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

OFFICE OF
CHIEF COUNSEL

January 31, 2002

Number: **200218022**
Release Date: 5/3/2002
CC:PSI:B01/POSTF-150654-01
UILC: 9214.00-00; 351.00-00; 162.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (COMMUNICATIONS, TECHNOLOGY, AND MEDIA)

ASSOCIATE AREA COUNSEL (FINANCIAL SERVICES)
CC:LM:FS:LI
Attn: Halvor Adams

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS & SPECIAL INDUSTRIES)
CC:PSI

SUBJECT: Lease Stripping Transaction

This Chief Counsel Advice responds to your memorandum dated October 2, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

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

LEGEND

Taxpayer =

Partnership 1 =

Partnership 2 =

Partnership 3 =

Partnership 4 =

Partnership 5	=
Partnership 6	=
Corporation 1	=
Corporation 2	=
Corporation 3	=
Corporation 4	=
Corporation 5	=
Corporation 6	=
Corporation 7	=
Corporation 8	=
Corporation 9	=
Corporation 10	=
Corporation 11	=
Corporation 12	=
Corporation 13	=
Equipment Group A	=
Equipment Group B	=
Note1	=
Note 2	=
Note 3	=
Note 4	=
Short-Term Note1	=

Short-Term Note 2	=
Long-Term Note 1	=
Entity	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
Date 15	=
Date 16	=
Date 17	=
Year 1	=
Year 2	=

Year 3	=
Month	=
$A	=
$B	=
$C	=
$D	=
$E	=
$F	=
$G	=
$H	=
$I	=
$J	=
$K	=
$L	=
$M	=
$N	=
$O	=
$P	=
$Q	=
$R	=
$S	=
$T	=

<u>$U</u>	=
<u>$V</u>	=
<u>$W</u>	=
<u>$Y</u>	=
<u>$Z</u>	=
<u>$AA</u>	=
<u>$BB</u>	=
<u>$CC</u>	=
<u>$DD</u>	=
<u>$EE</u>	=
<u>$FF</u>	=
<u>$GG</u>	=
<u>$HH</u>	=
<u>$II</u>	=
<u>X</u>	=
<u>Y</u>	=
<u>Z</u>	=
<u>XX</u>	=
<u>YY</u>	=
<u>ZZ</u>	=
<u>XXX</u>	=
<u>YYY</u>	=

ISSUES

1. Whether the Service may challenge Taxpayer's deductions on the grounds that they derived from transactions that lacked economic substance.

2. Whether the Service can allocate the deductions to Partnership 1, pursuant to the authority granted in section 482 of the Internal Revenue Code.

3. Whether the Service can challenge the deductions on the grounds that the transaction between Partnership 1 and Corporation 1 is not valid under section 351 of the Internal Revenue Code.

4. If the transactions are valid, whether the Service can challenge the deductions on the grounds that any rent payments made by Corporation 1 when it assumed Partnership 1's obligations are capital expenses of Corporation 1.

5. If the rent payments assumed by Corporation 1 from Partnership 1 are capital expenditures, to what asset would the cost be capitalized and would Corporation 1 be entitled to recover any cost of the asset for any of the years in issue.

6. Whether the Service may challenge the deductions that Taxpayer reported from Corporation 1's transfers of partial interests in the Long-Term Note 1 to Partnership 4 and Corporation 12 in exchange for their assumption of portions of Corporation 1's obligations under the Over Lease on the grounds that they do not produce the deductions.

7. Assuming alternatively that Corporation 1 would be entitled to the deductions, may the Service challenge the deductions on the grounds that the economic performance requirements of section 461(h) of the Code were not satisfied.

8. Assuming alternatively that Corporation 1 would be entitled to the deductions, may the Service challenge the deductions, referenced above, on the grounds that they are limited by section 467 of the Code.

9. Whether characterizing the transaction between Partnership 1 and Corporation 1 as an agency arrangement or as a payment by Partnership 1 to Corporation 1 for assuming Partnership 1's liability under the Over Lease, rather than as a transfer of property in exchange for stock, support the disallowance of the deductions.

10. Whether characterizing the transactions between Corporation 1 and Partnership 4/Corporation 12 as agency arrangements, rather than as payments by Corporation 1 to those entities for assuming Corporation 1's liability under the Over Lease, support the disallowance of the deductions reported by Taxpayer from those deductions.

11. Whether the Service can take the position that the accuracy related penalty provided by Code section 6662 applies to deficiencies that result from the deductions?

CONCLUSIONS

1. Under the facts as currently developed, the Service may challenge Partnership 1's deductions as they were derived from transactions that lacked economic substance.

2. From the facts provided, we conclude that section 482 potentially applies to Taxpayer and the other parties to this transaction. Because the participants appear to have acted in concert pursuant to a common plan to shift loss deductions to Taxpayer, they should be treated as part of the same controlled group for purposes of applying section 482. Accordingly, section 482 may be applied to reallocate the rental income, rental deductions and loss deductions among the participants to prevent the evasion of taxes and to clearly reflect the income of the participants.

   Section 482 may be applied under three alternative theories:

   1. Disregarding the Over Leases between Partnership 1 and Corporation 10, so that Taxpayer never acquires the obligation to pay rent to Corporation 10 and Corporation 10 never acquires the purchase obligation upon which Long-Term Note 1 was based, which would prevent Taxpayer from taking rental and loss deductions;

   2. Allocating the stripped rental income received by Corporation 11 from Corporation 8 under the Master Lease back to Taxpayer or allocating Taxpayer's rental deductions to Partnership 4 and Corporation 12, so that the income and deductions attributable to the leases on the equipment are not artificially separated; or

   3. Allocating Taxpayer's rental deductions and losses claimed on the dispositions of the Long-Term Note 1 to Partnership 1 on the basis that section 482 may be applied to allocate deductions attributable to property received in a section 351 transfer from the transferee corporation back to the contributor to clearly reflect income.

3. The determination of whether or not the transaction between Partnership 1 and Corporation 1 qualifies under section 351 will have no impact on the deductions reported by the Taxpayer from the leasehold interest.

4. The Service may challenge the deductions on the grounds that the payments of the rent obligation Corporation 1 assumed from Partnership 1 are capital expenses for Corporation 1.

5. Assuming the answer to issue number four (4) is affirmative, the cost would be capitalized to Long-Term Note 1 and Corporation 1 would not be entitled to recover any of the cost of Long-Term Note 1 in the years at issue.

6. The Service may challenge the deductions the Taxpayer reported from Corporation 1's transfers of partial interests in Long-Term Note 1 to Partnership 4 and Corporation 12 in exchange for their assumption of portions of Corporation 1's obligations under the Over lease since they do not produce the deductions.

7. Assuming alternatively that Corporation 1 would be entitled to the deductions, economic performance requirements must be satisfied. If such requirements, as stated in Internal Revenue Code section 461(h), are not met, the Service may challenge the deductions.

8. Assuming alternatively that Corporation 1 would be entitled to the deductions, the Service may challenge the deductions on the grounds that they are limited by Internal Revenue Code section 467.

9. The facts support the argument that Partnership 1 transferred Long-Term Note 1 to Corporation 1 as payment for Corporation 1 assuming Partnership 1's liability under the Over Lease. If this characterization of the transaction is correct, Partnership 1, rather than Taxpayer, would be entitled to the rental deduction. No facts exist that support the proposition that Corporation 1 acted as Partnership 1's agent.

10. Taxpayer cannot characterize the transactions between Corporation 1 and Partnership 4/Corporation 12 as agency arrangements. The facts do not support the existence of an agency relationship between any of these parties.

11. If the Service prevails in the case, our primary position is that the accuracy-related penalty applies to the portion of the underpayment that results from the disallowance of the deductions at the 40 percent rate for gross valuation

misstatements. The Service's secondary position should be that it applies at the 20 percent rate.

FACTS

The facts, as currently developed, are as follows:

Prior to Date 1, Corporation 2 owned Equipment Group A and Equipment Group B that was leased to Corporation 3 and Corporation 4, respectively. In addition, Corporation 2 also owned other property that was being leased to third parties.[1]

First Leasing Transaction

Corporation 2 sold "Equipment Package"[2] to Partnership 2 on Date 1. Partnership 2 paid $A, comprised of Corporation 2 debt assumed by Partnership 2 and Note 1. As a part of the deal, Corporation 2 obtained liens on the equipment to secure payment.

Also on Date 1, Partnership 2 sold the same Equipment Package to Partnership 3. Partnership 3 paid $B in the form of Note 2. In exchange, Partnership 2 took liens on both the equipment and the amount due under User Leases to secure payment.

In addition, on Date 1, Partnership 3 sold the Equipment Package to Corporation 5 for $C. As its payment, Corporation 5 issued two notes, Note 3 and Short-Term Note 1. Note 3 and Short-Term Note 1 were secured by liens in favor of Partnership 3 on the equipment and pre-existing User Leases.

Master Lease

Partnership 3 leased back the equipment from Corporation 5 on Date 1, in what is referred to as the "Master Lease." The expiration dates for the Master Lease were Date 2 and Date 3. The Date 2 ending date was applicable to the equipment leased to Corporation 3, while the Date 3 ending date applied to the equipment leased to Corporation 4. Under the terms of the Master Lease, the rental payments that Partnership 3 owed to Corporation 5 exactly equaled the payments Corporation 5 owed to Partnership 3 under the terms of Note 3.

[1] These are referred to collectively as "User Leases." The User Leases all ended in Year 3.

[2] The Equipment Package was comprised of Equipment Group A and Equipment Group B and "other property."

Remarketing Agreements

Finally, on Date 1, Partnership 3 and Corporation 5 entered into remarketing agreements with Corporation 2. Specifically, Partnership 3 and Corporation 2 agreed that Corporation 2 would be responsible for remarketing the equipment for the period between the expiration of the User Leases and the expiration of the Master Lease. In addition, Partnership 2 signed a consent to this transaction. Corporation 2 and Corporation 5 agreed that Corporation 2 would be responsible for remarketing the equipment after the expiration of the Master Lease periods.

The Income Strip – Partnership 3

On Date 4, Partnership 3 sold the initial lessor rights (the rights to the rental income from Corporation 3 and Corporation 4 during the terms of their leases and rental income from other property leased to other third parties during the terms of their leases) to Corporation 6. In exchange for these rights, Corporation 6 paid $D, which was used by Partnership 3 to partially repay the balance owed Partnership 2 from Note 2. In connection with the sale, Corporation 2 (holder of Note 1), Partnership 2 (holder of the remaining balance on Note 2), and Partnership 3 (holder of Note 3 and Short-Term Note 1) agreed to release their liens on the rents due under each of the user leases. Additionally, Corporation 2 and Partnership 2, but not Partnership 3, agreed to subordinate their liens on the Equipment Packages to the rights of Corporation 6. As a result, the end users were instructed to pay their money directly to Corporation 6.

Corporation 6 paid a portion of Corporation 2's debt that was incurred to acquire the property included in the Equipment Package and assumed the remainder of the debt. Partnership 2 had assumed that debt when it purchased the Equipment Package from Corporation 2 on Date 1.

Finally, Partnership 3 allocated 99 percent of the income from the sale of the rights to the rents to Entity, a tax neutral entity, which was a 99 percent partner of Partnership 3. This resulted in the stripping of the income from that portion of the leasehold interest off to a tax neutral entity.

Thus, in summary, Partnership 3 was left with the right to use the Equipment Package for the period of time between the end of the User Leases, and the end of the periods during which Partnership 3 had leased the equipment (Master Lease). Partnership 3 also owned a residual interest in the Equipment Package from the end of the terms of the User Leases until the end of the Master Lease. Corporation 5 owned the Equipment Package, subject to its obligation to provide the use of the property to Partnership 3, until the termination dates of the Master Lease and subject to the liens to which the equipment was encumbered.

Corporation 5 owned the interest that remained in the Equipment Package at the end of the Master Lease.

Second Income Strip – Partnership 3

On Date 5, Partnership 3 sold its first two years of residual rights to Equipment Group B to Corporation 7. In exchange for the residual rights, Corporation 7 paid $E. Partnership 3 allocated 99 percent of the income from the sale to its 99 percent partner, Entity, thereby stripping the income from Partnership 3's leasehold interest to a tax neutral entity. Partnership 3 partially repaid its financial obligation to Partnership 2 under Note 2 with the $E it received from Corporation 7.[3]

Transfer of Stripped Leasehold Interest to a Taxable Entity

On Date 6, Partnership 3 contributed to Corporation 8, a subsidiary of Corporation 9; (1) Partnership 3's remaining rights to Equipment Package under the Master Lease,[4] (2) Partnership 3's obligation to pay rent to Corporation 5 (pursuant to Master Lease) and Partnership 3's offsetting right to payments from Corporation 5 (Note 3), and (3) Short-Term Note 1. In exchange, Partnership 3 received X shares of preferred stock in Corporation 8. In addition, Corporation 9 contributed $H and received Y shares of common stock in Corporation 8. Thus, Corporation 8 claimed rent deductions on its obligation to pay rent to Corporation 5 which was satisfied by the payments it was entitled to receive from Note 3.

Second Leasing Transaction

On Date 7, Corporation 5 sold Equipment Package and right to receive rent payments from Corporation 8 (under Master Lease) to Partnership 1. In exchange, Partnership 1 paid $I in the form of a promissory note (Note 4) and assumed Corporation 5's obligation to make payments to Corporation 8, pursuant to Note 3. The obligations to make payments to Corporation 8 exactly offset the right to receive rent payments from Corporation 8, pursuant to the Master Lease.

---

[3] Partnership 3 had previously reduced the balance on Note 2 to $F by applying the proceeds from the rights to rent sale to Corporation 6. By applying $E to the remaining balance on Note 2, it was further reduced to $G.

[4] This covers the period between the end of the User Leases and the end of the Master Lease, minus the two year interest sold to Corporation 7.

Partnership 1's Sale of the Equipment to Corporation 10

Also on Date 7, Partnership 1 sold the equipment only (from Equipment Group A and Equipment Group B), along with Partnership 1's interest in the Master Lease,[5] to Corporation 10. As payment, Corporation 10 issued two notes, Long-Term Note 1 and Short-Term Note 2. The payment totaled $J, with Long-Term Note 1 being issued for $K and Short-Term Note 2 issued for $L.

Over Lease

Also on Date 7, Partnership 1 leased back the same equipment it sold from Corporation 10. In the transaction, Partnership 1 also received the right to the rental payments from Corporation 8, due on the equipment under the terms of the Master Lease. The lease between Partnership 1 and Corporation 10 is referred to as the "Over Lease." The payments pursuant to the Over Lease exactly offset the payments that Corporation 10 owed to Partnership 1 under Long-Term Note 1. In addition, the expiration dates on the Over Lease match up exactly with the end dates of the Master Lease. Thus, at the end of the day on Date 7, Corporation 10 had purchased the residual interest that remained in the equipment at the end of the Master Lease for $L.

Income Strip – Partnership 1

On Date 8, Partnership 1 sold the rights to rental payments on the equipment from Equipment Group A and Equipment Group B under the Master Lease from Corporation 8 to Corporation 11. Corporation 11, in exchange, assumed the portion of Note 3 relating to the equipment. Partnership 1 paid Corporation 11 $M to offset the amount by which the discounted present value of the payment obligations Corporation 11 assumed under Note 3 exceeded the discounted present value of the rights Corporation 11 received to rental income under the Master Lease. Partnership 1 allocated almost all of the income from the sale to Entity, a tax neutral entity.

Thus, at the end of the day on Date 8, Partnership 1 was left with only the right to receive payments under Long-Term Note 1 and an exactly offsetting obligation to make lease payments to Corporation 10, pursuant to the terms of the Over Lease. Partnership 1 also obtained or assumed rights or obligations offset as follows: (1) Partnership 1 had sold the right to rent due on equipment (Master Lease) which it had purchased from Corporation 5 on Date 7, then sold to Corporation 10 and leased back from Corporation 10 on Date 7, and sold to Corporation 11 on Date 8;

[5] On Date 7, Partnership 1's interest in the Master Lease was the right to receive rental payments from Corporation 8.

(2) Partnership 1 had sold the right to the use of the equipment at the end of the Master Lease, purchased from Corporation 5 on Date 7, to Corporation 10 on Date 7. Corporation 11 assumed, on Date 8, the portion of Note 3 Partnership 1 had assumed, on Date 7, to purchase the equipment from Corporation 5; and (3) Corporation 10 had given Partnership 1 Short-Term Note 2 on Date 7 which offset the portion of Partnership 1's obligation under Note 4 that related to the equipment.

Transfer of Stripped Leasehold Interest to Corporation 1

On Date 9, pursuant to a signed Assignment & Assumption Agreement, Partnership 1 transferred Long-Term Note 1 and "certain of Partnership 1's obligations" to Corporation 1, apparently including Partnership 1's obligation to make payments to Corporation 10, pursuant to the Over Lease.[6] In exchange, Corporation 1 transferred to Partnership 1 Z shares of Corporation 1 common stock. The amounts payable to Corporation 10 pursuant to the Over Lease were exactly offset by the payments that were due pursuant to Long-Term Note 1. Taxpayer contributed $N to Corporation 1 and received XX shares of Corporation 1 common stock in exchange.

Corporation 1 reported $O carryover basis in Long-Term Note 1. This figure was arrived at by adding the stated face value of Long-Term Note 1 ($P) and the interest ($Q).

Deductions in Year 1

On Date 10, Corporation 1 transferred to Partnership 4 its interest in Long-Term Note 1, to the extent of the pre-existing User Leases with Corporation 4. In exchange for this, Partnership 4 assumed Corporation 1's obligation to make rental payments to Corporation 10 under the terms of the Over Lease, to the extent of the assets leased to Corporation 4. Taxpayer characterized this partial disposition of Long-Term Note 1 as constituting a rental expense of $R. This resulted in a claimed net operating loss ("NOL") of $S for Taxpayer.

Deductions Claimed in Year 2

On Date 11, Corporation 1 transferred to Corporation 12 its interest in Long-Term Note 1 to the extent of a YY percentage interest in the pre-existing Users Leases with Corporation 3. In exchange for this, Corporation 12 gave Corporation 1 an unsecured promissory note with a face value of $T and assumed Corporation 1's

---

[6] As the facts are currently developed, it is unclear exactly which obligations "certain of Partnership 1's obligations" refers to under this transaction. Prior to this transaction, it appears that the only obligation that Partnership 1 retained was the obligation to make payments to Corporation 10.

obligation for rental payments to Corporation 10 under the Over Lease to the extent of the assets leased to Corporation 3.

Taxpayer reported a $U cost basis in the portion of its interest in Long-Term Note 1 transferred to Corporation 12. Taxpayer claimed a loss on this partial disposition in the amount of $V. Finally, Taxpayer also claimed rental expenses of $W for rent purportedly paid to Corporation 10.

Deductions Claimed in Year 3

On Date 12, Corporation 1 transferred to Corporation 12 its interest in Long-Term Note 1 to the extent of a ZZ percentage interest in the pre-existing user leases with Corporation 3. Corporation 12, in exchange, gave Corporation 1 an unsecured promissory note with a face value of $Y and assumed Corporation 1's obligation for rental payments to Corporation 10 under the Over Lease to the extent of the assets leased to Corporation 3.

Taxpayer reported a cost basis of $Z in the portion of its interest in Long-Term Note 1 that it transferred to Corporation 12. Taxpayer also claimed losses on this partial disposition in the amount of $AA.

Corporation 1's Redemption of Partnership 1's Stock

On Date 13, Corporation 1 redeemed, from Partnership 1, the Z shares of its stock that Corporation 1 issued to Partnership 1 in the transaction on Date 9 for $BB.

Relationships Between the Entities

It appears that all of the entities involved in setting up the lease stripping transactions were related through intertwined ownership, officers, agents, and directors.

Corporation 1 was the managing partner of Partnership 3. Under the facts as currently developed, Partnership 3 played a significant role in the first lease stripping transaction.

Entity, a 99 percent partner of Partnership 1's 99.9 percent partner Partnership 5, was also a 99 percent limited partner of both Partnership 3 and Partnership 4.

The president of Corporation 1 is the registered agent of Corporation 12. Furthermore, the address given for Corporation 12 is exactly the same as the address of Taxpayer.

The general partner of Partnership 1 who signed the Assignment & Assumption Agreement with Corporation 1, owned Corporation 7. Additionally, this individual, along with the president of Corporation 10, serve together on the board of another corporation, Corporation 13. Finally, the vice president of Corporation 5 is the same individual, referenced above, who signed the Assignment & Assumption Agreement as a general partner of Partnership 1.

Corporation 5 and Partnership 6, which was a limited partner of Partnership 2, are believed to be related through a common officer. In addition, the president of Corporation 11 and the aforementioned common officer of Corporation 5 serve together as officers and directors of five other corporations.

LAW AND ANALYSIS

Issue One

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. Winn-Dixie Stores, Inc. v. Commissioner, 254 F. 3d 1313 (11th Cir. 2001) aff'g 113 T.C. 254 (1999); United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequence of holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 T.C. at 769.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership, 157 F.3d at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

Moreover, claims of pre-tax profit are not dispositive. There has been some precedent that economic substance for a lease transaction will be satisfied if there is "some modicum" of economic substance, which may mean "some modicum" of pretax profit. See Rice's Toyota World, Inc. v. Commissioner, supra; Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985). In Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990), the Fourth Circuit found that a leasing transaction was a sham. In doing so, it described a $17,000 profit potential as "minimal" on an eight-year investment of $130,000. The Fourth Circuit also found evidence of tax motivation in the offsetting obligations to pay rent and debt service. The transaction also involved the use of related parties to avoid section 465. Under these facts, the court found that "the tax tail began to wag the dog." Hines, 912 F.2d at 741. Thus, small profits on a lease transaction may be overlooked when tax considerations have taken over the transaction. See also Pacheco v. Commissioner, T.C. Memo. 1989-296.

In Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001), the Tax Court found that petitioner's acquisition of certain stripped lease interests to shelter gain in an intermediary transaction lacked economic substance. Petitioner stepped into the transaction by purchasing the shares of a corporation and merging that corporation into petitioner. Petitioner then sold assets it had acquired in the merger, generating an approximately $11 million gain. Pursuant to a series of prearranged transactions including several section 351 transactions, petitioner acquired the purported interests and obligations relating to certain leases. The majority of the income relating to these interests had been stripped off and placed into a trust fund. Upon petitioner's subsequent transfer of these interests, petitioner claimed, inter alia, an ordinary business expense deduction of approximately $21 million.

In holding that the transactions lacked economic substance the court noted that "no credible business purpose and . . . no viable economic substance existed" for petitioner's transfer of the lease interests. Further the court noted that the prearranged transactions leading up to petitioner's acquisition of the purported interests created a circular flow of funds. In imposing the accuracy related penalty, the Court held that the participation of highly paid professionals did not provide petitioner any protection, excuse, justification, or immunity.

As discussed, transactions devoid of economic substance are not recognized for federal income tax purposes. AMC Partnership v. Commissioner, 157 F.3d at 246. As currently developed, the facts indicate that the series of transactions in which Corporation 1 obtained and sold its interest in both Long-Term Note 1 and rental payment obligations under the Over Lease lacked economic substance under both a subjective and objective inquiry. As further discussed below, the facts also do not suggest a plausible business purpose for the transactions.

The prearranged series of transactions executed among related parties, beginning with the original transfers on Date 1 of the leasehold interests and culminating with the transfers from Corporation 1 to Corporation 12, lacked economic substance. Since the series of transactions lacked economic substance, the deductions arising from the transactions are not recognized economically.

Corporation 1 entered the transaction on Date 9 after Partnership 1, Corporation 10, and Corporation 11 participated in a prearranged series of transaction which were executed within a one month period among parties that shared common officers, managers, agents, and directors, and which stripped the income from the leasehold interest and allocated it to Partnership 1's tax neutral partner, Entity. At the same time, Partnership 1 was also able to shift the deductions relating to the leasehold interest to Corporation 1. Corporation 1 realized the deductions by claiming rental expenses which had offsetting payments, due under the terms of Long-Term Note 1, against the rent due under the Over Lease and by transferring offsetting interests in Long-Term Note 1 and the Over Lease to Partnership 4 and Corporation 12. It is of some significance that in the final steps of the transactions, little consideration was given aside from assuming the obligations of the Over Lease on the part of Corporation 12 and no other consideration was given in the case of Partnership 4.

Furthermore, from a subjective business purpose and an objective perspective, it is not readily apparent how either Taxpayer, or the other parties involved could have reasonably expected to earn a pre-tax profit from this series of transactions. Based on the transactional documents, it appears that Corporation 1 received from Partnership 1 only Long-Term Note 1 and the exactly offsetting obligation to make rental payments to Corporation 10, under the terms of the Over Lease. Corporation 8 held the right to the equipment until the end of the Master Lease, having received that right from Partnership 3 on Date 6. Corporation 10 held the right to the equipment at the end of the Master Lease, having received that right from Partnership 1 on Date 7. Accordingly, it does not appear that Corporation 1 received anything from Partnership 1 from which it could have hoped to earn an economic profit independent of tax savings.

Based upon the facts as developed, the transactions lack economic substance and may be disregarded as shams and Taxpayer is not entitled to the deductions reported from them.

Issue Two

A. Section 482-Generally

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. Commissioner v. First

Security Bank of Utah, N.A., 405 U.S. 394, 400 (1972); Barford v. Commissioner, 194 F.3d 782, 786 (7th Cir. 1999); Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd., 358 F.2d 342 (6th Cir. 1966), cert. denied, 385 U.S. 899 (1966). Cf. H.R. Rep. No. 2, 70th Cong., 1st Sess., 16-17. Section 482 provides in relevant part:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of any of such organizations, trades, or businesses...(emphasis added).

For the reallocation rule of section 482 to apply to a transaction, the transaction must involve at least two entities owned or controlled by the same interests. Section 482 imposes two requirements: (1) ownership or control must exist in some manner among the participants, and (2) the same interests must possess the control. None of the participants in the Corporation 1 lease stripping transaction are directly or indirectly related to each other. While common ownership may often be indicative of the existence of a control group for section 482 purposes, section 482 is applicable where a party is found to have actually exercised control over the participants in the transaction at issue.

Legal Standard for Determining Control under Section 482

1. *Definition of control*

When control does not exist through majority ownership of voting stock or a legally enforceable agreement delegating the power to direct an entity's actions, the regulations provide alternatively that control results from the action of two or more taxpayers acting in concert or with a common goal or purpose. Treas. Reg. §1.482-1(i)(4). Control includes any kind of control, regardless of whether such control is direct or indirect or legally enforceable. Id.

Case law is in accord with the regulation's definition of control, indicating that it is actual and practical control which counts in the application of section 482 rather than record ownership or legally enforceable control,. Ach, 42 T.C. at 125; Grenada Industries, Inc. v. Commissioner, 17 T.C. 231, 254 (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; 1972-2 C.B. 2. See also Appeal of Isse Koch & Co., Inc., 1

B.T.A. 624, 627, acq. 1925-1 C.B. 2 ("Control not arising or flowing from means legally enforceable may be just as effective in evading taxation as if founded on the most formal and readily enforceable legal instrument."); DHL Corp. v. Commissioner, T.C. Memo 1998-461 (1998) (holding that foreign investors did not have section 482 control over a corporation despite their ability to appoint a majority of its board of directors because domestic shareholders retained the ability to control day-to-day operations and major events); Charles Town, 372 F. 2d at 419 (holding that two shareholders were in control of a corporation in which they only owned two percent of the outstanding stock because of their possession of effective and practical control over the corporation).

In addition, final regulations provide that a presumption of control arises if income and deductions have been arbitrarily shifted. Treas. Reg. §1.482-1(i)(4). Case law is in accord with the regulation's presumption of control through the arbitrary shifting of income or deductions. DHL Corp., T.C. Memo 1998-461 at 100 (When the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled.). See also Dallas Ceramic Co. v. U.S., 598 F.2d 1382, 1389 (5th Cir. 1979) (holding that the government correctly argued that proof of a shifting of income between two corporations establishes a presumption of common control under Treas. Reg. §1.482-1(a)(3) (1968)-predecessor to current section 482 regulations); Hall v. Commissioner, 294 F.2d 82, 85 (5th Cir. 1961) (finding presumption of control under section 29.45-1 of Regulation 111-predecessor to current section 482 regulations).

According to both the section 482 regulations and the applicable case law, it is not required that a taxpayer possess a majority stock ownership interest in a participant to establish control as defined under section 482. Both the regulations and case law provide the Service with the authority to determine the existence of control by considering the reality of the participant's relationships and examining whether the same interests effectively control the participants to the transaction involved, rather than basing the control determination solely on the taxpayer's percentage of ownership of voting stock or legal right to direct the participant's actions. Thus, proof of the actual exercise of control by a party or parties will establish the existence of control for section 482 purposes. Once section 482 control is established, the section applies to determine the clear reflection of income among the members of the controlled group under the section.

1. *Legal standard for determining "the same interests" under section 482*

The regulations provide no guidance as to what the term "the same interests" means under section 482. Case law has indicated that in using the term "the same interests," Congress intended to include more than "the same persons" or "the same individuals." See B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d

Cir. 1972), *cert. denied*, 407 U.S. 934 (1972) (rejecting Tax Court's view that two independently owned corporations acting in concert together to make interest-free loans to a jointly owned corporation did not constitute the same interests within the meaning of section 482); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), *cert. denied,* 386 U.S. 1016 (1967). Cf. Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233-34 (1925); Cf. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979). But see The Lake Erie and Pittsburg Railway Co. v. Commissioner, 5 T.C. 558 (1945), *acq.* 1945 C.B. 5, *acq. withdrawn* 1965-1 C.B. 5.

Case law indicates that the legal standard for determining whether "the same interests" control an entity is identical to the standard applied to determine whether control of an entity exists. Therefore, if different entities are found to have a common goal to shift income or deductions among each other, not only will control of the entities exist, but the entities will also constitute "the same interests" for the purpose of section 482. As previously discussed, there appears to exist a common plan among the lease strip participants to shift deductions to Taxpayer while shifting income away from Taxpayer. Consequently, Taxpayer constitutes "the same interests" with respect to the participants in this transaction under section 482, meaning that the Service may reallocate the rental income as well as the rental and loss deductions claimed by Taxpayer to prevent the evasion of taxes or to clearly reflect income.

3. *Existence of control among Taxpayer, Partnership 1, Corporation 11, Corporation 10, Partnership 4 and Corporation 12 -acting in concert and the control presumption*

Under Treas. Reg. §1.482-1(i)(4) and the relevant case law, Taxpayer is not required to own an interest in any of the participants, majority or otherwise, for the requisite control to exist under section 482. Instead, the Service may consider whether Taxpayer actually exercised control over the participants, despite Taxpayer's having no apparent legal or contractual right to direct their actions. Additionally, in making this determination, the Service may also apply the presumption of control provided for in Treas. Reg. §1.482-1(i)(4) and in the applicable case law.

From the facts provided to us, it appears as though the participants acted in concert pursuant to a common plan to arbitrarily shift substantial rental deductions and losses from Partnership 1 to Taxpayer while shifting the associated rental income to tax exempt entities. The leases which were used for the second lease strip originated with Partnership 1 which owned the equipment at the initiation of the second lease strip. Partnership 1 "sold" the equipment to Corporation 10 to generate Long-Term Note 1 through which substantial losses were ultimately claimed by Taxpayer. Partnership 1 immediately leased back the equipment under the Over Leases. Since the equipment was already subject to preexisting leases to Corporation 8 over the same terms as the Over Leases and for the same rent, Partnership 1 was able to retain ownership of the equipment for the term of the Over Leases without having to make any actual payments to Corporation 10. Partnership 1's retained ownership of the equipment for the Over Lease terms allowed it to strip the rental income to be received from Corporation 8 from the associated rental expenses through the use of Corporation 11. Entity, a tax exempt entity, was the recipient of all the stripped rental income. Partnership 1's and Corporation 11's participation in the lease strip enabled Corporation 1 to receive a leasehold interest in the purported section 351 transaction stripped of its associated income, but not of its associated rental deductions.

Corporation 10's issuance of Long-Term Note 1 served to ultimately provide Taxpayer the means to claim large loss deductions. Due to Partnership 1's immediate leasing back of the equipment under the Over Leases, Corporation 10 could offset the amounts due under Long-Term Note 1 by the amounts Partnership 1 owed under the Over Leases. When Partnership 1 transferred Long-Term Note 1 as part of the purported section 351 transaction, this provided Taxpayer with a large carryover basis in Long-Term Note 1 of $U, which Taxpayer could then use, and did in fact use, to generate substantial loss deductions upon a subsequent disposition of Long-Term Note 1. Corporation 10 was able to issue Long-Term Note 1 at no substantive cost to itself because, according to the facts, its obligation under Long-Term Note 1 was exactly offset by the payments Partnership 1 owed Corporation 10 under the lease back of the equipment.

Partnership 4's and Corporation12's participation in lease strip allowed Taxpayer to realize the loss deductions inherent in the transferred Long-Term Note 1. Taxpayer sold to Partnership 4 and Corporation 12, for minimal consideration, partial interests in the Long-Term Note 1 which were offset by Taxpayer's obligations under the Over Leases transferred by Partnership 1. Thus, Partnership 4 and Corporation 12 received nothing of substance in return for their purchases of interests in the Long-Term Note 1. It was these sales which resulted in losses on Long-Term Note 1 dispositions of $V ($U cost basis minus $T sales price) and $AA ($Z cost basis minus $Y sales price). Partnership 4 and Corporation 12 effectively acted as accommodation parties to allow Taxpayer to recognize the losses inherent in the transferred Long-Term Note 1.

These facts, considered in conjunction with the short time frame in which the transaction occurred, are supportive of a finding that Taxpayer and the other participants acted in concert within the meaning of the regulations. The parties had the common goal to: (1) separate rental income from the leases with the corresponding rental expenses and arbitrarily shift only the rental expenses to Taxpayer without any associated income inclusions; and (2) shift to Taxpayer losses which we recommend should be argued were not economically sustained due to the offsetting nature of all the obligations. Partnership 1 and Corporation 11 acted together to strip the lease income from the equipment into the hands of Entity, a tax neutral entity. Corporation 11 received $M from Partnership 1, which can be viewed as income analogous to fee income for its participation in the common plan. It is unclear what Partnership 1 received from its participation in the plan, other than $BB from Corporation 1 for Corporation 1's redemption of the stock. More facts should be developed to determine if Partnership 1 claimed a substantial loss on Corporation 1's stock redemption by reporting an inflated basis for the stock.

More facts should also be developed to determine what form of compensation or other benefit Corporation 10, Partnership 4, and Corporation 12 may have received for their roles in the common plan. Taxpayer, Partnership 1, Corporation 10, Partnership 4, Corporation 11, and Corporation 12 acted in conjunction with one another to effectuate the lease stripping transaction. Because each of the participants in the lease stripping transaction acted in concert and pursuant to a common plan to: (1) arbitrarily shift rental income away from Taxpayer to a tax neutral entity; (2) arbitrarily shift rental deductions away from Partnership 4, Corporation 12, and Partnership 1; and (3) arbitrarily shift loss deductions away from Partnership 1, control is presumed to exist among the parties for the purposes of section 482 pursuant to Treas. Reg. §1.482-1(i)(4) and the applicable case law. We fail to see any significant evidence that would rebut this presumption.

II. Application of Section 482 to this Transaction

There are two alternative bases to apply section 482 to this transaction: (1) to prevent the evasion of tax, and (2) to clearly reflect income.

A. Economic Substance/Tax Evasion Standards of Section 482

The application of section 482 has been upheld where the challenged transaction was arranged without a valid business purpose and solely in order to avoid taxes. See G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). When analyzing potential tax avoidance aspects of a transaction, the Commissioner will respect the transaction's contractual terms if consistent with the true economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B). The economic substance standard of the regulations overlaps with the economic substance and sham transaction doctrines developed in case law which allow the Service to disregard transactions lacking a business purpose and a potential for economic profit.[7] However, the

[7] See Gregory v. Helvering, 293 U.S. 465 (1935); Knetsch v. Commissioner, 364 U.S. 361 (1960) (interest deductions disallowed where nothing of substance could be realized from the transaction other than a tax deduction); Frank Lyon Co. v. United States, 435 U.S. 561, 572 (1978)

section 482 regulations expand upon case law guidance by providing additional guidance. 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 the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction. Treas. Reg. §1.482-1(d)(3)(ii)(B).
>
> 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).

Thus, section 482 provides an alternative approach to challenging a transaction for lack of economic substance 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 sham transactions. See G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987).

Under section 482, the economic substance of a transaction is analyzed by focusing on the parties' actual conduct; the economic risks purportedly transferred; and whether, from a business perspective, the transaction makes objective business sense. See Treas. Reg. §§1.482-1(d)(3)(ii)(B) and 1.482-1(d)(3)(iii)(B). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This treatment may result in a denial of deductions arising from the transaction at issue. See e.g. B. Forman, 453 F.2d at 1160-61.

("The simple expedient of drawing up papers" is not controlling for tax purposes when the objective economic realities of a situation are to the contrary) ; Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (transaction is a sham where taxpayer is motivated by no business purpose other than obtaining tax benefits in entering a transaction and where transaction has no economic substance because no reasonable possibility of profitability exists); ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (transaction devoid of economic substance cannot be the basis for a deductible loss).

1. *The contractual terms of this transaction are inconsistent with its economic substance*

This transaction was set up to resemble a series of leases financed with notes. However, the terms of this transaction are inconsistent with its true substance. Partnership 1's transfer of the equipment to Corporation 10 was structured to resemble a sale and Corporation 10's transfer of Long-Term note 1 was intended to represent Corporation 10's payment obligation under the purported sale. The transaction was also structured to include Partnership 1's leasing back of the equipment. In reality, structuring the transaction as a sale/leaseback with offsetting rental and note payment obligations on both sides of the transaction made possible the establishment of Long-Term Note 1 as a vehicle for generating loss deductions once transferred to Taxpayer. Creation of Long-Term Note 1 as a loss recognition vehicle occurred without Corporation 10 acquiring the burden of having to make payments under Long-Term Note 1 or Taxpayer acquiring the burden to make rental payments. The stripping off of all of the rental income associated with the equipment leases prior to Taxpayer's receipt of its interest in the equipment helped further tax avoidance objectives by ensuring Taxpayer could obtain the deductions and losses that the transaction was intended to achieve without having any corresponding income inclusion.

Since the Over Leases and the note do not actually invoke payment obligations on behalf of either Partnership 1 or Corporation 10, section 482 permits the recasting of this transaction consistent with its economic substance. Recasting the transaction consistent with its economic substance would result in disregarding the Over Leases between Partnership 1 and Corporation 10 so that Taxpayer never acquires the obligation to pay rent to Corporation 10 as a result of the purported section 351 transfer and Corporation 10 never acquires the purchase obligation upon which the long-term note was based. Treating the transaction consistently with its economic substance would prevent the avoidance of tax because Taxpayer would be prohibited from taking rental deductions for rent purportedly paid to Corporation 10 under the transferred Over Leases for which it bore no true economic burden. Taxpayer would also be prevented from claiming loss deductions upon the disposition of the Long-Term Note 1.

1. *The transaction lacks any apparent business purpose*

Taxpayer claims that it had a valid business purpose for this transaction. Taxpayer's asserted business purpose was to earn a profit from the re-leasing and/or sale of the equipment. Taxpayer claimed that it expected to earn $E, at the cost of a $CC investment, from re-leasing the equipment subject to the Corporation 3 end user leases at their expiration. However, it does not appear that Taxpayer had the right to engage in the future actions necessary to establish a business purpose for this transaction. According to the facts, Partnership 1 only leased the equipment from Corporation 10 for the terms of the Over Leases, which was equivalent to the terms of the Master Lease, and it is this partial interest that was transferred to Corporation 1 in the purported section 351 transaction. Corporation 10 retained the rights to the equipment subsequent to the expiration of the Over Leases/Master Lease. We question whether Taxpayer could have reasonably expected to receive any renewal rents from the equipment as it had no rights to the equipment subsequent to the expiration of the end user leases. It is not clear to what extent, if any, that Taxpayer assumed any risk with respect to this transaction. We are not aware of any facts which would support a finding that Taxpayer had any substantive risk with respect to the transaction[8].

B. Clear Reflection of Income Standard of Section 482-

1. *Allocation to prevent the artificial separation of income from expenses*

Even in the absence of tax avoidance motives, the Commissioner may make a section 482 allocation if necessary to clearly reflect income. The clear reflection of income prong of section 482 has been applied to transactions where the expenses attributable to property have been artificially separated from the income earned from the property. For instance, in Rooney v. United States, 305 F.2d 681 (9th Cir. 1962), the taxpayers transferred planted crops to another corporation in exchange for the corporation's stock. The profit from the harvested crop was included in the income of the transferee corporation while the transferors deducted the expenses attributable to raising the crop prior to the transfer. Applying section 482, the Commissioner allocated the expenses of raising the crop from the transferors to the transferee corporation. The court upheld the allocation, finding it necessary to clearly reflect income by matching the income with the expenses associated with producing it. Id. at 686. See also Central Cuba Sugar Co. v. Commissioner, 198 F. 2d 214 (2d Cir. 1952), cert. denied, 344 U.S. 874 (1952).

Applying the clear reflection of income standards of section 482, either the stripped rental income received by Corporation 11 from Corporation 8 under the Master Lease should be allocated back to Taxpayer, or Taxpayer's rental deductions for rent purportedly paid to Corporation 10 should be allocated to Partnership 4 and Corporation 12. Making one of these alternative allocations would prevent the artificial separation of the rental income and the deductions attributable to the payments due under the leases. The income from the leases would then be properly matched with the expenses incurred in producing the income -- the

---

8 But see, IES Industries, Inc. v. U.S., 253 F.3d 350 (8th Cir. 2001); Compaq Computer Corp. v. Commissioner, 2001 U.S. App. Lexis 27297 (5th Cir. 2001); UPS of America v. Commissioner, 254 F.3d 1014 (11th Cir. 2001).

corresponding obligation to pay rent under either the Master Lease or the Over Leases.

2. *Allocations involving nonrecognition transactions*

When a section 351 transfer is involved, the Commissioner may disregard the nonrecognition provisions of section 351 to make a section 482 allocation if necessary to clearly reflect income among controlled taxpayers. Sec.1.482-1(f)(1)(iii)(A) (to clearly reflect income or prevent the avoidance of taxes, the Commissioner may make an allocation under section 482 with respect to transactions that would otherwise qualify for nonrecognition of gain or loss under section 351). Additional authority exists through case law in support of the Service's position allowing the disregarding of nonrecognition provisions if necessary to clearly reflect income.

One such case in accord with the Service's position is National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), cert. denied, 320 U.S. 794 (1943), in which a parent corporation transferred stock with a substantial built-in loss to a wholly-owned subsidiary in a transaction which qualified as a nonrecognition transaction under the predecessor to section 351. The subsidiary sold the stock and claimed a loss deduction. Id. at 601. The Commissioner disregarded the nonrecognition transaction and treated the amount of the pre-contribution loss as sustained by the parent instead of the subsidiary under section 45 of the Revenue Act of 1936, the predecessor to section 482. Id. The taxpayer claimed that the subsidiary was entitled under the nonrecognition and basis provisions of the Code to claim a loss deduction by virtue of the carryover basis it received in the stock transfer. Id. at 602. The court rejected the taxpayer's argument, stating that in every case in which section 45 was applied its application would result in a conflict with the literal provisions of some other act. Id. According to the court, the section could still be applied to clearly reflect income, despite a conflict with the literal provisions of another section of the Code. Id.

Other cases are in accord with National Securities Corp. that section 482 may be applied to clearly reflect income despite apparent conflict with the provisions of another section of the Code. See Rooney v. United States, 305 F.2d at 686 (Section 482 will control when it conflicts with section 351); Central Cuba Sugar Co., 198 F.2d at 215-16 (Commissioner properly applied section 482 to reallocate deductions associated with property acquired in a reorganization to transferee to clearly reflect income); Dolese v. Commissioner, 811 F. 2d 543, 546 (10th Cir. 1987) (Commissioner has broad discretion under section 482 to correct distortion of income occurring through the strict application of other provisions of the Code and may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction); Aiken Drive-In Theater Corp. v. United States, 281 F.2d 7, 9-11(4th Cir. 1960); Foster v.

Commissioner, 756 F.2d 1430, 1433 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986) (Commissioner may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction). See also G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). But see Ruddick Corp. v. United States, 643 F.2d 747, 226 Ct. Cl. 426 (1981), aff'd. without opinion, 732 F.2d 168 (Fed. Cir. 1984) (In the absence of tax avoidance motives, the Commissioner may not disregard section 351 transactions to apply section 482, even if doing so would be necessary to clearly reflect income).

In the instant case, Partnership 1's transfer of the Long-Term Note 1 and its interest in the Over Leases resulted in a distortion of income. Partnership 1's section 351 transfer enabled Taxpayer to acquire, in a tax-free transaction, both the right to claim rental deductions on the equipment as a sublessee without the corresponding burden of having to make an actual cash outlay for rental payments as well as a high carryover basis in Long-Term Note 1. As a result of the section 351 transfer, Taxpayer was able to claim deductions collectively amounting to $DD from Year 1 - Year 2, for which Taxpayer paid only $EE. A significant distortion of income resulted from the section 351 transfer because Taxpayer acquired the right to deductions which it did not economically incur. No rental deductions were economically incurred by Taxpayer because Taxpayer never had any real, substantive obligation with respect to the rental payments owed to Corporation 10 under the Over Leases in that the payments due from Corporation 10 under Long-Term Note 1 appear to have been designed to offset any economic obligation.

Similarly, this offset prevented Corporation 10 from having an economic obligation under the note. Therefore, the note Taxpayer received did not justify the $O carryover basis that Taxpayer was able to report as a result of the section 351 transfer. Applying the analysis adopted in the National Securities Corp. line of cases, the Service may therefore disregard the section 351 transfer and allocate Taxpayer's rental deductions and loss deductions on the Long-Term Note 1 back to Partnership 1 to clearly reflect income. A section 482 allocation may be made despite the fact that its application would result in a conflict with the provisions of section 351, which would treat the transferee corporation, Corporation 1, as the true owner of the leasehold interests and allow Taxpayer to claim the rental deductions and losses.

Issue Three

Gain or Loss to Corporation 1 on exchange of stock

Whether or not the transaction between Partnership 1 and Corporation 1 is respected as a section 351 exchange, Corporation 1 would not recognize gain or loss on its transaction with Partnership 1. Section 1032 provides that "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation." Treasury Regulation § 1.1032-1 emphasizes that the "no gain or loss" rule applies regardless of the nature of the transaction and the facts and circumstances involved: "The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved."

Corporation 1's Loss on Sale of Long-Term Note 1

Corporation 1 will have the same basis in the Long-Term Note 1 it receives from Partnership 1 whether or not the transaction between Corporation 1 and Partnership 1 qualifies as a section 351 exchange. Therefore, a determination that the transaction between Partnership 1 and Corporation 1 fails to qualify under section 351 does not provide an independent alternate grounds for adjustments to the deductions for the loss on the sale of the portions of Long-Term Note 1 reported by the Taxpayer.

In a transaction that qualifies under section 351, the transferee's basis in the property it receives from transferor is computed under section 362. Section 362(a) gives the transferee a carryover basis -- that is, a basis equal to the basis of such property in the transferor's hands -- increased in the amount of any gain recognized to the transferor on such transfer.

Here, the property received by Corporation 1 from Partnership 1 in the purported section 351 transaction consisted of Long-Term Note 1. Partnership 1 had acquired Long-Term Note 1 (along with Short-Term Note 2) in a section 1001 taxable exchange less than one-month earlier. Under section 1001, Partnership 1 presumably recognized gain or loss on this taxable exchange, in an amount measured by the difference between the aggregate amount Partnership 1 realized (i.e. the face value of Long-Term Note 1 and Short-Term Note 2--$J) and its adjusted basis in the equipment. Because Partnership 1 took the face value of Long-Term Note 1 and Short-Term Note 2 into its amount realized, Partnership 1's tax cost basis in each such Note is its respective face value. Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184 (Ct. Cl. 1954). Therefore, if the Partnership 1 - Corporation 1 exchange qualifies under section 351, Corporation 1's basis in Long-Term Note 1 would appear to be that Note's face value ($K).[9] In

[9] In fact, however, Corporation 1 reported a $O carryover basis in Long-Term Note 1 (consisting of the face amount of $K, plus interest of $Q for Month of Year 1). Ordinarily, a taxpayer reports interest income paid or accrued in gross income under section 61(a)(4), but does not include that interest in Long-Term Note 1's basis. It is unclear on the facts before us what Partnership 1's rationale was for increasing its basis in Long-Term Note 1. We suggest you consider exploring this matter further, given that the effects of increasing basis in an asset include increasing the amount of loss (or decreasing the

addition, there is no apparent gain recognized by Partnership 1 from this transaction.[10]

If the transaction between Partnership 1 and Corporation 1 fails to qualify under section 351, Corporation 1's basis in the property it received from Partnership 1 (Long-Term Note 1) would be computed under section 1012. Treas. Reg. § 1.1032-1(d). Section 1012 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 to make the acquisition or any liability of the seller assumed by the taxpayer as consideration for 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).

Strictly speaking, in the recognition and nonrecognition transactions involved here, Corporation 1, as a transferee of Long-Term Note 1, derives its basis from different sources. In a taxable transaction, Corporation 1's basis would be its own section 1012 cost (via its assumption of Partnership 1's Overlease payment obligation), whereas the section 351 transaction involved here would give Corporation 1 a carryover basis that derives from Partnership 1's "tax cost" (resulting from Partnership 1 taking the face amount of Long-Term Note 1 into Partnership 1's amount realized, as noted above). As a practical matter, however, this "difference" is without significance. The note payment obligation on Long-Term Note 1 and the Overlease payment obligation exactly offset each other. Moreover, Corporation 1 obtained Long-Term Note 1 less than 1 month after Corporation 10 issued it, and there has been no evidence offered to suggest that the equivalency in value between the two payment obligations has been altered. Accordingly, Corporation 1's basis in Long-Term Note 1 should be the same whether it acquired Long-Term Note 1 in a taxable or a section 351 transaction.

Therefore, a determination that the transaction between Partnership 1 and Corporation 1 does not qualify under section 351 does not provide an independent alternate grounds for adjustments to the deductions for the loss on the sale of the portions of Long-Term Note 1 reported by Taxpayer.

---

amount of gain) realized on the subsequent disposition of that asset.

[10] Partnership 1's only potential for gain in this transaction lies in the application of section 357(c)(1). Partnership 1's basis in the property transferred (i.e. Long-Term Note 1) was its face value. However, the face value of Long-Term Note 1 was equal to Partnership 1's liability under the Over Lease. Accordingly, Partnership 1 will recognize no gain under section 357(c)(1).

Corporation 1's Rental Expense Deductions

We believe there is no theory under which failure of the transaction between Partnership 1 and Corporation 1 to qualify under section 351 will provide an alternate ground for adjustments to the rental expense deductions reported by Taxpayer from the leasehold interest.

Introductory Discussion Concerning Issues Four through Eight

The following discussion and analysis is meant to facilitate the analysis of Issues Four through Eight. This material analyzes certain aspects and parts of the overall transaction in detail and is intended to provide a basis for understanding the analysis of the aforementioned issues.

Date 7 Sale and Leaseback

On Date 7, Partnership 1 sold the equipment, subject to the Master Lease, to Corporation 10 in exchange for two notes totaling $J:

- a $K long-term nonrecourse secured installment note (Long-Term Note 1) and

- a $L short-term secured promissory note (Short-Term Note 2).[11]

Long-Term Note 1 was payable in semi-annual installments beginning on Date 14 and ending on Date 17.

Under section 1001, Partnership 1 presumably recognized gain or loss on this transaction, in an amount measured by the difference between the aggregate amount Partnership 1 realized ($J) and its adjusted basis in the equipment.[12]

---

[11] Corporation 10 did not actually execute a $L note in favor of Partnership 1. It simply assumed $L of Partnership 1's $I obligation to Corporation 5 under Note 4.

[12] Because we do not know Partnership 1's basis in the equipment it sold, we also do not know the exact amount of Partnership 1's gain or loss. The statutory formula for determining such gain or loss, however, is found in section 1001(a), which provides that a taxpayer's gain from the sale of property shall be the excess of the taxpayer's amount realized over the adjusted basis provided in section 1011 for determining gain, and that a taxpayer's loss shall be the excess of the taxpayer's adjusted basis provided in section 1011 over the amount realized. Section 1001(b) provides that a seller's amount realized from the sale of property is the sum of any money received plus the fair market value of the property (other than money) received. Section 1011(a) provides, for purposes of this analysis, that the adjusted basis for determining the gain or loss from the sale or other disposition of property shall be the basis of such property as determined under section 1012.

Because Partnership 1 took the face values of Long-Term Note 1 and Short-Term Note 2 into its amount realized, Partnership 1's tax cost basis in each is its respective face value. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

If Partnership 1 used the installment method under section 453 to report recognized gain over the term of Long-Term Note 1 and Short-Term Note 2, it would use the gross profit formula found in section 453(c) to determine the percentage of each payment that represented, respectively, the taxable gain and non-taxable return of basis on the equipment sale. Accrued interest on Long-Term Note 1 and Short-Term Note 2 would be includible in Partnership 1's gross income under section 61(a)(4).

Alternatively, if Partnership 1 elected out of the installment method and all gain was recognized in the year of sale, its subsequent-year collections on Long-Term Note 1 and Short-Term Note 2 would be tax-free (but would reduce the basis in Long-Term Note 1 and Short-Term Note 2), with accrued interest on Long-Term Note 1 and Short-Term Note 2 being includible in Partnership 1's income under section 61(a)(4).

On the same day as the sale, Partnership 1 leased the equipment back from Corporation 10. The rental payments that Partnership 1 agreed to make to Corporation 10 under the Over Lease exactly offset the payments that Corporation 10 owed Partnership 1 under Long-Term Note 1. These Over Lease payments generally are deductible by Partnership 1 ratably over the period of the lease term (regardless of whether Partnership 1 makes prepayments). See section 461(h)(2)(A)(iii) (economic performance for the use of property occurs as the taxpayer uses such property).

Date 8 Income Strip to Corporation 11

On Date 8, Partnership 1 sold the right to Master Lease income to Corporation 11. However, because Partnership 1 disposed merely of the Master Lease income stream, Partnership 1 continues as the lessor on the Master Lease, receiving current income from the payment by Corporation 11. Because Corporation 10 and Partnership 1 continue to be in a lessor/lessee relationship under the Over Lease, Partnership 1 continues both to be liable to Corporation 10 for lease payments under that Over Lease and to be entitled to ratable rental deductions.

Date 9's Purported Section 351 Transfer between Partnership 1 and Corporation 1

On Date 9, less than a month after Partnership 1's acquisition of Long-Term Note 1 in a taxable transaction, the following purported section 351 nonrecognition transaction occurred. Partnership 1 transferred Long-Term Note 1 to Corporation 1 in exchange for Corporation 1's assumption of Partnership 1's obligation to make rental payments to Corporation 10 under the Over Lease and for Z shares of Corporation 1 stock of nominal value.[13] The effect of this transaction was that Corporation 1: (1) became the owner of an asset – Long-Term Note 1 -- and thus became the party to which Corporation 10's "note payment obligation" ran; but (2) also became the party liable on the "Over Lease payment obligation" to Corporation 10. Conversely, Partnership 1, as a transferor in the section 351 exchange with Corporation 1, no longer owned Long-Term Note 1 and was no longer liable on the Over Lease payment obligation to Corporation 10.[14]

Partnership 1's realized gain (or loss) on the exchange, computed under section 1001, would be the difference between Partnership 1's amount realized on its disposition to Corporation 1 of Long-Term Note 1 and its adjusted basis in Long-Term Note 1.[15] The fact that the lease payments due initially from Partnership 1

---

[13] The record before us suggests that the Corporation 1 stock was valued at **$II** a share. This valuation derives from Taxpayer, which also participated in the purported section 351 transaction, and which received XX shares of Corporation 1 stock in exchange for its contribution to Corporation 1 of $N.

[14] The facts presented in the request for assistance do not indicate that Partnership 1 transferred the Over Lease to Corporation 1, but rather Corporation 1 merely assumed the liability to make lease payments to Corporation 10. Because Partnership 1 remains the lessee under the Over Lease, it may not claim a lump-sum lease deduction related to Corporation 1's assumption of this liability. See United States Bancorp v. Commissioner, 111 T.C. 231 (1998) (lump-sum payment to satisfy remaining lease obligation does not give rise to a current deduction if the lessee/lessor relationship continues). Partnership 1's deductions for lease expenses under the Over Lease continue to be allowable only ratably over the period of the lease.

[15] An amount realized under section 1001(b) is the sum of any money received and the fair market value of property (other than money) received. Relief from liabilities are treated as part of the amount realized under Crane v. Commissioner, 331 U.S. 1 (1947). The amount included in amount realized may, however, be affected by the type of liability involved. A common type of liability relief is the taking over of a debt obligation. In such circumstances, the face amount of the note is ordinarily the measure of what is included in an amount realized (assuming that the note carries adequate stated interest). Thus, if what Corporation 1 had taken over was a debt obligation of Partnership 1's, Partnership 1's amount realized would include Long-Term Note 1's face value.

However, Corporation 1 relieved Partnership 1 not of a debt liability, but of a liability to make a future stream of rental payments. Although we did not find authority directly on point, we believe that Partnership 1 would include in its amount realized the fair market value (rather than the face value) of Corporation 1's promise to assume Partnership 1's rental payment obligation to Corporation 10 under (and subsequently from Corporation 1) exactly equaled the note payments due from Corporation 10 under Long-Term Note 1 suggests that the parties viewed the fair market value of the Over Lease payment obligation (relief from which constituted Partnership 1's amount realized) and the face value of Long-Term Note 1 (in which Partnership 1 had basis) as being equal. Accordingly, Partnership 1 would appear to have only a nominal realized gain on the exchange (reflecting the fact that Partnership 1's amount realized also included the fair market value of the Z shares of Corporation 1 stock Partnership 1 received).

Under section 1001(c), gain or loss on a sale or other disposition of property is recognized unless a nonrecognition provision applies. Thus, Partnership 1's realized gain on the exchange with Corporation 1 would escape recognition if the purported section 351 exchange is given tax effect, but would be recognized if the transfer does not qualify under section 351.

Issue Four

In Pacific Transport Co. v. Commissioner, 483 F.2d 209, 214 (9th Cir. 1973), the court (citing Macgruder v. Supplee, 316 U.S. 394 (1942)) stated that "the payment of a liability by a subsequent purchaser is not the discharge of a burden ... but is actually as well as theoretically, a payment of the purchase price." Similarly, in David R. Webb Co. v. Commissioner, 77 T.C. 1134, 1137-1138 (1981), aff'd. 708 F.2d 1254 (7th Cir. 1983), the court held:

> It is well settled that the payment of an obligation of a preceding owner of property by the person acquiring such property ... is not an ordinary and necessary business expense. Rather, when paid, such payment is a capital expenditure which becomes part of the cost basis of the acquired property. Such is the result irrespective of what would have been the tax character of the payment to the prior owner.

See also Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946).[16]

---

the Over Lease. If the sum of the fair market value of Corporation 1's assumption of the Over Lease payment obligation and the fair market value of the Corporation 1 stock was less than Partnership 1's basis in Long-Term Note 1, the Partnership 1/Corporation 1 transfer would result in a realized loss to Partnership 1 (although such loss would not be recognized if the section 351 transaction is given effect).

[16] In issue 2 of Rev. Rul. 95-74, 1995-2 C.B. 36, we indicated that the Holdcroft decision would not be followed where a transferor transfers substantially all of the assets and liabilities associated with a trade or business. Here, Partnership 1 has retained the leasehold, and Corporation 1 merely assumed Partnership 1's obligation to make payments to Corporation 10 under the Over Lease. Accordingly, the

Corporation 1's assumption of the Over Lease payment obligation is, along with a nominal amount of stock, the consideration paid for Long-Term Note 1. Accordingly, any subsequent payment Corporation 1 makes pursuant to this assumption represents the purchase price.

Issue Five

As mentioned above, Corporation 1's transfer to satisfy the Over Lease payment obligation represents the purchase price of Long-Term Note. Long-Term Note 1 is a capital asset, and the satisfaction of the liability is reflected in Corporation 1's basis in Long-Term Note 1.

Issue Six

Corporation 1 claimed two types of deductions regarding these transfers. It claimed lease expense deductions with respect to the Partnership 4 transfer and payments to Corporation 10, and it claimed a loss on the transfer of the remaining portion to Corporation 12.

Based on the foregoing, it is clear that no deduction for lease expenses is allowable. Not only were payments of the Over Lease obligation merely the purchase price of Long-Term Note 1, but Partnership 1, rather than Corporation 1, was the lessee with respect to the Over Lease. See Magruder v. Supplee, 316 U.S. 394 (1942) (purchaser of property who paid outstanding property taxes of previous owner was not entitled to a deduction for tax payments). Corporation 1 would not, therefore, be entitled to a current deduction for “extinguishing” the lease obligation (compare Rev. Rul. 69-511, 1969-2 C.B. 23).

It is also clear that Corporation 1's claimed loss deductions on its transfers to Corporation 12 are not allowable, because those transfers created neither a tax nor an economic loss. Section 165(a) generally allows a deduction sustained during the taxable year and not compensated for by insurance or otherwise. Section 1001(a) provides that the amount of loss on a sale or exchange is the excess of the adjusted basis over the amount realized.

Corporation 1 obtained the Long-Term Note 1 from Partnership 1 in a purported section 351 transaction. If the section 351 transaction is given effect, Partnership 1's $P tax cost basis in Long-Term Note 1 carried over to Corporation 1. If instead the Partnership 1 - Corporation 1 exchange was a recognition transaction, Corporation 1 took a section 1012 cost basis in Long-Term Note 1. Given the exactly offsetting nature of the note payment and Over Lease payment obligations,

---

Holdcroft decision may be followed.

that cost basis must also be assumed to be $P. Regardless of the precise source of Corporation 1's Long-Term Note 1 basis, as an economic matter that basis reflects the equivalency in value between Long-Term Note 1 and the Over Lease payment obligation.

Corporation 1 transferred its remaining partial interests in Long-Term Note 1 to Corporation 12 in exchange for an unsecured promissory note with a face value of $T *and for Corporation 12's assumption of Corporation 1's remaining Over Lease payment obligation*. Corporation 1 then claimed a loss of $V -- the difference between the face value of the unsecured promissory note and Corporation 1's remaining $U basis in Long-Term Note 1. In other words, Corporation 1 included only one of the two types of consideration it received in its amount realized. We cannot discern, on the facts before us, any justification for Corporation 1's failure to include the fair market value of the assumed Over Lease payment obligation in its amount realized. In the absence of any indication that the value of this assumption is any lower than Corporation 1's basis in the allocable portion of Long-Term Note 1, Corporation 1 should be denied any loss deduction under section 165(a). Economically, Corporation 1 is in essentially the same position following the claimed deductions in Year 3 that it was in prior to the Date 7 sale and Over Lease.

Issue Seven

Generally section 461 allows a deduction for a business expense in the proper taxable year under the taxpayer's method of accounting – generally in the year in which all events establishing the fact and amount of the liability have occurred and, under section 461(h), economic performance has occurred. If a court were to accept that Corporation 1 was entitled to a lease termination expense deduction, it is clear that the "economic performance" prerequisite for current deduction under section 461(h) would be satisfied. The "payment" would fully satisfy the liability.

Issue Eight

Section 467 applies to "section 467 rental property," defined in section 467(d)(1) as any rental agreement for the use of tangible property under which:

> (A) there is at least one amount allocable to the use of property during a calendar year that is to be paid after the close of the calendar year following the calendar year in which such use occurs, or
>
> (B) there are increases in the amount to be paid as rent under the agreement.

The Over Lease provides for XXX semi-annual lease payments of $GG and YYY semi-annual payments of $HH, payable on Date 15 and Date 16. The first payment was scheduled to be paid on Date 14, but the transfer to Partnership 4 occurred on Date 10. The first transfer to Corporation 12 occurred on Date 11, and the second occurred on Date 12.

As stated above, the lease expense deductions are properly allocable to Partnership 1, as the lessee, rather than to Corporation 1. If a court found that Corporation 1 is the lessee, however, it would appear that the equipment subject to the Over Lease is section 467 rental property. Although neither Partnership 1 nor Corporation 1 have physical possession of the equipment, the agreement is for the "use" of tangible property and the property is still "used" in the sense that the Over Lease lessee subleases the property under the Master Lease. However, section 467 does not appear to apply to lease termination payments.

Issue Nine

A. Partnership 1 Paid Corporation 1 to Assume Partnership 1's Rental Obligation

We understand the analysis in the incoming, but believe (as explained below) that it is appropriate to characterize the rental expenses as still belonging to Partnership 1 even though they were paid by Corporation 1. Therefore, Partnership 1 (rather than Taxpayer) may claim rental deductions for Year 1, Year 2 and Year 3.

Partnership 1 transferred the Long-Term Note 1 to Corporation 1 in exchange for Corporation 1 assuming the rental obligations of Partnership 1. Where property is transferred in exchange for the transferee's assumption of the transferor's rental obligations, but the transferor continues to be the lessee, the rental expenses are still deductible by the transferor. Moreover, deductions of rental expenses for which the transferor already derived a benefit will continue to belong to the transferor and not to the transferee who is compensated for making those payments. See Deputy v. du Pont, 308 U.S. 488 (1940) (expenses of a corporation paid by a shareholder are not deductible by the shareholder, but instead by the corporation). Therefore, because Partnership 1 paid Corporation 1 for assuming its rental obligations, the deductions generated from these obligations continue to be deductible by Partnership 1, the transferor, and not by Corporation 1, the transferee. See Notice 2001-17, 2001-09 I.R.B. 730.

B. Treatment of Corporation 1 as an Agent of Partnership 1

To determine whether a corporation is a true agent of an owner-principal, the Supreme Court in National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949), looked to the following four indicia of an agency relationship:

1. Whether the corporation operates in the name and for the account of the principal.

2. Whether the corporation binds the principal by its actions.

3. Whether the corporation transmits money received to the principal.

4. Whether the receipt of income is attributable to the services of the principal's employees and to the assets of the principal.

Id. at 437. The Court in National Carbide also required that the corporation's business purpose must be the carrying on of the normal duties of an agent in order for an agency relationship to be recognized for tax purposes between a corporation and its owners. Id. The Supreme Court also held in Commissioner v. Bollinger, 485 U.S. 340, 349-50 (1988), that the genuineness of the agency relationship is adequately assured when the agency relationship is set forth in a written agreement, the corporation functions as an agent and the corporation is held out as an agent in all dealings with third parties related to the transaction.

None of the foregoing factors are present in this case. No written agency agreement exists between Partnership 1 and Corporation 1. Corporation 1 did not: (a) operate in the name and for the account of Partnership 1; (b) bind Partnership 1 by its actions; (c) transmit any money to Partnership 1; and (d) receive money attributable to the services of employees of Partnership 1 and to assets belonging to Partnership 1. Furthermore, Corporation 1 was not owned by Partnership 1. Thus, its relations with Partnership 1 were not dependent upon the fact that it was owned by Partnership 1, and its business purpose does not appear to have been the carrying on of the normal duties of an agent. Accordingly, the facts do not support the position that Corporation 1 served as Partnership 1's agent.

Issue Ten

The facts do not indicate that either Partnership 4 or Corporation 12 served as Corporation 1's agent. No written agency agreement exists between any of these parties. Neither Partnership 4 nor Corporation 12: (a) operated in the name and for the account of Corporation 1; (b) bound Corporation 1 by its actions; (c) transmitted money to Corporation 1; and (d) received money attributable to the services of employees of Corporation 1 and to assets belonging to Corporation 1. Finally, Partnership 4 is not owned by Corporation 1, and the fact that Corporation 12 and Corporation 1 share an address alone is not indicative that Corporation 12 acted as Corporation 1's agent. Therefore, the facts do not support the contention that either Partnership 4 or Corporation 12 carried on the normal duties of an agent.

Issue Eleven

Section 6662(a) imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement. There can, however, be no "stacking" of those components of the accuracy-related penalty. Treas. Reg. § 1.6662-2(c). Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement, I.R.C. section 6662(h)), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). See DHL Corp. v. Commissioner, T.C. Memo. 1998-461 (the Service alternatively determined that either the 40-percent gross valuation misstatement penalty under section 6662(h) or the 20-percent negligence penalty under section 6662(b) was applicable).

Negligence - Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in preparing a tax return. See I.R.C. section 6662(c); Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g on this issue, 43 T.C. 168 (1964). Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii).

In this case, Taxpayer's subsidiary issued ten shares of its common stock to Partnership 1, which were redeemed less than three years later for $BB, in exchange for a leasehold interest with built-in rent deductions that exceeded $FF million. Those numbers produce an astronomical writeoff/cost ratio in excess of 8,000 to 1. Although Taxpayer claims to have had a profit motive for the transaction, as was discussed herein in connection with issues 1 and 2, there is no apparent way Taxpayer could have earned a pre-tax profit from the transaction. As a result, this was a deal too good to be true.

Substantial Understatement - A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $10,000 in the case of corporations other than S corporations or personal holding companies. Section 6662(d)(1). The assigned revenue agent has indicated that the adjustments based on the disallowances of the losses and rental expenses in question meet these technical thresholds.

If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, see section 6662(d)(2)(C)(iii), the accuracy-related penalty applies to the understatement unless the reasonable cause exception applies. See Treas. Reg. § 1.6664-4(e). The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(e)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment.[17] Treas. Reg. § 1.6664-4(e)(2)(i). Based on all the above-described facts, we find the existence of neither substantial authority nor reasonable belief in the "more likely than not" standard.

In the unlikely event that the Taxpayer meets the "substantial authority" and "reasonable belief" requirements, that is still not dispositive of whether the Taxpayer acted with reasonable cause if the taxpayer's participation in the tax shelter lacked significant business purpose or if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter. Treas. Reg. § 1.6664-4(e)(3). As noted above, the Taxpayer's participation lacks business purpose and it is a deal too good to be true.

Substantial Valuation Misstatement - For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $10,000 in the case of a corporation other than an S corporation or a personal holding company. A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. Section 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." Section 6662(h)(2)(A). If there is a gross valuation misstatement, the 20 percent penalty under section 6662(a) is increased to 40 percent. Section 6662(h)(1). One

[17] The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6664-4(e)(2)(i)(B)(2). We are not aware that Taxpayer relied on the opinion of a professional tax advisor in reporting the deductions at issue.

of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143, 150-52 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992). If the facts establish that the adjusted basis of an asset with a basis traceable to a lease-stripping transaction is 200 percent or more of the correct amount, then either a substantial valuation misstatement or a gross valuation misstatement may exist.

Here, if the Service prevails in its challenge to the economic substance of the series of transactions involved in the lease stripping transaction in which Partnership 1, Corporation 1, Corporation 10, and Corporation 11 participated, we believe the basis in the Long-Term Note 1 would be disallowed. As that basis was the source of the deductions at issue, the penalty provided by Code section 6662(a) would apply to deficiencies resulting from the disallowance of the deductions on the grounds that a substantial valuation misstatement would exist.

In summary as to the accuracy-related penalty, the Service's primary position should be that it applies to the portion of the underpayment that results from the disallowance of the deductions at the 40 percent rate for gross valuation misstatements. The Service's secondary position should be that it applies at the 20 percent rate.

Please call if you have any further questions.

By: ______________________________
CAROLYN H. GRAY
Acting Assistant to the Branch Chief,
Branch 1
Office of the Associate Chief Counsel
Passthroughs and Special Industries