest in the Purchased Lease. The parties agreed that the purchaser would bear the risk of loss on non-payment of the rents in the Purchase Agreement, at 10, as follows:
>
> (b) Seller will ... do and perform any and all acts and execute any and all documents ... in order to effect the purposes of this Agreement and the sale of the Undivided Lease Interest hereunder and to perfect and evidence Purchaser's ownership of the Undivided Lease Interest....(c) Purchaser and Seller shall direct Lessee to make to Purchaser (i) payments of Rent (including any prepayments of Rent) representing the Percentage of the Purchased Lease, together with interest on overdue payments, which Rents are payable pursuant to Section 2(b) and (c) of the Lease after the date hereof but before the Early Termination Dates and (ii) payments of Casualty Value payable pursuant to ... the Lease.... Purchaser shall have the sole responsibility for demanding, collecting and receiving the Identified Payments, and Seller shall take no action with respect thereto.

It appears from the facts that D did not receive a security interest in the underlying leased equipment or the leases.

Furthermore, in the Purchase Agreement, at 11, the parties agreed that:

> Except pursuant to Section 3, Purchaser agrees not to sell, assign or participate any of its interest in this Agreement or the Undivided Lease Interest (other than Purchaser's interest in the Designated Rights and the Identified Payments, subject to the final proviso of this clause (f)), and any attempted assignment in violation of this provision shall be void; provided that Purchaser may sell or assign any of its interest (the "Transferred Interest") in this Agreement or the Undivided Lease Interest to one or more purchasers so long as any such purchaser agrees that such purchaser shall be bound by the terms of this Agreement with respect to such Transferred Interest, such purchaser shall become a "Purchaser" for all purposes hereunder with respect

> to such Transferred Interest and such purchaser shall properly execute and deliver Internal Revenue Service Forms upon the sale of such Transferred Interest to such purchaser if requested by Seller or Lessee; provided, further, that any sale, assignment, participation or transfer by Purchaser of its interest in this Agreement or the Undivided Lease Interest shall not be made without Seller's prior written consent if the same (i) would increase any obligations or costs, or diminish any rights, of Seller hereunder or in connection herewith or (ii) is to be made to a person other than a U.S. banking institution or a U.S. branch or a foreign banking institution.

In Exhibit A, the Intercreditor Agreement, of the Purchase Agreement, at 4-5, Section 2.6 reads, in relevant part, as follows:

> If, on or prior to Date 8, the Seller has not fully discharged its obligations toward the Bank under the Bank Note and the Bank [E] Security Agreement, the Purchaser agrees to promptly deliver to the Bank the Lease marked "Original", in which case the Bank shall hold such Lease as successor agent in accordance with Section 2.5; otherwise, the Purchaser shall immediately deliver the same to the Seller unless, as of such date, the Seller has not fully discharged its obligations toward the Nonrecourse Lender. Thus, D, the Purchaser, was required to deliver to either E or to B, the Seller, the original lease, and D, therefore, was required to keep the lease for approximately Months Y, from Period 3.

In the Purchase Agreement, at 5, the parties agreed that "Purchaser further agrees that it shall have no claim or recourse against Seller with respect to such Designated Rights or Identified Payments or such failure of Lessee to pay Rent or any other amounts pursuant to the terms of the Lease."

D subsequently assigned the Lease Receivables to G and H. See Letter dated Date 5 from Law Firm 1 to F.

In other documents relating to this transaction, the transaction is discussed as a sale of the Lease Receivables. See Letter of Date 5, from Law Firm 1 to F discussing the transaction as a sale;

Step 4. Transfer of B's Interest in Exchange for Stock in F

On Date 5, B and Taxpayer, which owned all of the stock of F, engaged in a transaction they intended to qualify as a section 351 transaction. [We assume that F files a consolidated return with Taxpayer.] Taxpayer contributed to F Amount 5 of cash in exchange for additional shares of F common stock. B contributed to F his interest in the equipment and lease in exchange for F preferred stock. His interest essentially consisted only of legal title to the equipment and a contingent rental stream associated with the lease after the Period 4 (as the rental stream associated with the first Months Y had already been sold to D). The future rental stream was not guaranteed because C had the option of terminating the lease by the Period 4. Thus, F' remaining economic interest appears to be based on the equipment's residual value and a contingent rental stream beginning in two years.

According to the Exchange Agreement, dividends on B's preferred stock would accrue at an annual rate of Percentage 2 of the Amount 6 liquidation value, payable in cash on the earlier of Date 6, or the date of redemption. After Date 6, the annual dividend rate dropped to Percentage 4. B was granted the right to redeem his stock, but only between Period 5. After Date 7, F had the option to redeem the stock.

Because the terms of the E loan required B to prepay the outstanding balance of the loan upon the transfer of his interest in the equipment and lease, part of the Amount 5 cash contribution from Taxpayer was used by F to pay off the outstanding Amount 7 balance of the loan.

Step 5. Appraisals of the Equipment and Early Termination of the Lease

On the date B purchased the equipment (Date 1), two appraisal companies were hired by B and/or C to estimate the residual value of the equipment. Taxpayer also obtained appraisals at the time it entered the transaction. The appraisers had uniformly estimated the equipment's fair market value at the early termination date to be Amount 8, and the residual fair market value at the regular termination date to be Amount 9.

Between Period 1, C exercised its early termination option. Because C asserted that the amount due on the balloon notes and accrued interest exceeded the actual fair market value at the early termination date, it sought to reacquire the equipment from F by paying the principal and accrued interest on the balloon notes, which was Amount 12.

In any event, the Amount 12 offered by C and apparently accepted by

Taxpayer required nothing more than cancellation of F' balloon note obligation to C. The reacquisition resulted in a Amount 13 loss for F.

Reported Tax Consequences

For its tax years Period 6, F claimed a total of Amount 14 of depreciation expense and a Amount 15 section 1231 loss. (It is unclear whether F claimed additional deductions for interest expense. The request for Field Service Advice only specified depreciation deductions and a section 1231 loss.) F did not report any rental income in connection with the equipment.

Although B's sale of the lease receivable to D was a recognition event for U.S. tax purposes, no U.S. tax was imposed on the gain from the sale because B was not subject to U.S. taxation. From F' perspective, it was not required to recognize this gain because it was not yet the legal owner of the equipment and lease when the gain was required to be taken into account for U.S. tax purposes. Thus, F claimed it was not liable for any tax on the gain on the sale of the lease receivable.

ISSUE 1

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

CONCLUSION

We concur with District Counsel and recommend asserting the sham transaction theory to attack the sales/leasebacks in this case.

LAW AND ANALYSIS

District Counsel has indicated it believes that the sham transaction theory is the strongest argument for challenging the transactions. If the Service prevails on this ground, the taxpayer's claimed depreciation deductions and § 1231 losses will be entirely disallowed.

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

As to the sham transaction theory, generally, where there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or

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

From the facts presented by District Counsel, we concur that the Service has a viable argument that the transactions are sham transactions. While it is impossible to have a simple test or checklist for determining whether a particular transaction is a sham, we see no reason not to assert the sham transaction theory in this case. This theory is the Service's primary weapon in virtually all sale/leaseback cases. Development of this theory is especially important here in light of the fact that this case does not involve a partnership and therefore the sales/leasebacks cannot be attacked on the various grounds generally asserted in partnership cases.

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Rice's Toyota World v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978). When a transaction is treated as a sham, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction.

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

Recently, the Service was successful in showing that a series of prearranged transactions involving the purchase and sale of debt instruments in an attempt to shift accelerated installment sale gain to a tax-neutral partner and manufacture a loss for another partner was a sham. ACM Partnership v. Commissioner, T.C. Memo. 1997-115, appeal docketed, No. 97-7484 (3rd Cir. September 8, 1997). In ACM Partnership, the Service argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance and lacking in economic reality.

In its opinion, the Tax Court said that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The Tax Court also stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transaction lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts when viewed as a whole have no economic substance.

Even if the entire transaction is not a sham, that is, if the debts created were genuine, the transaction could still be rejected by the court. In Goldstein v. Commissioner, 364 F.2d 734, 742 (2d Cir. 1966), the court disallowed petitioner's deductions for interest paid in connection with a loan on the grounds that the transaction lacked any expectation of profit and was entered into by petitioner without any purpose except to obtain an interest deduction. See also, United States v. Wexler , 31 F. 3d 117, 125 (3d Cir. 1994) and Lee v. Commissioner, ---F. 3d—, 1998 WL 640281, 82 A.F.T.R.2d 98-6110 (2nd Cir., August 25, 1998)(No. 97-4308).

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

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

While there is no case on point that involves a lease-stripping transaction of the nature in this case, there are many cases involving transactions in which courts have applied the Sham Transaction Doctrine. Resolution of the issue will depend on the facts in the case. We anticipate the taxpayer will argue that the transaction was entered into for a profit and had economic reality apart from the tax benefits it obtained. To counter this argument, the Service should argue that the transactions at issue were prearranged and predetermined, devoid of economic substance and lacking in economic reality. In this regard, the more facts that can be developed that show the relationships between the

parties and the prearrangements between them, the more likely the victory in this case.

ISSUE 2

Whether the step transaction doctrine applies to the lease stripping transactions at issue.

CONCLUSION:

Based on the facts presented, we believe that the Service should not assert the application of the step transaction doctrine.

FACTS:

The following facts briefly and generally summarize the facts set forth by District Counsel in its request for Field Service Advice.

Taxpayer entered into two (2) lease stripping transactions structured by C, using foreign citizens as intermediaries. As a result of the transactions, profitable Taxpayer subsidiaries took large depreciation deductions, while nontaxable foreign citizens realized the rental income.

The following facts briefly recount the steps of the first transaction[1]:

1. Sometime prior to Date 1, C, Inc. purchased computer equipment, which it then leased to end-users.

2. On Date 1, C sold some of its computer equipment to B, a Nationality citizen and resident, taking cash, nonrecourse balloon promissory notes, and recourse installment notes. B obtained the cash from loans, as evidenced by senior recourse notes. Also on Date 1, B leased the equipment back to C.

3. On Date 2, B sold a portion of the rents due under the leases to D. B used the sales' proceeds to satisfy the recourse installments notes (owed to C).

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[1] The second transaction is substantially similar to the first. District Counsel did not relate the facts of the second transaction in its request for FSA.

4. On Date 5, F, a subsidiary of Taxpayer, entered into an agreement with B to exchange shares of F stock for B's interest in the computer equipment and leases, subject to the nonrecourse balloon promissory notes and the senior recourse notes. Simultaneous with this agreement, taxpayer transferred cash to F in exchange for additional F stock.

5. Shortly after the Date 5, exchanges, F satisfied the senior recourse notes.

6. Sometime between Period 1, C exercised an early termination option under the leases.[2] Although taxpayer and C differed on the amount due to taxpayer under the early termination option, it does not appear any final resolution was ever reached.

7. Based upon the above transactions, B (a non-taxable foreign citizen), accelerated the realization of rental income prior to his exchange of computer equipment with taxpayer. Taxpayer, in turn, reported significant depreciation deductions and losses.

LAW AND ANALYSIS

The Field asks whether the equipment leasing transaction can be challenged under the step transaction doctrine. The step transaction doctrine is a subset of the substance over form doctrine and treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

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

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

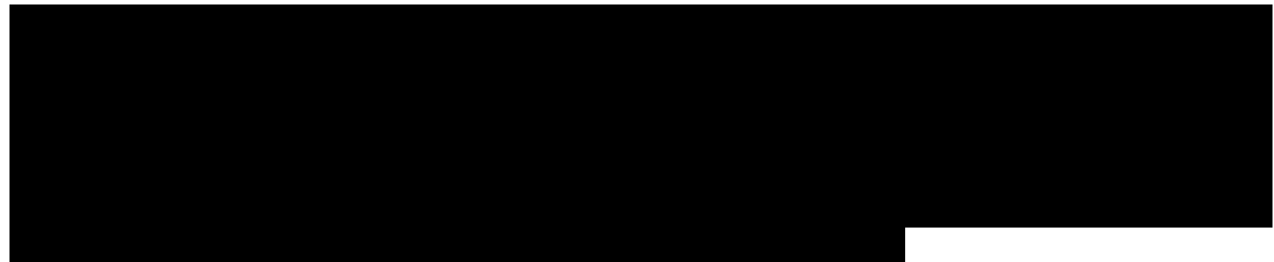
As explained elsewhere, we believe that there is an argument that the series of transactions can be recast to reflect the substance.

As explained elsewhere, we believe that there is an argument for ignoring B's role. Thus, the transaction between C and B and the transaction between B and D is reduced to a transaction between C and D. In other words, at this point the Service has

[2] After the Date 5 exchanges, C continued to be obligated to make rent payments under the leases.

eliminated one step in the series of transactions, which would support asserting the application of the step transaction doctrine.

Since B is no longer a party to the transaction, he is not deemed to have transferred property to F in the purported section 351 exchange. Instead, C would be treated as having transferred such property to F. Thus, the recast still has one less step, as described in the previous paragraph. However, B received F preferred stock. Any proposed recast must account for this.



ISSUE 3:

What is the proper characterization of D's purchase of the Lease Receivables?

CONCLUSION:

We conclude that the additional factual development is required in order to determine the proper characterization.

LAW AND ANALYSIS:

It has been proposed that the acceleration of the future rental income to B may be challenged by recharacterizing the assignment of the Lease Receivables to D as a financing rather than as a sale.

The effect of characterizing this transaction as a sale instead of a financing would be that B must recognize any gain or loss from the sale of the Lease Receivables for federal income tax purposes under section 1001, if subject to taxation in the U.S. Alternatively, if the transaction is a financing or a secured financing, then B does not include the borrowed amounts in gross income. United States v. Centennial Savings Bank FSB, 499 U.S. 573, 582 (1991), 1991-2 C.B. 30. Thus, when he transferred the leasehold interests to F on Date 5, B would have also transferred to F the right to receive the lease payments. Accordingly, B, and subsequently F, would then recognize the income from the lease payments over the period of the payments, from Period 3, instead of accelerating the income in Year W.

In general, federal income tax consequences are governed by the substance of a transaction. Gregory v. Helvering, 293 U.S. 465, 470 (1935), XIV-1 C.B. 193. A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996). Generally, courts examine a number of factors to determine whether a transaction is a sale or something else, such as a financing or a lease. E.g., Levy v. Commissioner, 91 T.C. 838, 859-62 (1988); Larsen v. Commissioner, 89 T.C. 1229, 1266-68 (1987), aff'd in part and rev'd in part, Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

The Tax Court in Grodt & McKay, 77 T.C. at 1237, enumerated eight factors to consider when making the determination of whether the transaction is a sale or a financing:

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

The courts have generally focused on the risk of loss and treated a transaction as a sale when the assignee bears the risk that the anticipated income will not be paid, where the assignment involves the right to receive future income in exchange for consideration. E.g., Estate of Stranahan v. Commissioner, 472 F.2d 867, 870-71 (6th Cir. 1973). Conversely, when the assignee is certain that it will be fully repaid, that certainty is characteristic of a loan. Mapco Inc. v United States, 556 F.2d 1107, 1110 (Ct.Cl. 1977). E.g., Watts Copy Systems v. Commissioner, T.C. Memo. 1994-124 (concluding assignment was a loan because the assignee received a security interest in the property generating the income and the assignor guaranteed that the income would be paid).

To establish that an assignment is a secured financing, it is necessary to show that: (1) the assignee received a security interest in the leased equipment; (2) the assignor expressly guaranteed the payment of the future income; or (3) the assignor implicitly guaranteed the payment of the future income. Watts Copy Systems, Inc. v. Commissioner, T.C. Memo. 1994-124. An implicit guarantee can be found where the assignor agrees to repurchase a lease in default or where the assignor provided the assignee with indirect collateral. See, e.g., Mapco, 556 F.2d at 1111 (concluding that certificates of deposits issued by a bank and held by the taxpayer were indirect guarantees intended to protect the bank against default even though the taxpayer was not personally liable to the bank for the borrower's loan); Hydrometals, Inc. v. Commissioner, T.C. Memo 1972-254, aff'd, 485 F.2d 1236 (5th Cir. 1973).

Upon an analysis of the sale or financing factors applied to the facts of this case, many of the facts indicate that it will be difficult to recharacterize the sale of the Lease Receivables into a financing, and additional factual development is required.

D was obligated to pay B for its acquired rights. Although D had a right to physically possess the underlying leases, D, and its assignees (G and H), were obligated to return the original leases to B in Date 8. These facts fail to support a recharacterization.

D bore the risk of loss or nonpayment of the underlying rents. D, however, had the right to seek payments from the lessee of the equipment, C. D's ability to profit from the transaction appears to have been limited to the rents that it received from the underlying leases, which were already contractually predetermined; D could have assigned or sold its interests in the leases at a price in excess of the price that it paid.

Nevertheless, the sale or financing argument should be used as an alternative to the substance-over-form argument and a denial of the depreciation deductions under section 167 taken by F, which we conclude are the better arguments with these facts. A successful application of the substance-over-form arguments will accomplish the goal of matching the income with the deductions. The depreciation deductions could be denied

if the computer equipment or leases were neither used in F's trade or business nor held for the production of income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

ISSUE 4

Whether the Service can challenge the depreciation deductions attributable to the lease stripping transactions under § 167.

CONCLUSION

We conclude that it is unnecessary to designate § 167 as a separate and alternative theory in this case as long as Service pursues the sham transaction theory.

LAW AND ANALYSIS

District Counsel asserts that, as an alternative theory, the Service may be able to challenge the depreciation deductions taken by the taxpayer under § 167 of the Code. F is entitled to its claimed depreciation deductions on the computer equipment under § 167(a) only if the equipment was "used in the trade or business" or "held for the production of income". As District Counsel acknowledges, the facts relevant to the sham transaction theory would control the disallowance of the depreciation deductions under § 167.

We conclude that it is unnecessary to designate section 167 as a separate and alternative theory in this case as long as Service pursues the sham transaction theory. If F's investments in the computer equipment were sham transactions, then it necessarily follows that the equipment was not "used in the trade or business" or "held for the production of income". Accordingly, the section 167 argument should be included with the sham transaction theory.

ISSUE 5

Whether section 482 applies to the taxpayer and other parties to the lease- stripping transaction at issue, and if so, what are the consequences of applying section 482.

CONCLUSION

From the facts provided, we conclude that section 482 may apply to Taxpayer and the other parties (collectively, the "participants") to the transaction. Because the participants acted in concert pursuant to a common plan to arbitrarily shift income and deductions, the participants will be treated as members of the same controlled group for purposes of section 482.

Section 482 may be applied to reflect clearly the income and deductions arising from the transaction under the following alternative theories.

LAW AND ANALYSIS

Economic substance standards of section 482

Recharacterize the sale-leaseback between C and B and the subsequent sale of the lease receivable from B to D as a loan from D to C, or (ii) disregard the section 351 transaction due to a lack of economic substance, so that F, a wholly owned subsidiary of Taxpayer, is treated as never having acquired ownership of the equipment. Thus, Taxpayer's deductions relating to the equipment would be disallowed and reallocated to C; or

Clear reflection of income and tax evasion standards of section 482

These standards may be applied under two alternatives:

Allocate F' deductions to B during the period B owned the preferred stock of F, so that income and deductions attributable to the sale-leaseback and sale of the lease receivable are not artificially separated; or

Allocate to F the proportionate amount of the proceeds from the sale of the lease receivable for the period of F' participation in the transaction;

Application of section 482 to nonrecognition transactions

Allocate F' deductions to B, on the basis that section 482 may allocate income or deductions attributable to property acquired by a transferee corporation F in a section 351 transaction back to the contributing shareholder B.

Overview

In order for section 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. I.R.C. section 482. The next section (Section 2) of this memorandum discusses the meaning of "control" and "same interests." We conclude that to the extent it can be shown that the transaction was carried out pursuant to a common design that was intended to include all of the parties

to the transaction and effect an arbitrary shifting of income and deductions, the parties may be treated for purposes of this transaction as controlled by the same interests within the section 482 meaning of control. Consequently, under such conditions, the participants would be part of the same controlled group evidenced by their acting in concert with a common goal to shift deductions to F and income to B. *See* Treas. Reg. § 1.482-1T(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). Accordingly, section 482 applies to the transaction.[3]

Section 3 of this memorandum discusses the application of section 482 to the transaction under three alternative theories (under the assumption that the requisite control has been established through the existence of a common design pursuant to which the participants acted):

Section 3.A analyzes the transaction under the economic substance standards in the section 482 regulations and section 482 caselaw. We conclude that the terms of the sale-leaseback and the sale of the lease receivable appear to be inconsistent with the economic substance of the transaction. *See* Treas. Reg. § 1.482-1T(c)(3)(ii)(B) (1993); Treas. Reg. § 1.482-1(d)(3)(iii)(B) (1994). By either (1) recharacterizing the sale-leaseback and the sale of the lease receivable as a loan from D to C, or (2) disregarding the section 351 transaction due to a lack of economic substance, F is treated as never having acquired ownership of the equipment, and its deductions should be disallowed accordingly.

Section 3.B discusses the artificial separation of the rental income, purportedly attributable to B, from the deductions to which F is purportedly entitled through B's transfer to F of his interest in the equipment and lease. *See* Notice 95-53, 1995-2 C.B. 334. Consequently, two alternative allocations under section 482 may be appropriate: allocate F' deductions to B during the period he owned F preferred stock, or allocate to F the proportionate amount of proceeds from the sale of the lease receivable for the period of F' participation in the transaction. *See* I.R.C. § 482; Treas. Reg. § 1.482-1T(a)(1) (1993); Treas. Reg. § 1.482-1(a)(1) (1994).

Section 3.C discusses the role of section 482 in nonrecognition transactions and the ability of the Service to allocate income and deductions attributable to an entity's disposition of built-in-loss (and gain) property, which it acquired in a nonrecognition

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[3] The 1994 final regulations under section 482 apply to the years at issue, unless Taxpayer's tax year begins on or before October 6, 1994. In that case, the 1993 temporary regulations may apply, unless Taxpayer makes an election to apply the final transfer pricing regulations retroactively. Treas. Reg. § 1.482-1T(h) (1993); Treas. Reg. § 1.482-1(j)(2) (1994). Consequently, we will distinguish between the two regulations by referring to their year of promulgation (in parenthesis) when each set of regulations is referred to.

transaction, to the contributing shareholder. We conclude that B's contribution of his interest in the equipment and lease after the income was "stripped" appears to be akin to such a situation. Consequently, an allocation of F' deductions to B also may be appropriate under this theory.

Meaning of "Controlled" & "Same Interests"

Statutory Language of Section 482

Section 482 provides the following:

> 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 distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations.

I.R.C. section 482 (emphasis added). Thus, in order for section 482 to apply to a transaction, the transaction must be between two or more organizations, trades or businesses owned or controlled by the same interests. As there is no common ownership among the participants to the transaction (other than B's receipt of preferred stock in the section 351 transaction), the question is whether any of the participants -- C, B, and Taxpayer/F in particular -- are controlled by the same interests and may be said to be members of the same controlled group.

Legal Standard for Control

The section 482 regulations define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1T(g)(4) (1993), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4) (1994), 1994-2 C.B. 93. See also Appeal of Isse Koch & Co. Inc., 1 B.T.A. 624, 627 (1925), acq., 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument."). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. Id. Accord Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert denied, 385 U.S. 899 (1966); Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223, 224; Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g T.C. Memo. 1996-15, cert. denied, 389 U.S. 841 (1967).

Moreover, the regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted," as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-1T(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). See Dallas Ceramic Tile Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on Treas. Reg. § 1.482-1(a)(3) (1968), the Service properly argued that proof of income shifting between two corporations establishes a presumption of common control). Thus, under the regulations, joint legal ownership, or overlapping ownership, is not required for unrelated corporations to fall within the purview of section 482 if there is a common goal to shift income or deductions. But see Lake Erie & Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq., 1945 C.B. 5, acq. withdrawn and substituted for nonacq., Rev. Rul. 65-142, 1965-1 C.B. 223; B. Forman v. Commissioner, 54 T.C. 912 (1970), rev'd in relevant part, 453 F.2d 1144 (2d Cir. 1972), cert denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq, 1975-2 C.B. 3 (nonacquiescence related to Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with the 1993 and 1994 section 482 regulations).

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of section 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile, 598 F.2d at 1390. We believe that this burden may be met by the "stripping" of income from the leases to B, an entity outside of the United States' taxing jurisdiction, and the reporting of the deductions relating to that income by F. *See* Notice 95-53, 1995-2 C.B. 334 ("[T]he parties to a stripping transaction are controlled by the same interests, because, among other factors, they act in concert with a common goal of arbitrarily shifting income and deductions between a transferor and a transferee.").

Legal Standard for "Same Interests"

If control is found to exist, the Service may allocate income and deductions among members of the "controlled group." Treas. Reg. § 1.482-1T(a)(2) (1993); Treas. Reg. § 1.482-1(a)(2) (1994). A controlled group or controlled taxpayer is defined as the entities owned or controlled by the "same interests," and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. §§ 1.482-1T(g)(4), (5) (1993); Treas. Reg. §§ 1.482-1(i)(5), (6) (1994). Unlike the term "control," the phrase "same interests" is not defined in the section 482 regulations. Case law as well as the legislative history of section 482 provide guidance.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal income taxes, and thereby "milk" a taxable entity, *i.e.,* placing deductions in one entity and income related to those deductions in another entity. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing H. Rep. No. 2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rep. No. 960, 70th Cong.,

1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, 598 F.2d at 1379; South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), aff'g 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967); Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233 (1925). See also LXI-Part 6 Cong. Rec. 5827 (1921) (statement of Sen. King referring to the "same forces" controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. See South Texas Rice Warehouse, 366 F.2d at 894-95. See also Brittingham, 598 F.2d at 1378-79, citing Ach, 42 T.C. at 125-26 (the phrase "same interests" should not be narrowly construed to frustrate the intent of section 482); Appeal of Rishell Phonograph Co., at 233 ("If 'the same interests' was intended to mean only 'the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). Accord Grenada Indus., supra.

Thus, it is not necessary that the same person or persons own or control each controlled business before section 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of "same interests" is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met. See Hall v. Commissioner, 32 T.C. at 409-10 (arbitrary shifting of income coupled with ability to direct actions of entity establishes control for section 482 purposes, regardless of whether ownership exists).

The Common Design of the Transaction at Issue

Based on the facts provided, the transaction has the hallmarks of a prearranged, structured transaction marketed by a promoter, where the participants in the transaction appear to have acted in concert pursuant to a common design to shift income and deductions for tax purposes. Indeed, this common design provides an explanation for why the participants engaged in the several uneconomic transactions and circular flows of cash that, when bound together, constituted the stripping transaction:

When B purchased the equipment from C, the equipment was subject to pre-existing, third-party leases, from which B did not have the right to receive rental income. B and C then immediately entered into a leaseback agreement, under which C was obligated to pay rent to B, but C itself did not actually use the equipment as it had already leased the equipment to the third parties. But for the creation of C's obligation to pay rent to B, there would have been no opportunity to accelerate recognition of income for U.S. tax purposes and leave the corresponding (deductible) obligation to pay C outstanding and available for transfer to F. The income acceleration was achieved through the sale of the lease receivable. C could have achieved the same acceleration effect by prepaying all rent due directly to B, but through the sale of the lease receivable, C effectively

obtained a loan from D, thus avoiding using its own funds and the potentially adverse effect of carrying an Amount 17 liability on its books (which could have raised C's borrowing costs vis-a-vis other creditors). Absent this recognition event, the transaction would have been unmarketable to Taxpayer or any other taxable U.S. party, because if Taxpayer had been required to recognize the income, it would result in an economic loss (except in the unlikely event that the highly inflated estimated residual value of the equipment was realized).

D was fully aware of the purpose of, and its role in, the lease- stripping transaction and was informed of each step of the transaction. It knew that the purchase of the lease receivable would accelerate taxable income to B, after which B could sell his interest to a U.S. company with a tax appetite. See D's "Transaction Description." The bank knew that the transaction would allow a U.S. company to subsequently purchase the tax benefits of depreciation on the equipment without incurring the income acceleration associated with the [lease receivable purchase]." Id.

The existence of a common design is further evidenced by the restrictions imposed by C on B under the sale, leaseback, and security agreements. C, not B, controlled the funds associated with the transaction at all times. This is because B nominally possessed the right to the rent due under the leaseback (prior to selling this right to D), but this right was substantially limited in that the rent payments were equal to amounts due on the installment notes. Similarly, B had nominal rights to the proceeds from the sale of the lease receivable, but he was required to use these proceeds to pay off the installment notes. Additionally, at the termination of the lease when C reacquired the equipment, B was required to first use the proceeds to pay off the balloon notes. Thus, B did not have any right to the rent or sale proceeds other than to have the sale proceeds applied to its obligations to C. (F, as transferee of B's interest, similarly had no control over the funds.)

Similarly, the fact that the leaseback terms (and we assume the sale document's terms) were made expressly conditioned on B's ability to sell the right to receive rent under the B - C lease further demonstrates the existence of a common design to effectuate a lease strip. Indeed, if the sale - leaseback would have been void without B's ability sell the stream of C's rent payments, B's presence in the entire transaction appears solely to provide an accommodation person to absorb, tax-free, the rent from the sale of the rental rights under the leaseback. This is because there is no net economic difference in effect between C entering into the sale - leaseback with either B or D, where B had to find a purchaser of C's rental stream in order to give the C - B sale/leaseback effect.

B's participation in the transaction depended on the future entry of a taxpayer who could utilize depreciation and interest deductions. Absent the fully anticipated entry of a U.S. taxpayer such as Taxpayer, we question whether B would have participated in this transaction. He was not entitled to use the proceeds from the sale of the lease receivable since the terms of the equipment sale required the proceeds to be applied to

pay off C's installment notes. There appears to be no source of income from this transaction except Amount 6 plus dividends accruing at a rate of approximately Percentage 2, which B would receive if he redeemed his F preferred stock, per the exchange agreement, five years from the date he transferred his interest in the equipment and lease to F (between Period 5). We do not know what compensation B has been paid up to this point.

Further indicia of the existence of a common design to shifting income and deductions is that all of the participants in the transaction received substantial benefits that were contingent on their coordinated activity under the common plan. These benefits, as described below, were to be realized only if each participant performed its specific role under the common plan.

Benefits to Taxpayer and its subsidiary F

For an investment of approximately Amount 16, Taxpayer received Amount 19 of deductions over three years, which at a Percentage 5 federal tax rate resulted in more than Amount 20 of tax benefits. Moreover, while Taxpayer (through its consolidated return with F) received a substantial tax benefit for engaging in the transaction, it neither had a reasonable possibility of economic profit nor realized an actual economic profit. F' economic interest, and its pre-tax economic profit, were based solely on the residual value of the equipment and the potential stream of rental payments after the termination date, since B had sold its right to all pre-termination rents to D. According to the terms of the lease, if C exercised its option to terminate the lease early, it could reacquire the equipment for the greater of its fair market value or the balance outstanding on the installment notes. If C opted to lease the equipment for the regular term, it could reacquire the equipment for its fair market value at that time. When C exercised its early termination option, the Amount 12 outstanding balance on the balloon notes exceeded the equipment's fair market value (as appears to have been anticipated by the common plan). Thus, F, having to use the proceeds to pay off the balloon notes, earned no profit.

Benefits to C

C received Amount 2 of cash paid up-front on the sale of the equipment. It also earned a return on the Amount 17 from D (assuming that it invested the Amount 17 payment in an interest bearing asset that yielded more than LIBOR plus 75 basis points (which was the amount that had to be paid back to D)), which C probably did not repay (through a "rent prepayment") until several months later. According to D, C's other benefits from the equipment sale included off-balance sheet financing and minimization of the risk associated with the equipment's residual value. Also, as the likely promoter of the tax shelter, C possibly earned additional fees, the amounts of which we do not know.

Although C had sold and leased back the equipment from B, C still maintained the third-party leases, collected rents, and performed other lessor duties. Neither B nor F performed any of these duties.

Benefits to B

We do not know what up-front compensation B received in consideration for his participation in the transaction, nor the source of this compensation, *i.e.*, from which participants in the transaction. It is likely that he received a fee from C if C was the promoter of this transaction. We do not know, however, the amount of this fee nor when it was paid. F was obligated to pay B Amount 6 and accrued dividends upon the redemption of B's stock, but this was not likely to occur until Period 7. Considering that his costs were likely relatively minimal, B stood to receive a generous return on a minimal up-front investment, assuming this amount was paid.

However, it is important to note that B's anticipated Amount 6 was contingent on the success of the transaction as a lease strip. This is because of B's agreement to indemnify F up to the value of his preferred stock in the event of any U.S. tax liability (of F) arising as a result of B's participation in the section 351 transaction. Thus, if the transaction failed its goal as a lease strip, B stood to loose any benefit that he might have received as a result of the section 351 transaction.

Further, as indicated above, B's primary purpose was to serve as an accommodation party for the benefit of F. B's profit appears to be limited to the cash associated with the stock redemption and dividends, and a possible a fee from C and/or F. Although the proceeds from the sale of the lease receivable were recognized during B's period of ownership, he did not have any right to use these proceeds other than to apply the amounts to pay off the installment note. For this reason, we assume (and recommend factual development of the point) that B was not subject to tax in Belgium on this U.S.

recognition event. As insulation against the risk of tax exposure, C promised to indemnify B for any U.S. taxes arising from the sale, purchase, or subleasing of the equipment, and rent or any other proceeds payable to B.

Benefits to D

D earned an interest rate spread on Amount 17 at a rate of LIBOR plus 75 basis points for assuming a short-term, unsecured credit position with C (which had a credit rating of Rating), and Amount 21 in fees paid by C.

Benefits to E

E earned interest at an unspecified rate on its Amount18 loan to B and probably some fees.

In sum, for the same reasons that C, B, Taxpayer/F, and D appear to constitute the same interests -- the common design to shift income and deductions -- they are all members of the same control group. Notice 95-53, supra; Treas. Reg. § 1.482–1T(g)(4)-(6) (1993); Treas. Reg. § 1.482-1(i)(4)-(6) (1994). The participants also satisfy the control requirement because it is likely that the actions and roles of the accommodation parties, B in particular, were hand crafted by C and Taxpayer so as to effectuate the desired lease strip. See Hall v. Commissioner, supra, 32 T.C. at 409-10 (an arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of section 482 whether or not ownership exists).

Although section 482 applies to “organizations, trades, or businesses,” section 482 may apply to B as an individual, because of his putative leasing activities of C's assets and participation (for a profit) in the lease-stripping scheme. See Keller v. Commissioner, 77 T.C. 1014 (6th Cir.), aff'd, 723 F.2d 58 (10th Cir. 1983); Treas. Reg. § 1.482-1T(g)(1), (2) (1993); Treas. Reg. § 1.482-1(i)(1), (2) (1994). We recommend factual development as to whether B engaged in this lease-stripping transaction as an individual or through his trade or business.

Thus, section 482 may be applied to scrutinize the equipment sale from C to B; the subsequent leaseback to C; the sale of the lease receivable to D; the purported section 351 transaction between Taxpayer, F, and B; and the separation of the income and deductions arising under the entire transaction. Our conclusion that section 482 may apply to the transaction at-issue is bolstered by the Fifth Circuit’s decision in South Texas Rice Warehouse, supra, in which the Tax Court and the Fifth Circuit applied section 482 to a lease-stripping transaction involving a corporation and a partnership owned by four unrelated families. The court upheld the Service’s application of section 482 to prevent the stripping of the income to one entity for the purposes of allowing the other entity to realize losses from depreciation deductions, notwithstanding the fact that the two entities were owned by approximately 16 individuals in varying percentages.

Like South Texas Rice Warehouse, for the reasons outlined below, we believe that the transaction may be viewed as a common design among the participants to create tax deductions for F without corresponding income Inclusions.

Application of Section 482 to the Transaction

We believe section 482 may be applied under three alternative approaches set forth below. Under the first approach discussed in section 3.A, the terms of the sale, leaseback, and the sale of the lease receivable are inconsistent with the economic substance of the transaction. Under the second approach discussed in section 3.B, the separation of income and deductions arising from the transaction does not clearly reflect income for tax purposes. The third approach, discussed in section 3.C, addresses section 482's role in nonrecognition transactions, and in the section 351 transaction between Taxpayer and B in particular.

Economic Substance Analysis

Relationship of Case Law Standard to Section 482 Standards

Section 482 overlaps with the case law[4] 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. §§ 1.482-2T(a)(1)(ii)(B), -2T(a)(3) (1993); 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) (1994). However, the section 482 regulations expand upon case law principles and provide additional guidance in specific areas. Specifically, the regulations provide the following:

> 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.

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[4] See ACM Partnership v. Commissioner, 73 T.C.M. 2189, 2217 (1997), *aff'd in relevant part*, 157 F.3d 231 (3d Cir. 1998)); United States v. Wexler, 31 F.3d 117 (3d Cir. 1994) (transaction is a sham if it "has no substance other than to create deductions"); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (transaction is a sham if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and ... the transaction has no economic substance because no reasonable possibility of a profit exists."); Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989) (standard for sham is "whether the transaction has any practicable economic effects other than the creation of income tax losses.... A taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to this inquiry."); Saviano v. Commissioner, 765 F.2d 643, 654 (7th Cir. 1985) ("The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along."); Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988), cert. denied, 488 U.S. 824 (1988) ("sham analysis ... [consists of examination of] whether the transaction had any practical economic effects other than" generating tax benefits) (citations omitted); Collins v. Commissioner, 857 F.2d 1383, 1385-86 (9th Cir. 1988) (transaction related to gold mining venture had no non-tax economic effect); Kirchman v. Commissioner, 862 F.2d 1486, 1492-93 (11th Cir. 1989) ("transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer") (citations omitted); Sheldon v. Commissioner, 94 T.C. 738, 769 (1990)(same); Cherin v. Commissioner, 89 T.C. 986, 992-93 (1987) (deductions denied due to lack of economic substance); Chapman v. Commissioner, 73 T.C.M. 2405, 2414 (1997).

Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994); Treas. Reg. § 1.482-1T(d)(1) (1993). The regulations further provide:

> In making allocations under section 482, the district director 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) (1994); Treas. Reg. § 1.482-1T(d)(1)(i) (1993).

Thus, section 482 provides an alternative approach to challenging the transaction at issue by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions. See G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 367 (1987). We note that in the context of this transaction (and similar tax-shelter transactions), this allocation authority would exist only where there is a common tax avoidance scheme among the participants to arbitrarily shift income and/or deductions.

Economic Substance of the Sale - Leaseback Transaction & Sale of the Lease Receivable

The economic substance of the sale-leaseback between C and B appears to be other than its purported form. Specifically, for the reasons set forth below, the sale-leaseback may be disregarded as an interim step with no economic substance that when considered in conjunction with the sale of the lease receivable, constitutes a Amount 17 loan by D to C. Such a consideration of both transactions in conjunction with one another is appropriate as both were intended to be part of the same common plan, and the validity of the sale-leaseback was conditioned on the sale of the lease receivable. See Alpha Tank & Sheet Metal Mfg. Co. v. United States, 116 F. Supp. 721, 724 (Cl. Ct. 1953). The following points support this conclusion:

In a bona fide sale, the buyer assumes the risk that it may not realize income from property purchased. See Estate of Stranahan v. Commissioner, 472 F.2d 857 (6th Cir. 1973); Watts Copy Systems, Inc. v. Commissioner, T.C. Memo. 1994-124. However, as the putative buyer of the equipment from C, B assumed no such risk, nor did it assume any risk vis-á-vis the transaction. First, B ostensibly purchased the property for Amount 1
-- Amount 18 of which came from a E loan and the remaining Amount 22 coming from loans of C, *i.e.,* purchase money notes. Although the E loan to B was recourse in name, by its own terms, it was not recourse to B; E's recourse was limited to third-party rents and the equipment, which were already assigned to other financiers who already had security interests in the equipment. See Corbin West Partnership v. Commissioner, 56

T.C.M. 153, T.C. Memo. 1988-436 (recourse loan made to undercapitalized obligor that is not likely to be paid may be disregarded as an economic sham). Concerning the remaining
Amount 22 in loans, these were to be paid from rents from C under the sale-leaseback. In sum, there were simply circular flows of funds with no economic effect. See Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543, 1549 (9th Cir. 1987) (Transactions which constitute a circular flow of funds between entities pursuant to a common plan that are motivated and shaped by tax avoidance concerns may be considered shams.). Accord Erhard v. Commissioner, 46 F.3d 1470 (9th Cir. 1995); Karme v. Commissioner, 73 T.C. 1163 (1980), aff'd, 673 F.2d 1962 (9th Cir. 1982); Marine v. Commissioner, 921 F.2d 280 (9th Cir. 1991); Estate of Nazarian v. Commissioner, T.C. Memo. (CCH) 1989-179; Gurdin v. Commissioner, 1987-69. Thus, like the E loan, B was not at risk on the C notes, as any loan payment obligation to C could be offset against rents to be received from it; nor was B subject to any of the risks normally indicative of a purchase of property. *See also* Treas. Reg. § 1.482-1T(c)(3)(ii)(B) (1993) and Treas. Reg. § 1.482-1(d)(3)(iii)(B) (1994) (discussing the non-exclusive, three-prong tests that apply when members of the same controlled group seek to allocate risks between them).

B sold the lease receivable to D for Amount 17. As required by the sale - leaseback agreement, the sale of the lease receivable accelerated the installment note that B owed to C. Accordingly, D paid the Amount 17 directly to C, rather than to the putative seller of the lease receivable, B. Thus, B's presence in the transaction was essentially reduced to that of an accommodation party in order to facilitate the transfer of tax benefits to Taxpayer. See Allied Signal, Inc. v. Commissioner, T.C. Memo (CCH) 1998-305 (It is appropriate to disregard thinly capitalized entities utilized for the sole purpose of engaging in a transaction designed to secure tax benefits where the parties disregarded the entities in the transaction and treated them as mere conduits.).

The only economic interest B (and later F) had as owner and lessor of the equipment was based on the residual value of the equipment at the time C terminated the lease. Indeed, because we have reason to believe that this residual value was, in reality, anticipated to be less than the balance of the balloon note, this economic interest was illusory. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978), and Stacom v. Commissioner, 61 T.C.M. (CCH) 2691, 2697, aff'd per curiam, 987 F.2d 774 (11th Cir. 1993) (In the sale-leaseback context, a sale-leaseback transaction will be recognized for tax purposes where (1) it is multiparty; (2) possesses economic substance; (3) compelled or encouraged by business or regulatory realities; and (4) is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached).

This economic substance analysis of the sale leaseback transaction should be further developed in light of the following authorities: Smoot v. Commissioner, T.C. Memo. (CCH) 1991-268, Stacom v. Commissioner, 61 T.C.M. (CCH) 2691, aff'd per curiam, 987

F.2d 774 (11th Cir. 1993); Karme v. Commissioner, 73 T.C. 1163 (1980), aff'd, 673 F.2d 1062 (9th Cir. 1982); Southeastern Canteen Co. v. Commissioner, 410 F.2d 615 (6th Cir. 1969); Unger v. United States, 61-1 U.S.T.C. ¶ 9163; Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981); W.B. Lasher Co. v. Commissioner, 51 T.C.M. (CCH) 1234 (1986); Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd, 671 F.2d 316 (9th Cir. 1982).

Pursuant to the common plan, B was never intended, nor did he ever receive a positive cash flow from the combined sale - leaseback and sale of the lease receivable. Further, also per the common plan, he never had to pay off the installment note, balloon notes, or the E loan. This is because (1) the proceeds from the sale of the lease receivable fully satisfied the installment note; (2) cash from Taxpayer paid off the outstanding balance of the E loan; and (3) C's Amount 12 payment to reacquire the equipment paid off the balloon notes.

Accordingly, any ostensible payments by C to B and/or D do not constitute "rent" under income tax principles. *See, e.g.,* I.R.C. section 543(b)(3); Treas. Reg. § 1.1362-2(c)(5)(ii)(B) (Rent, under income tax principles, is compensation for use of, or the right to use, property.). Rather, as intended by the common plan, the combination of (a) "rent" due under the leaseback to B by C, (b) B's offsetting payments due to C under the installment notes, and (c) the sale of the lease receivable by B to D effectively converted any compensation due to B or D for the use of the equipment to a loan from D to C.

Thus, the actual conduct of the participants and the legal and economic substance of the rights and obligations assumed and assigned were inconsistent with their purported form. The combination of the sale - leaseback and sale of the lease receivable was economically and legally structured to constitute a loan by D to C. It would be inappropriate to treat the combination of these transactions in any other fashion that would exalt form over substance.

Other Economic Substance Considerations in re: F

Also relevant to an economic-substance analysis is whether, from a business perspective, the transaction makes objective business sense, or under the language of some cases, would have been entered into by a "hard-headed business[person]." B. Forman v. Commissioner, 453 F.2d 1144, 1160-1 (2nd Cir. 1972). See Id. (Section 482 may overlap with section 162 and result in the denial of deductions where the lack of arm's length dealings results in payments between parties with a "close relationship" in an attempt to avoid taxes.); Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455 (RIA) 3277, 3322 (Royalty payments to a related foreign entity that was not the owner or developer of an intangible were disallowed as deductions. The payments had no economic substance under section 482, because the foreign entity was not the creator, developer, or in substance have the ability to transfer the intangibles.).

Considering this economic substance factor, it appears that the section 351 transaction may be said to be devoid of economic substance. [Note, this argument is distinct from the analysis found later in section 3.C of this Memorandum relating to section 482's role in allocating to a contributing shareholder losses arising from the disposition of built-in-loss property contributed to a corporation.] First, F could not have had any reasonable expectation of profit from the sale of the lease receivable since the proceeds from the sale were recognized for tax purposes by B prior to F' entry into the transaction. Even after F bought B's interest in the equipment and lease, F did not have any right to the proceeds, as all the proceeds were used to pay off the installment note.

Second, because F had no right to the proceeds from the sale of the lease receivable, F' only opportunity to realize an economic benefit was contingent on the residual fair market value of the equipment at the termination of the lease exceeding the principal and accrued interest on the outstanding balloon note. F in fact never earned any income from the transaction, because at the time C opted to terminate the lease early, the amount due on the balloon note exceeded the equipment's fair market value.

Several appraisers had uniformly estimated that the equipment's fair market value was Amount 8 on the early termination date, and Amount 9 on the regular termination date. However, it appears that when C reacquired the equipment on the early termination date, the Amount 12 outstanding balance on the balloon note exceeded the equipment's fair market value.

See also Caruth v. United States,

688 F. Supp. 1129 (D.C. Tex. 1988), aff'd, 865 F.2d 644 (5th Cir. 1989) (Section 351 transactions must be supported by a business purpose.).

In sum, it appears that the sale, leaseback, sale of the lease receivable, and the section 351 transaction are devoid of economic substance and may be disregarded. The effect of disregarding either (1) the sale and leaseback (and the sale of the lease receivable as a necessary consequence); (2) the lease receivable; or (3) the section 351 transaction, is to break the chain of transactions that give rise to F' claim that it is entitled to depreciation and interest deductions.

Application of Section 482's Clear Reflection of Income & Tax Evasion Standards

Section 3.A of this memorandum discussed applying section 482 to disregard the individual steps in the transaction under section 482's economic substance standards. As an alternative to disallowing deductions by disregarding the steps, section 482 may effectively disallow deductions of a taxpayer by allocating them to another entity pursuant to the Service's authority to allocate income and deductions to clearly reflect income and prevent the evasion of taxes. *See* I.R.C. § 482; Treas. Reg. § 1.482-1T(a)(1) (1993); Treas. Reg. § 1.482-1(a)(1) (1994). This analysis, and the case law affirming the Service's exercise of this allocation authority, is not based upon an economic-substance analysis. Rather, it focuses on the distortions in taxable income caused by the separation of income from deductions. See Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1951), *rev'g*, 16 T.C. 882, cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962).

As stated in Notice 95-53, the separation of income from deductions in lease-stripping transactions does not clearly reflect income, particularly where they are achieved through a transaction structured to evade taxes. Accordingly, to prevent the evasion of taxes and to effect a clear reflection of income, two alternative allocations may be appropriate: either (1) F' deductions could be allocated to B during the period B owned F preferred stock; or (2) income (*i.e.,* a portion of D's Amount 17 payment) could be allocated to F in proportion to the period it owned the interest in the equipment and lease. See, e.g., Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967); J.R. Land Co. v. Commissioner, 361 F.2d 607, 609-10 (4th Cir. 1966), aff'g sub nom, Brentwood Homes, Inc. v. United States, 240 F. Supp. 378 (E.D.N.C. 1965);. Central Cuba Sugar Co.v. Commissioner, 198 F.2d 214 (2nd Cir.), rev'g, 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Advance Machinery Exchange, Inc. v. Commissioner, 196 F.2d 1006 (2d Cir. 1952), cert. denied, 344 U.S. 835 (1952).

Section 482's Application in Nonrecognition Transactions

Another approach which may be used to challenge F' depreciation and interest deductions focuses on the section 351 transaction between F and B. Section 482 may be applied to allocate income or losses from the disposition of property acquired in a nonrecognition transaction, such as a section 351 transaction, where the property was contributed to the corporation for tax avoidance purposes. *See* Treas. Reg. § 1.482-1T(d)(1)(iii) (1993); Treas. Reg. § 1.482-1(f)(1)(iii) (1994). The seminal case illustrating section 482's role in section 351 transactions is National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943).

In National Securities, a parent corporation contributed property with a basis of $140,378 and a value of $8,563 to the capital of its subsidiary. The property was stock of an unrelated corporation which had declined substantially in value from the time the parent corporation purchased the stock. Approximately 10 months after receiving the stock from its parent, the subsidiary sold the stock for $7,175 and claimed a $133,203 loss. *Id.* at 600-01.

The Service disallowed the loss, stating that the subsidiary was only entitled to the loss realized from the decline in value during the 10 months it held the stock, and not the loss attributable to the decline in value when the parent held the stock. The Service allocated the remaining loss to the parent under section 45 of the Internal Revenue Code of 1936 (the predecessor to section 482), reasoning that the allocation of the pre-contribution built-in-loss to the parent was necessary to reflect income clearly. The court agreed with the Service's determination and reasoned:

> Section 45 is directed to the correction of particular situations in which the strict application of the other provisions of [the Code] will result in a distortion of the income of affiliated organizations....The parent made the investment in Standard stock in 1929 and held on to the stock as an investment until 1936 [when it was contributed to the capital of the subsidiary and sold 10 months later]...It seems most reasonable to treat the loss as one which had in fact been sustained by the parent rather than by its subsidiary. The shifting of the loss to the subsidiary gives an artificial picture of its true taxable income and one which it was unnecessary for the Commissioner to accept.

Id. at 602-03. Numerous other cases have followed National Securities in allocating pre-contribution (or pre-distribution before the repeal of the General Utilities doctrine) gain or loss to the transferor or transferee on the subsequent disposition of contributed or distributed property by the transferee. See, e.g., Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff'd without op., 732 F.2d 168 (Fed. Cir. 1984); Northwestern Nat. Bank of Minneapolis v. United States, 556 F.2d 889, 892 (8th Cir. 1977), aff'g, 37 A.F.T.R.2d ¶76-1400 (D. Minn. 1976); Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987), aff'g, 82 T.C. 830 (1984); Foster v.

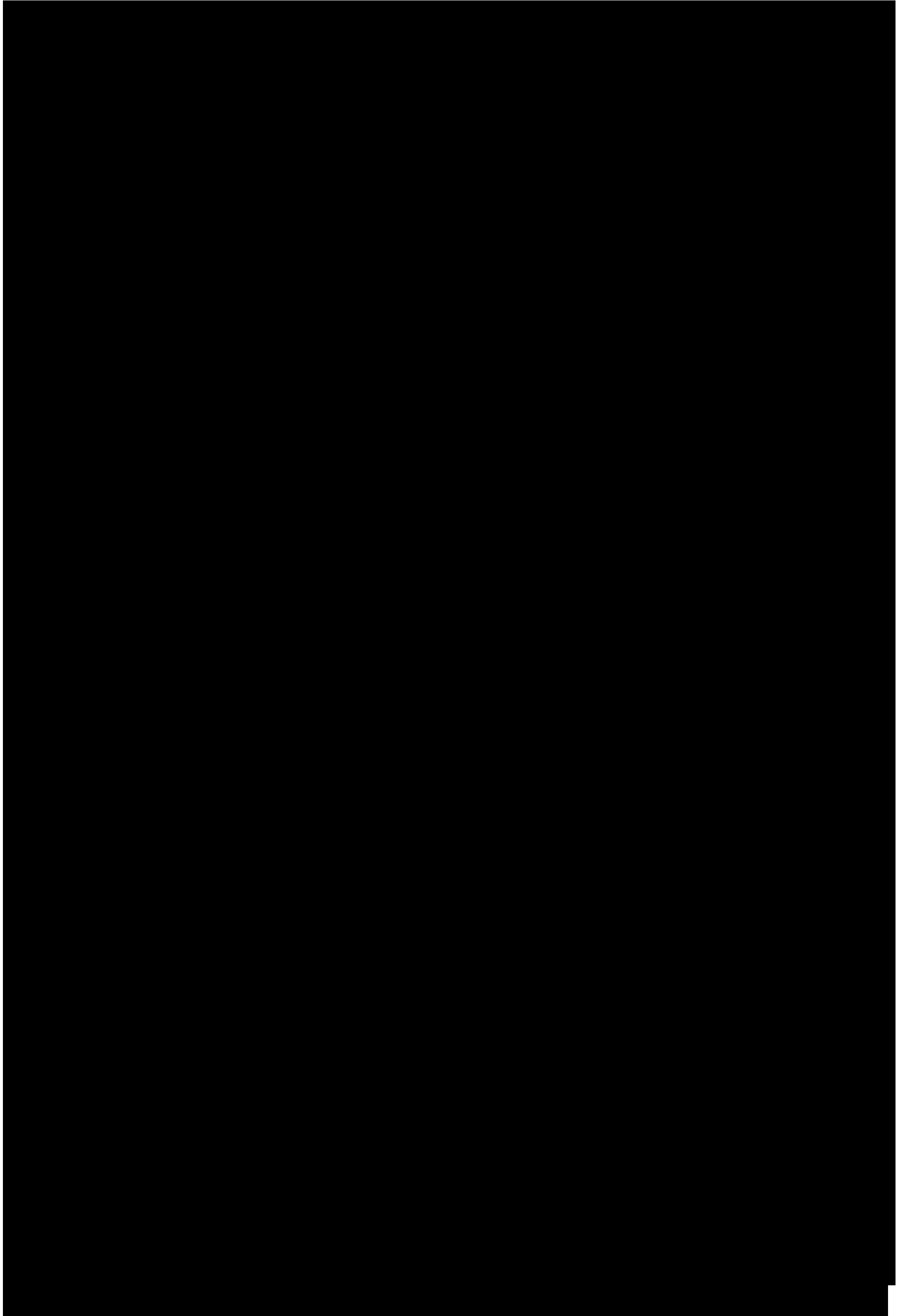
Commissioner, 80 T.C. 34, 160, 172-77 (1983), aff'd in relevant part, 756 F.2d 1430, 1433-4 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986). The Tax Court has recently interpreted the National Securities line of cases to apply in instances where there is a tax avoidance purpose. Eli Lily & Co. v. Commissioner, 84 T.C. 996, 1119 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988).

Thus, given the substantial amount of evidence indicating the tax avoidance purpose of the transaction at issue, we believe that section 482 may apply to the section 351 transaction involving F, B, and Taxpayer. Focusing on the section 351 transaction, the proper allocation under section 482 would be to allocate the deductions from F to B during B's ownership of F stock. Our rationale is that from a tax perspective, the depreciation and interest expenses of F could only result in a tax loss to F after B had "stripped off" all of the gross taxable income, regardless of any realistic residual value of the leases. Thus, in effect, B contributed built-in-loss property to F, like the shareholder in National Securities, pursuant to a tax avoidance plan to allow F, the transferee corporation, to recognize the tax losses.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

We believe that the Service's ability to apply section 482 is enhanced significantly in this case by the close proximity in time (approximately three months) during which all participants entered the transaction at issue.

For purposes of applying section 482, we believe that it is crucial to obtain promotional materials, as well as any correspondence and internal documents relating thereto, in order to support the proposition that the participants acted pursuant to a common plan. We believe that if promotional materials were to be obtained, they would contain a description and/or diagrams outlining the entire scheme and the roles of each participant, possibly identifying several or all of the participants. It will also be important to determine whether this transaction was a registered tax shelter, as it would further evince the common plan to evade taxes.



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