OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
Attn:

FROM: Paul Epstein
Senior Technical Reviewer, CC:INTL:Br5

SUBJECT:

This Field Service Advice responds to your request for advice on October 13, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

A =
B =
C =
D =
E =
F =

G =
H =
J =
K =
L =

Law Firm =
Appraisers =

State =
Country M =
Country N =
Country O =

Date 1 =
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Year W =
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Amount 1 =
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Shares =

Percentage 1 =
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Percentage 5 =
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Percentage 7 =
Percentage 8 =

ISSUE

Whether section 482 may be applied between the taxpayer and the other parties to the transaction during the taxpayer's taxable years W, X, Y, and Z, and if so, what are the consequences.

CONCLUSION

From the facts provided, we conclude that section 482 may potentially apply between the taxpayer and the other parties to the transaction (the "participants") because it appears that income and deductions arising from the transaction were arbitrarily shifted between the participants pursuant to a common design. To the extent that a common design to shift income and deductions can be shown, the participants will have "acted in concert" pursuant to that common design. Accordingly, the participants will be treated as members of the same controlled group for purposes of applying section 482.

Section 482 may be applied to reflect the income from the leasing transaction clearly under the following alternative theories:

1. *Economic substance standards of section 482*
   These standards may be applied under two alternatives:

   (i) Disregard the sale from D to A and the simultaneous leaseback so that H is treated as never having acquired indirect ownership of the equipment through its ownership interest in A. Therefore, H's depreciation and interest expense deductions relating to the equipment would be disallowed and reallocated to D. A further consequence of disregarding the sale-leaseback is disregarding the subsequent sale of the lease receivable by A to E because A never had the right to the lease receivable; or

   (ii) Respect the sale-leaseback, and disregard only the sale of the lease receivable, so that A is deemed to receive rents from D over the same time period as it accrues depreciation and interest expense deductions;

2. *Clear reflection of income and tax evasion standards of section 482*
   These standards may be applied under two alternatives:

   (i) Allocate H's deductions to P during the period B owned preferred stock of H, so that income and deductions attributable to the sale-leaseback and sale of the lease receivable are not artificially separated. The sale-leaseback is

not disregarded, but it is possible that the sale of the lease receivable may be disregarded to reflect clearly the timing of the income and deductions; or

(ii) Allocate to H the proportionate amount of the proceeds from the sale of the lease receivable to E for the period of H's participation in the transaction;

3. *Application of section 482 to nonrecognition transactions*
Allocate H's deductions to B, on the basis that section 482 may allocate income or deductions attributable to property acquired by a transferee corporation (H) in a section 351 transaction back to the contributing shareholder (B).

FACTS

1. Steps of the transaction

Based on the information provided to us, the following is a summary of the steps of the transaction at issue. We understand that either D or B was the promoter of this transaction (both parties were key participants). All of the participants were brought into the transaction within a span of less than three months, which began and ended within the same calendar year period that was also H's taxable year W. Within this three-month period, the following key steps involving all the participants occurred which facilitated the splitting of income and deductions:

1) the formation of A, a U.S. limited liability company, by two non-U.S. resident individuals;

2) A's purchase of equipment from, and simultaneous leaseback to, D, an unrelated U.S. corporation, financed by a loan from F and separate installment and balloon notes issued by A to D;

3) the subsequent sale to E of A's right to the stream of rental income from D one month later, which in one lump sum payment, provided A with sufficient funds to pay off the installment note;

4) five weeks later, the transfer by the two foreign owners of A of their Percentages 1 and 2 interests, respectively, to two domestic corporations, H and G. In a section 351 transaction related to this transfer, (1) the foreign owner who transferred his Percentage 1 interest in A to H received preferred stock in H, and (2) H's parent contributed to H an amount of cash, which was used to pay off A's obligation to F (via contribution by H to A).

The following is a more detailed description of the steps of the transaction at issue.

Step 1 *Formation of A*

On Date 1, two nationals of Country M, B and C, formed A, under the limited liability company statute of State for the purpose of owning and leasing computer equipment. We understand that B was a resident and citizen of Country M, had spent fewer than 183 days each year in the United States, did not conduct any business in the United States, and did not have a permanent establishment in the United States. We understand C is a national of Country M but do not have any information concerning C's residency. B contributed Amount 6 (giving B a Percentage 1 interest in A), and C contributed Amount 7 (giving C a Percentage 2 interest). A was treated as a partnership for U.S. tax purposes.

A's principal place of business was Country N. We do not know whether A had any operations in the United States. A's manager, per the Operating Agreement between B and C, was L, a company, located in Country O.[1] According to a letter dated Date 2 from Law Firm to F regarding A's loan application, B had experience in structuring leasing and asset-based financing transactions.

Step 2 *Purchase of the Equipment*

On Date 2, A purchased computer equipment from the promoter, D, Inc., a U.S. corporation, for Amount 8. To finance the purchase, A borrowed Amount 12 from F[2], and borrowed Amount 9 from D in the form of an Amount 10 recourse installment note and a separate Amount 11 nonrecourse balloon note. The F loan appears to have been secured by a "Senior Security Agreement," which has not been provided. We do not know whether under the Senior Security

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[1] We do not know whether B and C are related to L, whether L was formed for purposes of this transaction, whether L performed its managerial responsibilities in the ordinary course of its business as an independent agent, or whether such activities were performed through an office or fixed place of business in the United States. Accordingly, this Field Service Advice does not address the possibility that A could have been engaged in a U.S. trade or business during the period of B's and C's ownership.

[2] It is not known whether F treated the loan as effectively connected to its U.S. trade or business, or whether it considered any interest to be foreign source, non-effectively connected income by virtue of the residency of A's owners. If F expected the loan to generate foreign source interest, then it necessarily must have contemplated that A's owners would never be U.S. residents or that A was not an agency, trade or business of its owners. See I.R.C. sections 861(a), 862(a), 875(1), and 884(f)(1)(A).

Agreement, F had recourse to parties other than A if A defaulted. We also do not know whether the scope of the recourse was limited to the residual value of the equipment. A also gave D a subordinate interest in the equipment, including proceeds, *i.e.* rent, from the leaseback of the equipment to D described in Step 3 below.

The installment note provided that the Amount 10 principal (plus interest) would be payable in installments equal to rent payments due over the term of the leaseback to D. As for payment of the balloon note's principal and interest, D provided written acknowledgment that it would look solely to its security interest in the equipment. It could not assert personal liability against A or any of its partners under the balloon note.

The equipment was subject to pre-existing user leases between third parties and D, as well as liens of financial institutions securing non-recourse loans entered into by D. D, however, was not entitled to receive the third party rents. These amounts were paid directly by the third party lessees to the financial institutions holding the existing liens. D did not transfer the right to receive rent from these third party leases to A. The purchase agreement also provided that during the terms of the third party leases, the third parties were permitted to sublease or relocate the equipment without A's consent.

Besides the leaseback to D described in Step 3, A was prohibited from selling or assigning its interest in the equipment and from leasing the equipment during the term of the existing third party leases. A was permitted to sell its right to receive rents under the leaseback. If such sale occurred prior to the maturity of the installment note, however, the note would be accelerated and all principal and interest would become immediately payable. All proceeds from such a sale were required to first be used as prepayment of principal and accrued interest on the installment note.

Besides its Amount 20 initial start-up capital contribution, the only asset A ever owned was the equipment purchased from D. The only activity A engaged in was the acquisition, financing and leasing of this equipment. It did not engage in any subsequent activity and terminated its business following D's exercise of its option to reacquire the equipment in Year Z, described in Step 6 below.

Step 3 <u>*Leaseback of the Equipment*</u>

On Date 2, simultaneously with the purchase agreement, A leased back the equipment to D (the "Lease" or "Leaseback") for a term of approximately four years. The terms of the Lease were expressly conditioned on A's anticipated ability to sell or assign its right to receive rent under the lease. (Lease, p.24.) Under the terms of the Lease, D had an option to purchase the equipment at the end of the lease for its fair market value at such time. D also had a unilateral option to terminate the Lease at an earlier date (in Year Z rather than Year ZZ), providing D with the right to reacquire the equipment for the greater of its fair market value or the balance outstanding on the balloon note, plus a small early termination fee. Rent payments, up to the early termination date, were set equal to the present value (using an "implicit interest rate" of Percentage 5) of prepaid rent covering the period up to the early termination date. After the early termination date, rent payments were adjusted using an implicit interest rate of Percentage 6. (Lease, p.2.) D also effectively had an unconditional and absolute obligation to pay the full amount of rent due each year to A, as the Lease expressly provided D with no right of set-off, counterclaim, etc.

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

Step 4 <u>*Sale of the Lease Receivable*</u>

On Date 6, A sold its right to receive rents under the Lease in lump sum to E, a U.S. bank, for Amount 13 (the "Lease Receivable"). Amount 13 represented the discounted value of the lease receivable. Under the terms of the agreement between A and E, D's rent payments owed to A would be payable directly to E. E was solely responsible for demanding and collecting these payments; A was under no obligation to take such action. E had no security interest in

the equipment, and its recourse was limited to “the general credit” of D, thus excluding A from potential liability.

E effectively treated the transaction as a loan to D, not a purchase of a lease receivable. In describing the transaction, it stated “D has approached E to provide financing for a sale-leaseback transaction involving a lease receivable purchase with <u>D as the obligor</u>." It described itself as “an unsecured lender to D.” According to E’s description of the transaction, D’s other benefits from the equipment sale included “(1) off-balance sheet financing, (2) a competitive and diversified funding source [Percentage 5], and (3) residual risk management [a portion of the residual risk is passed onto the L.L.C. equity investors].”

E had previously entered into two other identical rent receivable purchases arranged by D. These two transactions together had generated Amount 24 of net interest income for E. It appears that E entered into the A transaction based on D’s creditworthiness, the adequate yield of Percentage 8, and D’s history of prepayment within six months with respect to the two other rent receivable purchases.[3] (See E’s memo titled “Transaction Description.”) D did in fact prepay all the rent due under the lease five months later, on Date 13, as described in Step 6.

The sale of the lease receivable triggered the acceleration of the installment note. Thus, A was required to use the Amount 13 sale proceeds to pay off the installment note as required by the terms of the note and the security agreement.

Step 5 *<u>Transfer of Interest in A</u>*

On Date 8, C transferred his Percentage 2 interest in A to G, a U.S. corporation. (No other information concerning the transfer of C’s interest is known, such as consideration paid for C’s interest, except the facts that G’s address was its corporate parent, J, and that the Notice of Beginning of Administrative Proceedings issued to G was signed by the secretary for K’s Vice President (Tax).) The next day, Date 9, B and J, a U.S. corporation that owned all of the stock (Amount 25 shares of common stock) of H, engaged in a transaction

[3] According to an e-mail sent by a E official to other bank employees, “Based on our significant relationship with D, the fact that regardless of the underlying performance of the lease transaction D is still obligated to us, and as we have done a couple of smaller but similar deals which have paid out in six months, I favor this exposure despite it putting us slightly over our house limit.”

with H that they intended to qualify as a section 351 transaction. J contributed Amount 14 of cash in exchange for additional shares of H common stock.

Pursuant to the section 351 transaction, B contributed his Percentage 1 interest in A in exchange for Shares of H preferred stock. (We do not know the amount of the transferred basis, although it appears to be Amount 31.) According to the Exchange Agreement, dividends would accrue at a rate of Percentage 3 per year of the Amount 22 liquidation value per share. These dividends would accrue from the date of issuance regardless of whether dividends were "earned or declared" and regardless of whether funds were "legally available" during this period. It thus appears from the Exchange Agreement that B was entitled to a distribution of Percentage 3 irrespective of H's earnings or H's legal ability to pay dividends. The dividends were payable in cash on the redemption date. Thus, on the redemption date, B was guaranteed to receive Amount 21 (Amount 22 per share), plus unpaid, accrued dividends. Thus, B's Percentage 3 return appears to be the economic equivalent of accrued interest payable in arrears. It is not known if and when H redeemed B's preferred stock.

Because the terms of the F loan required A to prepay the outstanding balance of the loan upon the transfer of more than a Percentage 7 interest in A, the Amount 14 cash contribution from J was used by H in its capacity as Percentage 1 owner of A to pay off the outstanding balance of the loan. We understand F's repayment was effected through a contribution of the cash to A, presumably so that A's debt to F would not be treated as distributed by A.

At this time, A's only asset was the equipment. The rental stream had already been sold to E. The Amount 20 initial capital contribution had been withdrawn by this time. (This amount may have been used to reduce the balance of the F loan from Amount 12 to Amount 14.) Therefore, A's only remaining economic interest appeared to be based on the residual future value of the equipment.

Step 6 <u>*Appraisals of the Equipment and Early Termination of the Lease*</u>

On the date A purchased the equipment (Date 2), Appraisers estimated the residual value of the equipment. We understand that D, the promoter, hired at least one of Appraisers. Appraisers had estimated the equipment's fair market value at the early termination date as Amount 26, and at the regular termination date as Amount 27. We understand that the taxpayer itself adopted a more conservative

expected value at the early termination date of approximately Amount 28.

In Year Z, D exercised its early termination option. Because the balloon note and accrued interest exceeded the actual fair market value at the early termination date, it reacquired the equipment by paying the principal and accrued interest on the balloon note, which was Amount 16. In effect, this required nothing more than cancellation of A’s balloon note obligation to D. Because A’s adjusted basis in the equipment was Amount 29, the reacquisition resulted in an Amount 5 loss for A.

A terminated its business following D’s exercise of its option to reacquire the equipment. H was dissolved on Date 14.

Reported Tax Consequences

The change in A's ownership on Date 9 was considered a section 708(b) termination. Consequently, A filed an initial (and final) partnership return for Date 7. A treated the sale of the lease receivable as a recognition event for U.S. tax purposes and reported net income from "other rental activities" of Amount 30 (the Amount 13 proceeds from the sale reduced by three months of depreciation deductions). No U.S. tax was imposed on the proceeds that were passed through to B and C because neither B nor C was subject to U.S. taxation. B’s “recognition" of Percentage 1 of the proceeds added Amount 30 to the carryover tax basis of his share of the partnership interest, which totaled Amount 31 when B transferred his interest to H. From H’s perspective, it was not required to recognize the sale because it had not yet legally become an owner of A when the gain was required to be taken into account for U.S. tax purposes. Thus, H was not liable for any tax on the gain. The same analysis applied to G.

Exam has been unable to locate A's short period partnership return for Date 10. However, the prepaid rent was likely reported to B and C during this period. On its partnership return for the Year X, A reported a net loss from “other rental activities” of Amount 2 (consisting of depreciation and interest expense). This loss was passed through to the new owners, H (Percentage 1) and G (Percentage 2). Similarly, on its Year Y return, A reported an Amount 3 loss (from depreciation and interest expense), which was passed through to H and G. In Year Z, after D exercised its option to terminate the lease early and reacquire the equipment, A filed a final return. The Year Z return reported an Amount 17 loss (expenses from “other rental activities” and a section 1231 loss of Amount 5 from the disposition of the equipment), which was passed through to H and G.

H, J, and likely G were part of K's consolidated group during the years at issue. K claimed H's share of the Years X, Y, and Z losses totaling Amount 15 on its consolidated returns for this three-year period. The Amount 31 of depreciation and interest deductions for this period equaled H's basis in the partnership interest. (The remainder was the section 1231 loss on the sale to D.) We do not know the amount of G's deductions for this three-year period.

On Date 11, a Notice of Final Partnership Administrative Adjustment (FPAA) was issued to A for Year X, because the statute of limitations for A's Year X partnership return was scheduled to expire on Date 12, and A had refused to extend the statute of limitations. The FPAA proposed disallowing the losses from "other rental activities," and Amount 18 in liabilities and other partnership items. Alternatively, it determined that the sale of the lease receivable was a financing arrangement for tax purposes and not a true sale. A filed a petition with the Tax Court on Date 15.

Reporting for Financial Statement Purposes

A treated the proceeds from the sale of the lease receivable as a financing, not gain from a sale. Thus, it did not report the equipment on its books (in accordance with FAS 13). Although A reported Amount 1 of net income from "other rental activities" for tax purposes in Year W, A's book income for financial statement purposes was a loss of Amount 32.

In Year X, A reported only Amount 33 of interest expense as a book loss; it did not report as an additional book loss the Amount 34 of depreciation that was reported for tax purposes. We do not know how A reported the expenses for Years Y and Z.

2. **Economics of the transaction at issue**

A. **Circular Cash Flow**

The sale-leaseback and the sale of the lease receivable were part of a circular cash flow that provided liquidity for this tax shelter.

- A purchased computer equipment from D, which financed Percentage 4 of the purchase price by loaning Amount 9 to A in the form of an installment and balloon notes. The remainder of the purchase price was funded by F. A simultaneously leased back the equipment to D. As security for the notes, A pledged its rights and interest in the equipment, including rent proceeds, to D. Rent payments were equal to the payments of principal and interest due on the installment note.

- A sold the lease receivable to E for Amount 13. As required by D, A immediately applied this amount to pay off the remaining principal and interest on the installment note.

- Within five months of the lease receivable sale, D prepaid all rent due to E.

In effect, E had financed the transaction: it loaned Amount 13 to D, and D, as obligor, timely paid the principal and interest due on the unsecured loan within the six-month time frame expected by E.

A did not control the funds at any time. D's Amount 9 loan to A was used to finance the purchase of equipment from D. A nominally possessed the right to rent due under the lease (prior to selling this right to E), however, this right was effectively restricted in its entirety in that rent payments were equal to amounts due on the installment note. Similarly, A had nominal rights to the proceeds from the sale of the lease receivable, yet it could not use the proceeds except to pay off the installment note. Thus, A did not appear to have any right to the rent or sale proceeds other than to have the sale proceeds applied to its obligations to D. The owners of A, B and C (and later H and G), similarly had no control over the funds. A, B, and C were merely passive players in this transaction.

Moreover, at no time did A or its owners have any realistic expectation that they would have to obtain funds to pay off the installment note, balloon notes, or the F loan: (1) the Amount 13 proceeds from the sale of the lease receivable fully satisfied the installment note; (2) the Amount 14 of cash from J paid off the outstanding balance of the F loan; and (3) D's Amount 16 payment to reacquire the equipment paid off the balloon notes.

B. **<u>Economics to the K Group</u>**

Based on the facts provided, we do not know whether H, J, and K (collectively the K Group) had a reasonable possibility of economic profit from the transaction at issue. We do not know K's estimated pre-tax economic profit, nor its cost of investing in the transaction. The transaction costs would include, but are not limited to: (1) the Amount 14 of cash used to pay off the loan from F to A, (2) the cost of redeeming H's stock (Amount 21 plus dividends accrued at a rate of Percentage of 3 per year), and (3) fees paid to D, E, and/or F, which we estimate cost K at least dollars. Thus, Amount 35 is a conservative estimate of K's transaction costs.

The pre-tax economic profit would be based solely on the residual value of the equipment and not the stream of rental payments, since A had sold its right to the rent receivables to E. Thus, A's economic interest in the equipment was solely based on the residual value of the equipment. According to the terms of the lease,

if D exercised its option to terminate the lease early, it could reacquire the equipment for the greater of its fair market value or the balance outstanding on the installment note. If D opted to lease the equipment for the regular term, it could reacquire the equipment for its fair market value at that time. When D exercised its early termination option, the Amount 16 outstanding balance on the balloon note exceeded the fair market value, so A, having to use the proceeds to pay off the balloon note, earned no profit.

Appraisers had estimated on Date 2 that the equipment's fair market value was Amount 26 on the early termination date, and Amount 27 on the regular termination date. However, it appears that when D reacquired the equipment on the early termination date, the Amount 16 outstanding balance on the balloon note exceeded the equipment's fair market value. Exam believes that the three appraisals are overstated. According to studies performed by an IRS engineer, the equipment's value at the early termination date was only Amount 36, and Amount 37 at the regular termination date. In another case involving a different lease stripping transaction that also used a valuation by one of Appraisers, the Service's expert found that the residual value of the equipment at issue was only 30 percent of this Appraiser's estimated value. If a similar result were to be reached in the instant case, the residual value on the early termination date would be approximately Amount 38 (not the projected Amount 26), which, given K's transaction costs of at least Amount 35, would yield no potential for pre-tax economic profit.

In addition to lacking a reasonable possibility of profit, A and its partners were not subject to any realistic risk of having to pay principal or interest on the notes, even if for some reason D defaulted on its rent payments to A. The nonrecourse installment note provided that the Amount 10 principal (plus interest) would be payable in installments equal to rent payments due under the equipment lease. There was no realistic risk that D would default on its rent payments to A. As to A's obligations under the nonrecourse balloon note, D acknowledged in the contract that it would look solely to its security interest in the equipment for payment of the balloon note's principal and interest. D agreed not to assert personal liability against A or any of its partners under the balloon note.

As insulation against the risk of tax exposure, A and its owners were the beneficiaries of a tax indemnity clause in the lease, which provided that D would indemnify A and its owners for any U.S. tax liability arising from rents or any other proceeds payable by D to A, or A's sale of the lease receivable. (Lease, pp.14,18.) Thus, from H's perspective, it was liable for little, if any, tax on the Amount 13 payment from E.

C. **Economics to the other parties**

1. **D**

As seller of the equipment, D earned Amount 12 of cash paid upfront. D also earned a float on the Amount 10 paid by E on Date 6, which D did not repay (through a "rent prepayment") until Date 13, five months later. According to E's description of the transaction, D's other benefits from the equipment sale included "(1) off-balance sheet financing, (2) a competitive and diversified funding source [Percentage 5], and (3) residual risk management [a portion of the residual risk is passed onto the L.L.C. equity investors]." Also, as the likely promoter of the tax shelter, D possibly earned additional fees, the amounts of which we do not know. We believe, but are not certain, that D had bona fide ownership of the equipment prior to the sale to A. As owner, D could have recorded a book profit on its financial statements for the equipment sale.

Although D had sold and leased back the equipment from D, D still maintained the third party leases, collected rents, and performed other lessor duties. Neither A nor any of its owners performed any of these duties. We do not know – although we believe it is unlikely – whether the third party lessees were informed that D had transferred title to the equipment to A.

2. **B and C**

B and C together made an initial capital contribution of Amount 20 on Date 1. We do not know what other amounts, if any, B and/or C were required to pay in connection with the transaction. Although we do not know when such payments were made, they may have been timed and supported by amounts owed to B and/or C at separate points in the transaction.

We also do not know what compensation B and C received in consideration for their participation in the transaction, nor from what sources, *i.e.*, from which participants in the transaction. For example, we do not know the amount of consideration G paid C for C's Percentage 2 interest in A. It is likely that B and C received a fee from D if D was the promoter of this transaction, but we do not know the amount of this fee, nor when it was paid. H was obligated to pay P Amount 21 and accrued dividends upon the redemption of P's stock, which was guaranteed to occur some time in the future. We do not know, however, when H redeemed this stock.

It appears that B's and C's primary purpose for forming A was to serve as an accommodation party for the benefit of H's and G's needs. B's total potential profit from its participation in the transaction appears to have been limited to cash associated with the stock redemption and dividends, and possibly a fee from D.

(As previously stated, we do not know the amount or type of consideration C received from G in exchange for C's Percentage 2 interest in A.) Although the Amount 13 proceeds from the sale of the lease receivable were recognized during B's and C's period of ownership, they did not have any right to use these proceeds other than to apply the amounts to pay off the installment note. For this reason, we assume that B and C were not subject to tax in Country M on this U.S. recognition event.

3. **E**

E earned interest on Amount 13 at a rate of Percentage 8 for assuming a short-term, unsecured credit position with D (which had a credit rating of BBB/Baa2), and transaction fees of nearly Amount 39 paid by D. E had no residual equipment risk since D and A assumed equity risk.

E had considered three risk factors and how they were mitigated:

- The risk that D would not prepay the Amount 13 Lease Receivable within six months was minimal. Although the maximum maturity was three years, E fully expected that D would prepay all rent on by Date 13. D had historically prepaid the two previous lease receivable purchase transactions funded by E. If D did not prepay the rent, D's ability to fund future transactions would be reduced. E would consider "selling a portion of the new loan in the event the exposure is not prepaid after six months." (E analysis of transaction.)

- The risk that A would cease to exist did not affect E. E's "entire repayment risk is to the obligor [D] who makes lease payments directly to E." Thus, E had no risk associated with A.

- The risk that the underlying equipment would become unmarketable, so that the equipment did not generate rental income or the end users (the third party lessees) failed to pay rent, was also minimal as to E. D bore the risk that the equipment would become unmarketable, as well as the risk of collecting third party rents. Regardless of these risks, it was still fully liable to E for payment of rent.

As further insulation from risk, D promised to indemnify E (in its capacity as assignee of A's rights to the rent receivables) for any U.S. tax liability arising from D's actions in connection with the Lease. (Consent and Agreement to Sale of Lease Receivable, p.2.) To the extent D did not indemnify E under the terms of the Lease, A promised to indemnify E for any tax imposed on the sale of the Lease Receivable. (Lease Receivable Purchase Agreement, p.11.)

4. **F**

F earned interest on its Amount 12 loan to A and probably some fees. It is unlikely that F would loan Amount 12 to an undercapitalized limited liability company without an assurance, guarantee, or at least the knowledge that it would be repaid in the future. Thus, we believe that it is possible that at the time F made the loan to A, F was made aware by D or another party to the transaction that a future owner of A, *e.g.* K, would have the ability to repay the Amount 12 principal plus interest. Further, if in fact F did make an Amount 12 unsecured loan to A, we expect that the bank would have been required by banking regulatory authorities to post a loan loss reserve of an amount representing a substantial portion of the loan balance.

DISCUSSION

1. **Overview**

In order for section 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. I.R.C. section 482. The next section (Section 2) of this memorandum discusses the meaning of "control" and "same interests." We conclude that to the extent it can be shown that the transaction was carried out pursuant to a common design that was intended to include all of the parties to the transaction, the parties may be treated for purposes of this transaction as controlled by the same interests within the section 482 meaning of control. Consequently, under such conditions, the participants would be part of the same controlled group evidenced by their acting in concert with a common goal to shift deductions to H and G and income to B and C. *See* Treas. Reg. § 1.482-1T(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). Accordingly, section 482 applies to the transaction.[4]

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

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[4] The 1993 temporary regulations under section 482 apply to the years at issue, unless A makes an election to apply the final transfer pricing regulations retroactively. Treas. Reg. § 1.482-1T(h) (1993) (providing that the temporary regulations are generally effective for taxable years beginning after April 21, 1993, but are also applicable to transfers made to foreign persons after November 17, 1985, or after August 17, 1986, for transfers to others); Treas. Reg. § 1.482-1(j)(2) (1994), We do not know if K made such an election to date, and note that it may make such an election in the future. Consequently, we will distinguish between the two regulations by referring to their year of promulgation (in parenthesis) when each set of regulations is referred to.

- Section 3.A analyzes the transaction under the economic substance standards in the section 482 regulations. We conclude that the terms of the sale-leaseback and the sale of the lease receivable appear to be inconsistent with the economic substance of the transaction. Under section 482, either the sale-leaseback (and consequently the sale of the lease receivable) could be disregarded for tax purposes, or only the sale of the lease receivable could be disregarded. *See* Treas. Reg. § 1.482-1T(c)(3)(ii)(B) (1993); Treas. Reg. § 1.482-1(d)(3)(iii)(B) (1994). By disregarding the sale-leaseback, H is treated as never having acquired ownership of the equipment, and H's deductions should be disallowed accordingly. Alternatively, by disregarding only the sale of the lease receivable, A is deemed to receive rents from D over the same time period as it accrues deductions, and accordingly, H's deductions are matched with its income.

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

- Section 3.C discusses the role of section 482 in nonrecognition transactions, and the case law allowing the Service to allocate income and deductions attributable to an entity's disposition of built-in-loss (and gain) property, which it acquired in a nonrecognition transaction, to the contributing shareholder (or partner). We conclude that B's contribution of its interest in A after the income was "stripped" appears to be akin to such a situation. Consequently, an allocation of H's deductions to B also may be appropriate under this theory.

2. **Meaning of "Controlled" & "Same Interests"**

A. **Statutory Language of Section 482**

Section 482 provides the following:

> In any case of two or more organizations, trades, or businesses owned or ***controlled*** directly or indirectly by the ***same interests***, the

> Secretary may distribute apportion, or allocate gross income, deductions... between or among such organizations...if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations.

I.R.C. section 482 (emphasis added). Thus, in order for section 482 to apply to a transaction, the transaction must be between two or more organizations, trades or businesses owned or controlled by the same interests. As there is no common ownership among the participants to the transaction, the question is whether any of the participants -- D, A, and E in particular -- are controlled by the same interests.

B. **Legal Standard for Control**

The section 482 regulations define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1T(g)(4) (1993), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4) (1994), 1994-2 C.B. 93. The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. *Id. Accord Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert denied*, 385 U.S. 899 (1966); *Grenada Indus., Inc. v. Commissioner*, 17 T.C. 231 (1951), *aff'd*, 202 F.2d 873 (5th Cir. 1953), *cert. denied*, 346 U.S. 819 (1953), *acq. in part and nonacq. in part*, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223, 224.

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

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

C. **Legal Standard for "Same Interests"**

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

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, *i.e.,* placing deductions in one entity and income related to those deductions in another entity. *Brittingham v. Commissioner*, 598 F.2d 1375, 1379 (5th Cir. 1979), *citing* H. Rep. No. 2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rep. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." *Brittingham*, 598 F.2d at 1379; *South Texas Rice Warehouse Co. v. Commissioner*, 366 F.2d 890, 894-95 (5th Cir. 1966), *aff'g*, 43 T.C. 540 (1965), *cert. denied*, 386 U.S. 1016 (1967). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. *Brittingham,* 598 F.2d at 1379; *South Texas Rice Warehouse*, 366 F.2d at 894-95. *See also Brittingham*, 598 F.2d at 1378, *citing Ach,* 42 T.C. at 125-26 (the phrase "same interests" should not be narrowly construed to frustrate the intent of section 482). *Accord Grenada Indus., supra.*

Thus, it is not necessary that the same person or persons own or control each controlled business before section 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interest is identical to the

definition of control (and the presumption relating thereto) in the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met.

D. **The common design of the transaction at issue**

Based on the facts provided, the participants in the transaction appear to have acted pursuant to a common design to shift income and deductions for tax purposes. Further factual development is required on all points.

First, from the facts provided, the transaction has the hallmarks of a prearranged, structured transaction marketed by a promoter.

Second, a common design strongly supports why the parties to the transaction engaged in otherwise unprofitable activities:

- When A purchased the equipment from D, the equipment was subject to third party leases, and A apparently did not have the right to receive third party rents. A and D then immediately entered into a leaseback agreement, under which D was obligated to pay rent to A, but D could not actually use the equipment as it had already leased the equipment to third parties. But for the creation of D's obligation to pay rent to A, there would have been no opportunity to accelerate recognition of income for U.S. tax purposes. This income acceleration was achieved through the sale of the lease receivable. D could have achieved the same acceleration effect by prepaying all rent due directly to A, but through the sale of the lease receivable, D effectively obtained a loan from E and avoided using its own funds. Absent this recognition event, the transaction would have been unmarketable to K or any other taxable U.S. party, because if K had been required to recognize the income, it would have been an economic loss (unless the highly inflated estimated residual value of the equipment was likely to be realized).

- The existence of a common design is further evidenced by the restrictions imposed by D on A under the sale, leaseback, and security agreements. D, not A, controlled the funds associated with this transaction: A nominally possessed the right to rent due under the leaseback (prior to selling this right to E), but this right was restricted in that rent payments were equal to amounts due on the installment note. Similarly, A had nominal rights to the Amount 13 proceeds from the sale of the lease receivable to E, but A was required to use these proceeds to pay off the installment note. Additionally, at the termination of the lease when D reacquired the equipment, A was required to first use the proceeds to pay off the balloon notes.

- F's participation in the transaction appeared to depend on the future entry of an entity which had the capacity to assume A's Amount 12 obligation. It is questionable whether a bank would make an Amount 12 term-loan to an entity capitalized with Amount 20 by two individuals, based on a letter of recommendation from a law firm vouching for the individual owners of the entity. If it did, U.S. bank regulatory authorities would require F to create a reserve of, *i.e.* set aside, a large portion of the Amount 12 loan amount due to the riskiness of the transaction, which would immediately impact F's current earnings. Thus, we believe that it is possible that F knew when it entered the loan that an entity such as K would be brought into the transaction soon after F made the loan.

- The participation of the two initial foreign partners, B and C, in the transaction appeared to depend on the future entry of a taxpayer who could utilize depreciation and interest deductions, such as K. B and C had contributed Amount 20 to A initially, which was applied to reduce the outstanding balance of the F loan. (We do not know whether B and C were obligated to pay any other amounts during the period they owned A.) For U.S. tax purposes, B and C recognized the Amount 13 proceeds from the sale of the lease receivable, but they were not entitled to use the proceeds since the terms of the equipment sale required the proceeds to be applied to pay off D's installment note. Absent the fully anticipated entry of a U.S. taxpayer such as K, we question whether B and C would have participated in this transaction. There appears to be no source of income from this transaction except Amount 21 plus accrued dividends at a rate of Percentage 3, which B received upon redemption of his preferred stock in H. (We do not know what C received from G in exchange for his Percentage 2 interest in A.)

- The participation of C and subsequently G as Percentage 2 owners of A appeared to serve the sole function of qualifying A as a partnership for U.S. tax purposes, *i.e.* having at least two owners.

Third, all of the participants in the transaction received substantial benefits that were contingent on their coordinated activity.

- For B's participation in the transaction, B earned at least Amount 21 plus accrued dividends at the rate of Percentage 3 upon redemption of his preferred stock in H. This represented a generous return of more than 300% of B's Amount 6 initial capital contribution. B may have received additional compensation from D. We do not know what consideration C received from G for his Percentage 2 interest in A.

- As seller of the equipment, D earned Amount 12 of cash paid upfront. D also earned a float on Amount 10 paid by E on Date 6, which D did not repay

(through a "rent prepayment") until Date 13, five months later. According to E's description of the transaction, D's other benefits from the equipment sale included "(1) off-balance sheet financing, (2) a competitive and diversified funding source [Percentage 5], and (3) residual risk management [a portion of the residual risk is passed onto the L.L.C. equity investors]." Also, as the likely promoter of the tax shelter, D possibly earned additional fees, the amounts of which we do not know. It is not known whether D owned the equipment prior to the sale, although it appears that it did because of the existence of third party leases. As owner, D could have recorded a book profit on its financial statements for the equipment sale.

- E earned interest on Amount 13 at a rate of Percentage 8 for assuming a short-term, unsecured credit position with D (which had a credit rating of BBB/Baa2), and transaction fees of nearly Amount 39 paid by D. E had no residual equipment risk since D and A assumed equity risk.

- F earned interest on its Amount 12 loan to A and probably some additional fees paid by D.

A final reason why we believe that the parties acted pursuant to a common design is that D effectively operated A's entire business by managing and operating the third party leases.

In sum, for the same reasons that D, B, C, the K Group, and E appear to constitute the same interests -- the common design to shift income and deductions -- they are all members of the control group. Notice 95-53, *supra*; Treas. Reg. § 1.482–1T(g)(4)-(6) (1993); Treas. Reg. § 1.482-1(i)(4)-(6) (1994). Thus, section 482 may be applied to scrutinize the equipment sale from D to A; the subsequent leaseback to D; the sale of the lease receivable to E, the section 351 transaction between H, J, and B; and the separation of the income and deductions arising under this transaction.

Our conclusion that section 482 may apply to the transaction is bolstered by the Fifth Circuit's decision in *South Texas Rice Warehouse, supra*, in which the Tax Court and the Fifth Circuit applied section 482 to a lease stripping transaction from the late 1950s involving a corporation and a partnership owned by four unrelated families. The court upheld the Service's application of section 482 to prevent the stripping of the income to one entity for the purposes of allowing the other entity to realize losses, notwithstanding the fact that the two entities were owned by approximately 16 individuals in varying percentages.

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

that each component of the transaction was mutually interdependent and that each party contemplated that the components would be executed accordingly.

3. **Application of section 482 to the transaction**

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

A. **Economic substance analysis**

i. **Relationship of case law standard to section 482 standards**

Section 482 overlaps with the case law[5] relating to economic substance and sham doctrines by allowing the Service, in certain instances, to disregard contractual terms and agreements and to recharacterize a transaction. *See* Treas. Reg. §§ 1.482-2T(a)(1)(ii)(B), -2T(a)(3) (1993); Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1), -1(d)(3)(ii)(C) ex. 3, -1(f)(2)(ii), -2(a)(1)(ii)(B), -2(a)(3), -4(f)(3)(ii)(A) (1994).

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[5] *See ACM Partnership v. Commissioner*, 73 T.C.M. 2189, 2217 (1997), *aff'd in relevant part*, No. 97-7527 (3d Cir. 1998) (transactions without economic substance are not given tax effect); *United States v. Wexler*, 31 F.3d 117 (3d Cir. 1994) (transaction is a sham if it "has no substance other than to create deductions"); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985) (transaction is a sham if "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and ... the transaction has no economic substance because no reasonable possibility of a profit exists."); *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989) (standard for sham is "whether the transaction has any practicable economic effects other than the creation of income tax losses.... A taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to this inquiry."); *Saviano v. Commissioner*, 765 F.2d 643, 654 (7th Cir. 1985) ("The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along."); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988), *cert. denied*, 488 U.S. 824 (1988) ("sham analysis ... [consists of examination of] whether the transaction had any practical economic effects other than" generating tax benefits) (citations omitted); *Collins v. Commissioner*, 857 F.2d 1383, 1385-86 (9th Cir. 1988) (transaction related to gold mining venture had no non-tax economic effect); *Kirchman v. Commissioner*, 862 F.2d 1486, 1492-93 (11th Cir. 1989) ("transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer") (citations omitted); *Sheldon v. Commissioner*, 94 T.C. 738, 769 (1990)(same); *Cherin v. Commissioner*, 89 T.C. 986, 992-93 (1987) (deductions denied due to lack of economic substance); *Chapman v. Commissioner*, 73 T.C.M. 2405, 2414 (1997).

However, the section 482 regulations expand upon case law principles and provide additional guidance in specific areas. Specifically, the regulations provide the following:

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties.... If the contractual terms are inconsistent with economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994); Treas. Reg. § 1.482-1T(d)(1) (1993);
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> In making allocations under section 482, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

Treas. Reg. § 1.482-1(f)(1)(i) (1994); Treas. Reg. § 1.482-1T(d)(1)(i) (1993).

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

ii. **Actual conduct of the parties and characterization of the sale, leaseback, and sale of the lease receivable**

The participants' actual conduct appears inconsistent with the purported characterization of the sale, subsequent leaseback, and the sale of the lease receivable. The economic substance of the sale-leaseback appears more akin to a mere assignment of the right to the equipment's residual value, and the sale of the lease receivable from A to E appears to be in substance a loan from E to D.

A lease conveys to the lessee the right to use or enjoy property in exchange for rent. BLACK'S LAW DICTIONARY (Abridged 5th Ed. 1983); WEBSTER'S II NEW RIVERSIDE

UNIVERSITY DICTIONARY, (Riverside 1983). Rent, under income tax principles, is compensation for use of, or the right to use, property. *See, e.g.,* I.R.C. section 543(b)(3); Treas. Reg. § 1.1362-2(c)(5)(ii)(B). In light of the meanings of the terms lease and rent, the payments made under the leaseback should not be considered rent. This is because the sale-lease never transferred the current right to use the computer equipment to any of the participants. The third-party lessees continued using the computers as if the transactions never occurred. They may have in fact been totally unaware of this transfer.

The sale of the equipment to A should have separated D from the stream of rent payments from third-party lessees. However, A never obtained control of the rental income from the third-party lessees. Moreover, D also effectively controlled, and A did not profit from, the purported rent payments D was obligated to make to A, since the rent payments were equal to the amounts due under the installment note. When A sold the lease receivable to E, rents were payable directly to E, not A. D also retained control over the sale proceeds, since the terms of the sale and security agreements required A to first use the proceeds to pay off the installment note. Thus, A's presence in the transaction was essentially reduced to that of an accommodation party for which the initial owners, B and C, received some consideration (the amount of which is not known at this time). The only economic interest A had as owner and lessor of the equipment was based on the residual value of the equipment at the time D terminated the lease. A was effectively denied the ability to receive and freely use all other economic flows associated with the equipment. Accordingly, the actual conduct of the participants is inconsistent with the characterization of the sale-leaseback as a bona fide sale and lease. Whether A's expectation of the equipment's residual value at the time it entered the transaction was reasonable will have a direct bearing on whether A will be considered the owner of the equipment for tax purposes.

As for the purported sale of the lease receivable, the actual conduct of D and E indicates that the sale of the lease receivable by A to E was more akin to a loan from E to D. E treated and analyzed the transaction as a loan to D. In its analysis of the transaction, E stated that "D had approached E to provide financing for a sale-leaseback transaction involving a lease receivable purchase with D as the obligor." E regarded itself as an "unsecured lender of D." The transaction at issue was the third rent receivable purchase entered into by E that was arranged by D. The documentation shows that from its prior dealings with D, E expected D to prepay the rent within six months, which D did in fact do. In effect, E had financed the transaction: it loaned Amount 13 to D, and D, as obligor, paid back the principal and interest within the six-month time frame expected by E.

Thus, the actual conduct of the participants and the economic substance of rights and obligations assigned is inconsistent with the contractual terms of the sale, leaseback, and sale of the lease receivable. Further, the purported allocation of

risks pursuant to the sale-leaseback, accompanied by the attendant sale of the lease receivable, is not at arm's length, as analyzed below, and is further evidence that the transaction lacks economic substance.

iii. **Allocation of risks**

(1) **Section 482 standard**

In considering whether an allocation of risk has economic substance, Treas. Reg. § 1.482-1T(c)(3)(ii)(B) (1993) outlines the following three-prong test, which may be supplemented by other factors not enumerated in the regulations:

- Whether the controlled taxpayer has a reasonable opportunity to realize an economic benefit that is commensurate with the risks assumed, and that would cause a similarly situated uncontrolled taxpayer to bear the risks that the controlled taxpayer assumed;

- Whether the controlled taxpayer has the financial capacity to bear potential losses that might be expected to occur due to the assumption of risk; ***and***

- Whether the controlled taxpayer is engaged in the ***active*** conduct of a trade or business to which the risk at issue relates, and carries out substantial managerial and operational control over the principal business activities that directly influence the amount of income or loss to be realized. The regulations provide that the trade or business considerations of Treas. Reg. §§ 1.367(a)-2T(b)(2), (3) are relevant in determining whether this prong is met.

Treas. Reg. § 1.482-1(d)(3)(iii)(B) (1994) also contains a non-exclusive, three-prong test that considers the economic substance of a purported allocation of risk and whether such an allocation will be respected. The first and third prongs of the test in the final regulations are somewhat different, however:

- Whether the pattern of the controlled taxpayer's conduct is consistent with the purported allocation of risk; and

- The extent to which each controlled taxpayer exercises managerial control over the business activities that directly influence whether a profit or loss will be realized on the transaction. The reference to the section 367 regulations was removed.

Other than these differences, the two sets of regulations share two common traits. First, the second prong of the tests -- financial capacity to bear potential losses -- is the same under both sets of regulations. Second, the prongs of the tests are

conjunctive rather than disjunctive, meaning that an allocation of risk may lack economic substance if it does not meet all three prongs.

(2) **Application of section 482 risk standard to the transaction at issue**

Applying the section 482 risk analysis standards set forth above to the facts of this case leads to the indication that the transfer of risk associated with the sale, leaseback, and sale of the lease receivable may not satisfy the regulations.

The first prong of the regulations considers whether the controlled taxpayer had a reasonable opportunity to realize an economic benefit commensurate with the risks assumed (under the temporary regulations) or whether the pattern of conduct over time is consistent with the purported allocation of risk (under the final regulations). Under either standard, we believe that the transfers of risk to A and H do not satisfy this requirement:

- Based on the facts provided, we believe that the transfer of the initial foreign partners' ownership of A to H and G occurred as part of a tax avoidance plan marketed by a promoter. The transfer of the ownership of A, after the sale-leaseback and the sale of the lease receivable, was at the heart of the plan.

- At no time did the initial foreign owners and later H and G have any realistic expectation that they would have to obtain funds to satisfy A's obligations to D under the installment and balloon notes (beyond B's and C's initial Amount 20 contribution, possibly). First, during the brief, one-month period that D paid rent directly to A, A's payments under the installment note equaled the rent received. There was little risk of D's default because in effect it was paying funds to itself. This was evidenced by the "rent payments" which equaled A's payments on the installment note. Second, when E paid A Amount 13 in exchange for the lease receivable, A used the proceeds to pay off the installment note, as required by the terms of the sale and security agreements. Not only was A's obligation under the installment note extinguished completely, but E had no recourse to A in the unlikely event that D defaulted on its rent payments to E. Third, upon termination of the leaseback to D, in order to reacquire the equipment, D was required to pay the greater of the equipment's fair market value or the principal and interest on the balloon note. This guaranteed A (and ultimately H) that no additional funds would need to be obtained to satisfy A's obligations under the balloon note. Under these circumstances, one could conclude that neither the initial foreign owners nor the K Group bore any realistic risk of being obligated to make payments of principal or interest under the installment or balloon notes. For acting as an accommodation party, B would stand to realize at least Amount 21 plus accrued dividends at the rate of Percentage 3 while incurring relatively small upfront out-of-pocket expenses.

- H did not have any realistic expectation or possibility of profit from the sale of the lease receivable, since E's payment had been recognized for tax purposes by the initial foreign owners prior to H's entry into the transaction. Even after H became an owner of A, it did not have any right to the proceeds, as all the proceeds were used to pay off the installment note. Similarly, H did not have any risk that it would be liable to E in the unlikely event that D defaulted on rent payments to E, because the lease receivable sale agreement provided that E's recourse was limited to the "general credit" of D. Additionally, A and its owners were the beneficiaries of a tax indemnity clause in the lease, which provided that D would indemnify A and its owners for any U.S. tax liability arising from any payments by D or E.

- K's transaction costs exceeded Amount 12. Since H essentially had no right to the proceeds from the sale of the lease receivable, H's only opportunity to realize an economic benefit, commensurate with the risks assumed, was contingent on the residual fair market value of the equipment at the termination of the lease exceeding the principal and accrued interest on the outstanding balloon note. H in fact never earned any income from the transaction, because at the time D opted to terminate the lease early, the amount due on the balloon note exceeded the equipment's fair market value. We believe a material factor in H's expectation of profit is whether there was a reasonable likelihood that D would exercise its option to terminate the lease.

The equipment sale by D to A does not meet the second factor of the economic substance test relating to the financial capacity of A to bear potential losses. In connection with the purchase of the equipment, A obligated itself to pay Amount 9 to D and Amount 12 to F (not including accrued interest). Given the questionable residual value of the equipment and A's minimal capitalization of Amount 20, it is clear that A did not have the financial capacity to bear potential losses relating to the valuation of the residuals or the unlikely event that D defaulted on its rent payments.[6] *See* Treas. Reg. § 1.482-1T(c)(3)(ii)(E) ex. 2 (1993); Treas. Reg. § 1.482-1T(d)(3)(iii)(C) ex. 2 (1994) (contracts seeking to allocate risk to an entity lacking the financial capacity to bear the putative risk allocation may be disregarded for tax purposes). *Accord Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995). Like A, it may be possible that H's and/or G's capitalization was minimal, which, if true, would be a factor indicating that H and/or G were merely accommodation parties used by K to accrue depreciation and interest deductions that it reported on its consolidated returns. (However, we do not know the capital structure of H or G before or after the transaction.)

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[6] We do not know whether A's initial owners, B and C, could be held liable for A's default or whether they were beneficiaries of indemnity agreements.

The third factor in the risk allocation test relates to the taxpayer's exercise of managerial factors over the activities to which the risk relates. We do not know whether A was actively engaged in the computer leasing business. We only know that according to a letter of recommendation written by Law Firm on B's behalf, B purportedly was experienced in structuring leasing and asset-based financing transactions. This statement, however, may extend solely to B serving as an accommodation party for U.S. participants in other lease stripping transactions. Additionally, although the operating agreement between B and C indicated that A's manager was L, it is unclear what role, if any, this entity had with respect to lease management. The possible fact that A "hired" D, *e.g.*, paid D a fee, to manage the third party leases is not controlling. Since the regulation requires that substantial managerial and operational activities be carried out by A rather than by independent contractors, it is not determinative if A hired an independent contractor to perform its lessor functions. *See* Treas. Reg. § 1.367(a)-2T(b)(2), (3).

In sum, it appears that the sale, leaseback, and sale of the lease receivable failed to transfer significant risks to A and H, and accordingly they appear to have failed to meet the requirements of Treas. Reg. §§ 1.482-1T(c)(3)(ii)(B)(1993) and 1.482-1(d)(3)(iii)(B)(1994). *See also Medieval Attractions N.V. v. Commissioner*, 1996-455 T.C. Memo. (RIA) 3277, 3322 (disallowing deductions of royalty payments to related foreign entity that was not the owner or developer of an intangible; the payments had no economic substance under section 482 because the foreign entity was not the creator or developer of, and in substance had no ability to transfer, the intangible). The effect of disregarding either (1) the sale and leaseback (and the sale of the lease receivable as a necessary consequence), or (2) the lease receivable, is to break the chain of transactions that give rise to H's claim that it is entitled to depreciation and interest deductions.

B. **<u>Application of section 482's clear reflection of income & tax evasion standards</u>**

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

As stated in Notice 95-53, the separation of income from deductions in lease stripping transactions does not clearly reflect income, particularly where they are achieved through a transaction structured to evade taxes. Accordingly, to prevent the evasion of taxes and to effect a clear reflection of income, two alternative allocations may be appropriate. First, H's depreciation and interest deductions could be allocated to B during the period B owned preferred stock of H. Second, a portion of E's Amount 13 payment could be allocated to H in proportion to the period H owned A. At this stage, we believe the better theory for reallocation among the parties under section 482 is to allocate H's deductions to B (the former alternative). Because we do not know (1) whether the Amount 13 payment was at arm's length, and (2) whether H, J, or any other member of the K Group was a party to the plan at the time of the sale of the lease receivable, we are less certain whether some or all of the Amount 13 payment may be shifted from B to H.

C. **Section 482's application in nonrecognition transactions**

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

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

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

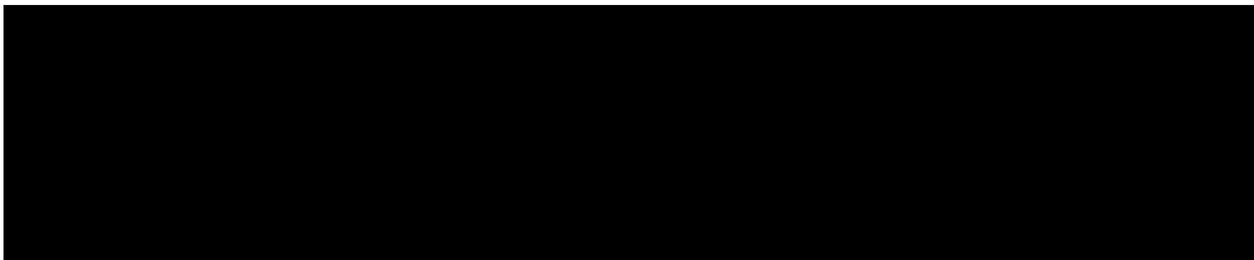
> Section 45 is directed to the correction of particular situations in which the strict application of the other provisions of [the Code] will result in a distortion of the income of affiliated organizations....The parent made

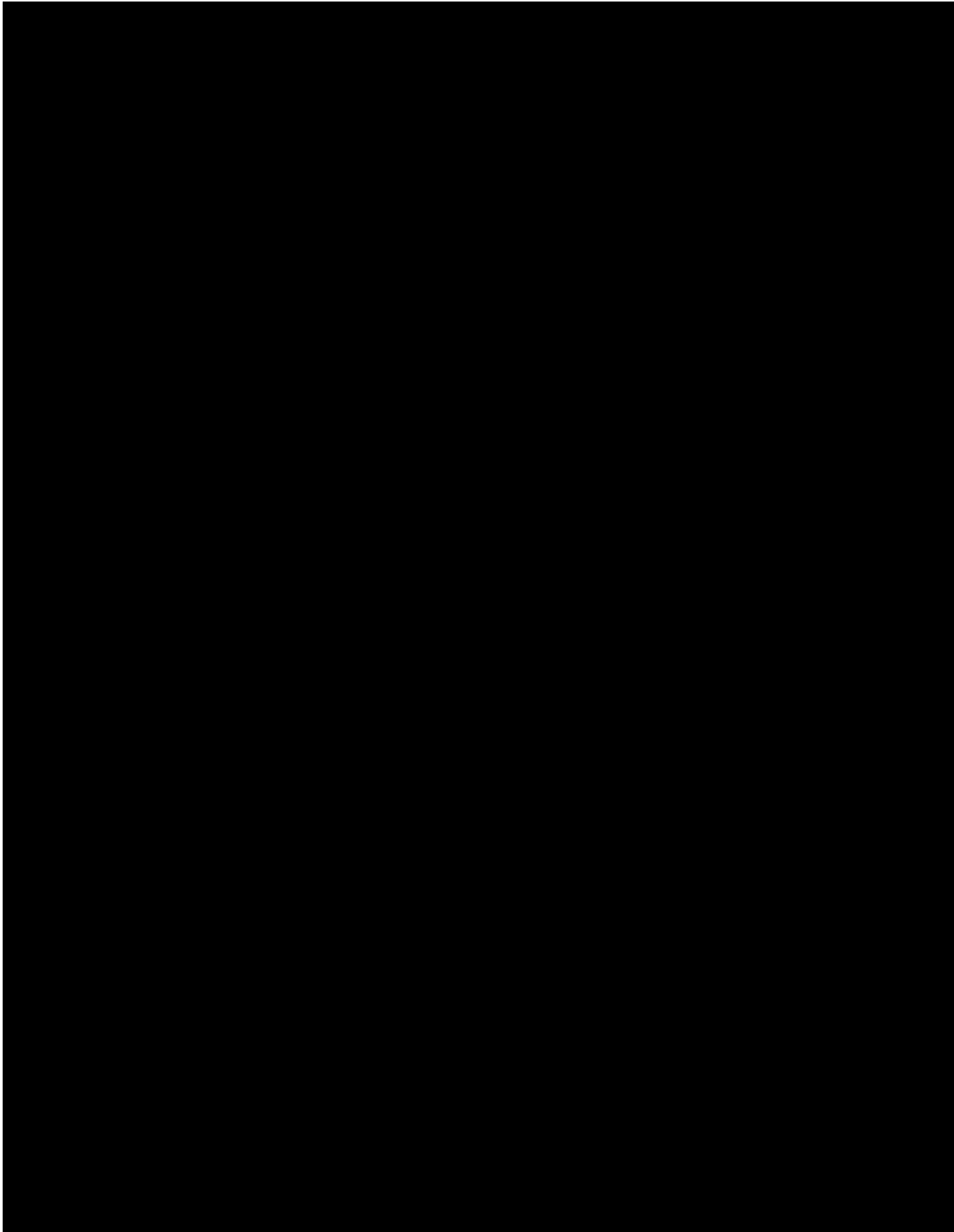
> the investment in Standard stock in 1929 and held on to the stock as an investment until 1936 [when it was contributed to the capital of the subsidiary and sold 10 months later]...It seems most reasonable to treat the loss as one which had in fact been sustained by the parent rather than by its subsidiary. The shifting of the loss to the subsidiary gives an artificial picture of its true taxable income and one which it was unnecessary for the Commissioner to accept.

Id. at 602-03. Numerous other cases have followed *National Securities* in allocating pre-contribution (or pre-distribution before the repeal of the *General Utilities* doctrine) gain or loss to the transferor or transferee on the subsequent disposition of contributed or distributed property by the transferee. *See, e.g., Ruddick Corp. v. United States*, 643 F.2d 747 (Cl. Ct. 1981), *on remand*, 3 Cl. Ct. 61, 65 (1983), *aff'd without op.*, 732 F.2d 168 (Fed. Cir. 1984); *Northwestern Nat. Bank of Minneapolis v. United States*, 556 F.2d 889, 892 (8th Cir. 1977), *aff'g*, 37 A.F.T.R.2d ¶76-1400 (D. Minn. 1976); *Dolese v. Comm'r*, 811 F.2d 543 (10th Cir. 1987), *aff'g*, 82 T.C. 830 (1984); *Foster v. Comm'r*, 80 T.C. 34, 160, 172-77 (1983), *aff'd in relevant part*, 756 F.2d 1430, 1433-4 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986). The Tax Court has recently interpreted the *National Securities* line of cases to apply in instances where there is a tax avoidance purpose. *Eli Lily & Co. v. Commissioner,* 84 T.C. 996, 1119 (1985), *aff'd in part, rev'd in part*, 856 F.2d 855 (7th Cir. 1988).

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

<u>CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS</u>





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