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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
Att.:

FROM: Jeffrey L. Dorfman
Chief, CC:INTL: Br5

SUBJECT: A Corp

We are writing pursuant to your Date M memorandum which requested advice on the development of facts and legal theories to be applied in analyzing a sale-leaseback transaction ("the Transaction"). Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used as precedent.

LEGEND

A Corp =
B Corp =
C Corp =
D Corp =
E Corp =
R Products =
S Products =
Date M =
Date N =
Date O =
Date P =
Date Q =

Date R	=
Date S	=
Year X	=
$J	=
$K	=
$L	=
$M	=
$N	=
$P	=
$Q	=
$R	=
$S	=
$T	=
$U	=
Bank K	=
Bank L	=
Bank M	=
Document Q	=
Document R	=
Y%	=
Z%	=
Florida	=
Excerpt A	=

ISSUE

What facts should be developed and what legal theories should be used in analyzing the Transaction?

CONCLUSION

We recommend that three economic substance analyses be performed to analyze the Transaction: sham in substance; sale-leaseback vs. secured financing; and step transaction. Additional facts need to be developed in order to properly perform these analyses.

However, based on the information available to date, an argument can be made that the substance, or end result, of the Transaction should be given tax effect, rather than looking at the sale and leaseback as separate steps. This could have the effect of disregarding the sale, leaseback, and the rent prepayment. In turn, the Transaction could be recharacterized as a section 301(c) distribution followed by a capital contribution -- which appears to be the net effect of the Transaction. An alternative characterization would be to treat the net difference between the asset purchase price and the rent prepayment as a loan.

FACTS

From your Date M memorandum and the Date S package of materials, we understand the facts to be as follows.

A Corp ("A Corp") is a publicly traded manufacturer of R Products that is organized in the United States. A Corp acquired B Corp ("B Corp"), also a U.S. corporation, on Date N in a non-taxable stock acquisition under I.R.C. § 368(a)(2)(E). B Corp is a manufacturer and supplier of S Products. When B Corp was acquired, it had approximately $J in net operating losses, which could be offset only against B Corp's post-acquisition income. Subsequent to the acquisition, A Corp filed consolidated returns which included B Corp.

On Date P, B Corp and A Corp's controlled foreign corporation (“CFC”), D Corp ("D Corp") entered into the Transaction. [D Corp is comprised of three separate CFCs. However, for the purposes of our discussion, we will not distinguish between them.] D Corp develops, manufactures and markets a variety of generic and branded R Products in foreign countries.

Under the Transaction, B Corp purchased from D Corp tangible assets valued at approximately $K, which B Corp immediately leased back to D Corp. Included in the assets subject to the Transaction were office equipment, factories, factories under construction, machinery, furniture, computers, and communications equipment. At least with respect to some of the assets sold, ownership registration forms were changed to reflect the sale of the assets, and value added taxes were paid.

The leases were net leases, but B Corp was required to insure the assets. D Corp's obligation to pay rent was unconditional. All risk of loss associated with the destruction of the assets remained with D Corp, with D Corp also being responsible for all taxes relating to the property.

Although rent was payable in fixed (and constant) amounts on the first of every month, D Corp prepaid to B Corp rental payments of approximately $M -- approximately Y% of the rent due under the leaseback. Such a rent prepayment was explicitly permitted under the terms of the leases, but could only be made for the full amount of outstanding rent under the entire lease terms. [We are uncertain, however, why only Y% of the outstanding rent was subject to the prepayment. We ask that the District consider whether this difference may be accounted for through a discounting factor.]

Several other aspects of the leases are also worthy of mention. B Corp, if permitted under local law, could sell the assets without notice to D Corp. The lease terms for computer and communications equipment was 2 years. The lease terms for all other assets were between 4 and 10 years, depending on the asset. We have no information on the useful of life of any of these assets, and whether the sale price or the rent price reflected their fair market values.

The examining agent identified the following cash flows associated with the Transaction:

Date	Amount	Paid By	Bank	Recv'd By	Bank	Comments
Date O	$U	B Corp	Bank K	B Corp	Bank L	[1]
Date P	$S	A Corp	Bank M	B Corp	Bank L	[2]
Date P	$Q	B Corp	Bank L	D Corp	Bank L	[3]
Date P	$R	D Corp	Bank L	B Corp	Bank L	[4]
Date P	$R	B Corp	Bank L	A Corp	Bank L	[5]
Date P	$S	A Corp	Bank L	A Corp	Bank M	[6]

A Corp identifies three business reasons for the Transaction: (1) the assets were moved to A Corp's consolidated balance sheet to avoid value fluctuations due to foreign exchange rates; (2) B Corp obtained funds to reduce its outstanding debt and related interest expense; and (3) U.S. lending institutions looking to lend to A Corp (or extend lines of credit) would extend more favorable terms if the assets of the borrower were owned by a subsidiary organized and doing business in the United States.

The tax consequences of the Transaction, according to A Corp, was B Corp's recognition of the rent prepayment as income, which A Corp used in its Year X consolidated income tax return to offset a portion of B Corp's net operating losses that were subject to SRLY limitations. B Corp also began claiming depreciation on the property purchased.

The District believes that the Transaction is merely a shuffling of assets undertaken principally, if not exclusively, for tax purposes. The District refers to an excerpt from Document Q of D Corp in support of their position that the Transaction is devoid of economic substance:

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[1] B Corp's interbank transfer of cash invested in marketable securities.

[2] Borrowing by A Corp (on credit line) transferred to B Corp as a capital contribution.

[3] B Corp's purchase of property from D Corp.

[4] D Corp's rent prepayment to B Corp.

[5] B Corp's section 301(c) distribution to A Corp.

[6] A Corp repayment of Bank M loan.

Excerpt A

On Date Q, A Corp sold B Corp to C Corp, an unrelated entity. The next day, on Date R, approximately two and one-half years after the original sale-leaseback, D Corp repurchased from B Corp the assets remaining under the sale-leaseback for approximately $N in a transaction assumed to have been arranged before A Corp's sale of B Corp. Document R provides that the assets were sold at their fair market value.

The District would like to know which additional facts should be developed and which legal theories should be applied in analyzing the Transaction.

LAW AND ANALYSIS

A. **Overview**

The sham doctrine is the principal theory under which the Transaction may be analyzed. Under this doctrine, the economic substance of the Transaction is considered in determining whether the Transaction's form is other than its purported characterization. Under *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), one of the seminal cases on sale-leaseback transactions, the form of a sale-leaseback transaction will be respect where (1) it is multiparty; (2) possesses economic substance; (3) is compelled by business or regulatory realities; and (4) is imbued with tax-independent considerations, while not being shaped by tax avoidance motives with meaningless labels. Under the progeny of *Frank Lyon*, the second factor, the presence of economic substance, is determined under a non-exclusive, five-factor test: (1) the presence of arm's length negotiations; (2) the relationship between the sales price and fair market value of the assets; (3) the financing structure of the transaction; (4) the adherence to the contractual terms; and (5) the reasonableness of the income and residual value projections. Also relevant in this latter analysis is the fact that the buyer/lessor and the seller/lessee are related entities, which warrants special scrutiny in an economic-substance inquiry. If the foregoing five-factor analysis reveals that a sale-leaseback transaction lacks economic substance, the transaction is unwound. Accordingly, (a) the rental income inclusions and depreciations deductions (of the buyer/lessor), and (b) the sales income inclusions and rental deductions (of the seller/lessee) are disregarded and may be recharacterized in accordance with their substance. A possible recharacterization would be to treat the transaction as a series of a section 301(c) distributions and contributions to capital.

Similarly, rental and sales income and depreciation and rental deductions may be disregarded where the economic substance of a sale-leaseback transaction is more akin to a secured financing than a sale. In such an instance, the parties are treated as experiencing the tax consequences of a secured loan, rather than a sale-leaseback. In making the sale-vs.-secured-financing determination, relevant factors include whether the seller/lessee still possesses the benefits and burdens of ownership, the tax and accounting treatment of the transaction, whether the payment terms reflect a loan or a sale, the entity that has the risk that the property will not yield the anticipated revenue, and whether the documentation and conduct of the parties reflect a sale. Additional factors are discussed later in this Memorandum.

A third type of economic-substance analysis may also be used to analyze the Transaction: the step-transaction doctrine. Like the prior two analyses, the step-transaction analysis may result in disallowing the tax consequences of a sale-leaseback transaction. This may be achieved by application of the "end-result test" of the step-transaction analysis. Under this test, an inquiry is made as to whether the sale-leaseback transaction at issue, as well as the concomitant transactions that are related thereto, are a series of formally separate steps that are really prearranged parts of a single transaction, which was intended at out the outset. If so, then all steps of the transaction are collapsed and tax effect is only given to the end result.

Based on the information available to-date, an argument can be made that under (a) the five-factor, economic substance test; and (b) the end-result test of the step-transaction doctrine, the economic substance of the Transaction is really a $T section 301(c) distribution by B Corp to A Corp, followed by a $L capital contribution from A Corp to D Corp. An alternative characterization under the sale-vs.-secured-financing analysis can be argued that would to treat the net difference between the asset purchase price and the rent prepayment as a $P loan from B Corp to D Corp. [Below, we discuss how these figures were derived.]

B. **<u>Economic Substance — Generally</u>**

It is well established that a transaction devoid of economic substance must be disregarded for federal income tax purposes, even where its form indisputably satisfies the literal requirements of the relevant statutory language.[7] *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978); *ACM Partnership v. Commissioner*, 157 F.3d 231, 246-47 (3d Cir. 1998), *aff'g in pertinent part,* T.C.

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[7] Transactions that lack economic substance are to be distinguished from transactions that are alleged to have taken place but in fact did not (<u>i.e.</u>, factual shams). No question was raised in your request for field service advice that suggested the transaction at issue was a factual sham and we assume it was not.

Memo. 1997-115, 73 T.C.M. 2189 (1997); *Agro Science Co. v. Commissioner*, 934 F.2d 573, 576 (5th Cir. 1991); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985). Whether a transaction has economic substance is a factual determination and the burden of proof rests with the taxpayer. *ACM Partnership*, 73 T.C.M. at 2217.

In determining whether a transaction has economic substance, the transaction must be viewed as a whole, and each step is relevant. *ACM Partnership*, 157 F.3d at 247. Thus, an analysis of the Transaction must take into account, *inter alia,* funds borrowed by A Corp that were contributed to the capital of B Corp, the sale and leaseback arrangement between B Corp and D Corp, the prepayment of rent obligations by D Corp, the section 301(c) distribution from B Corp to A Corp, and the pre-existing net operating losses of B Corp at the time it was acquired by A Corp.

Generally, the inquiry into the economic substance of a transaction looks to the objective economic substance of the transaction and the subjective business purpose behind the transaction. These two aspects of an economic substance inquiry do not constitute a rigid two-step test, but rather represent related factors, both of which inform the analysis. *Id.*; *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988).

The phrasing of the objective test has varied among the different courts. For example, in *ACM Partnership*, the Tax Court articulated the objective test as requiring that there be "a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs." 73 T.C.M. at 2217. On appeal, the Third Circuit in *ACM Partnership* repeatedly searched for "any practical economic effects" of a transaction other than the creation of income tax benefits by examining the taxpayer's financial condition before and after the transaction. 157 F.3d at 248-252. Under the Fourth Circuit's expression of the test in *Rice's Toyota World*, a transaction has no economic substance where "no reasonable possibility of a profit exists." 752 F.2d at 91. *See also Friendship Dairies v. Commissioner*, 90 T.C. 1054, 1062 (1988). *Cf. Killingsworth v. Commissioner*, 864 F.2d 1214, 1218 (5th Cir. 1989) (objective analysis involved examination of "profit making potential").

While the specific articulation of the objective test has differed among the courts, the fundamental principle is that a transaction must have real and practical economic effects other than the creation of income tax benefits in order to satisfy the objective aspects of the sham analysis. *See Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988), *cert. denied*, 488 U.S. 824 (1988) (objective and subjective factors are considered in determining "whether the transaction had any practical economic effects other than" generating tax benefits). *See also Rose v.*

Commissioner, 868 F.2d 851, 853 (6th Cir. 1989); *Chapman v. Commissioner*, T.C. Memo. 1997-147, 73 T.C.M. 2405, 2414 (1997).

Like the objective test, various articulations of the subjective test have been set forth by the courts. *See, e.g., ACM Partnership,* 157 F.3d at 253 (whether the transaction was intended to serve any "useful non-tax purpose"); *Rice's Toyota World, Inc.*, 752 F.2d at 91 (whether "the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering in the transaction"); *Friendship Dairies, Inc.*, 90 T.C. at 1062 (same). *See also Yosha v. Commissioner*, 861 F.2d 494, 501 (7th Cir. 1988) ("Judges can't peer into people's minds or 'weigh' motives.... Rather, the usual approach is to focus the analysis on whether any non-tax goals or functions were or plausibly could have been served by the action."). The common thread of these expressions, however, is whether the transaction has a business purpose other than obtaining tax benefits.

The general economic substance principles set forth above have been applied to sale-leaseback arrangements. In doing so, the courts have tailored these general principles to address factors unique to such arrangements.

C. **Economic Substance Test in Sale-Leaseback Cases**

1. **Generally**

In the sale-leaseback context, the economic substance inquiry is made with three foci – one on the seller/lessee's interest, another on the buyer/lessor's interest, and a third on the contractual relationship between the two. *Hilton v. Commissioner*, 74 T.C. 305, 348 (1980), *aff'd,* 671 F.2d 316 (9th Cir. 1982) (interpreting *Frank Lyon*). *See, e.g.,* Levy *v. Commissioner*, 91 T.C. 838, 853 (1988) (the buyer/lessor must retain the significant and genuine attributes of traditional lessors in order for a sale-leaseback to be respected). *Accord Stacom v. Commissioner,* 61 T.C.M. (CCH) 2691, 2700, *aff'd per curiam,* 987 F.3d 774 (11th Cir. 1993). *Frank Lyon* Co., *supra*, at 584. Each of these three items must have substantial legal and economic significance aside from tax consequences. *Id.* This legal and economic significance is analyzed under the principles set forth by the Supreme Court in *Frank Lyon*. Under these principles, a sale-leaseback transaction will be recognized for tax purposes where (1) it is multiparty; (2) possesses economic substance; (3) is compelled or encouraged by business or regulatory realities; and (4) is imbued with tax-independent considerations, while not being shaped solely by tax-avoidance features that have meaningless labels attached. *Frank Lyon Co., supra*, 435 U.S. at 583-584. *See also Stacom, supra,* 61 T.C.M. (CCH) at 2697; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1990), *aff'g*, 87 T.C. 905 (1986); *Hilton, supra,* 74 T.C. at 347.

The fact that the seller/lessee and buyer/lessor in a sale-leaseback transaction are related entities warrants special scrutiny, as use of legal formalities may give the appearance of substance where it would otherwise be lacking. *Riverpoint Lace Works, Inc. v. Commissioner*, 13 T.C.M. (CCH) 463, 466 (1954) (citations omitted); *Shaffer Terminals, Inc. v. Commissioner*, 16 T.C. 356, 362 (1951), *aff'd per curiam,* 194 F.2d 539 (9th Cir. 1952), *citing, Higgins v. Smith,* 308 U.S. 473 (1940); *Carroll v. Commissioner*, 37 T.C.M. (CCH) 736, 741 (1978). In the related-party context, the concern is that,

> [A] person may reduce his income tax by transferring his money from one pocket to another even though he uses different trousers. A man with a half-dozen pockets might almost escape [tax] liability altogether.

Alpha Tank & Sheet Metal Mfg. Co. v. United States, 116 F. Supp. 721, 723 (Cl. Ct. 1953). *See Berry v. Commissioner,* 23 T.C.M. (CCH) 1077, 1083 (1964), *citing inter alia*, *Shaffer Terminals, Inc., supra*, 16 T.C. at 362 (Shamming a sale-leaseback transaction between related parties where the purported sale could be financed solely through the rent received, and the seller/lessee had complete control over the property and the right to use the property as it wished, lacking only bare legal title.); *Waegemann v. Commissioner*, 66 T.C.M. (CCH) 1808, 1817-8, 1820 (1993), *rev'g itself on other grounds*, 67 T.C.M. (CCH) 3096 (1994) (holding that a circular flow of funds among related persons consisting of interest and rent payments arising from loans and leases between related parties that were intended to generate tax deductions without economically changing the parties' economic positions and/or interests were shams). *See generally Garvey v. United States,* 75 A.F.T.R.2d (RIA) 1632 (N.D. Ga. 1995) (Holding that circular flow of funds created by a series of sale-leaseback transactions insulated the taxpayer from economic loss); *Vander Heide v. Commissioner*, 75 T.C.M. (CCH) 1588 (1998) (same); *Weller v. Commissioner,* 270 F.2d 294, 297 (3d Cir.1959), *cert. denied*, 364 U.S. 908 (1960) (Transactions which do not vary control or change the flow of economic benefits are to be dismissed from consideration if they "do not appreciably change the taxpayer's financial position." [Internal citations and quotations omitted.]). Note, however, although relevant to an economic substance inquiry, the fact that one party to a sale-leaseback transaction is related to the other party does not, alone, render the transaction a sham.[8] An economic substance analysis must still be performed.

Thus, these authorities referring to sale-leaseback transactions between related parties may be used in challenging the Transaction if it can be demonstrated that the Transaction did not change D Corp's and/or B Corp's economic rights and interests in the property. However, before a position by the District is formulated, we ask that you consider the following case law discussion that outlines courts' approaches to the economic substance inquiry in the sale-leaseback context.

2. **Economic Substance of Buyer/Lessor's & Seller/Lessee's Interests**

As indicated above, a sale-leaseback, economic-substance inquiry is made with three foci: on the seller/lessee's interest; on the buyer/lessor's interest; and how their interests are expressed contractually. In this context, courts consider whether to recognize the sale-leaseback and its concomitant tax consequences, or to apply other tax consequences more reflective of the transaction's true substance. Immediately below in sections C.2.a. and C.2.b., we discuss the factors upon which the courts have focused in determining whether a buyer/lessor's (B Corp) and seller/lessee's (D Corp) interests support the form of the sale-leaseback, or warrant alternative characterization (such a section 301(c) distribution and followed by a contribution to capital). Following this section in section C.3, we discuss whether the buyer/lessor's and the seller/lessee's interests are more reflective of a secured loan, rather than a sale-leaseback.

a. **Significant Factors in Analyzing a Buyer/Lessor's & Seller/Lessee's Interests**

Courts have found the following factors significant in analyzing the economic substance of the buyer/lessor's and seller/lessee's interests:

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[8] *Carroll,* 37 T.C.M. at 741. The relationship of the parties to the sale-leaseback transaction is also relevant to a point made in the Court's rationale in *Frank Lyon*. Specifically, the Court noted that the presence of more than two entities in a sale-leaseback transaction, such as a third-party financier, may be suggestive of economic substance. *Frank Lyon, supra,* at 575-6 (The Court in *Frank Lyon* respected a sale-leaseback involving three parties, and stated that this fact -- the number of participants in the transaction -- removed the case from *Lazarus v. Helvering*, 308 U.S. 252 (1939) (which held that the economic substance of the sale-leaseback transaction at issue was akin to a mortgage loan rather than a true sale-leaseback) as controlling authority. *See also Hilton, supra,* 74 T.C. at 363.

1. The presence or absence of arm's length negotiations;
2. The relationship between the sales price and the fair market value;
3. The structure of the financing;
4. The degree of adherence by the parties to the contractual terms; and
5. The reasonableness of the income and residual value projections.

Stacom, supra, at 2698, *citing*, *Helba v. Commissioner*, 87 T.C. 983, 1005-1011, *aff'd per curiam,* 860 F.2d 1075 (3rd Cir. 1988), *cert. denied,* 490 U.S. 1046 (1989); *Karme v. Commissioner*, 73 T.C. 1163, 1186 (1980), *aff'd*, 673 F.2d 1062 (9th Cir. 1982); *Zirker v. Commissioner*, 87 T.C. 970 (1980); *Rice's Toyota World, Inc., supra*, 81 T.C. at 204-7. *See also Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. 41, 45-9 (1950), *acq.,* 1950-2 C.B. 4 (Analyzing these factors in holding that a sale-leaseback transaction had economic substance where (a) arm's length negotiations were present; (b) the property was sold at its fair-market value, (c) the financing of the transaction was not structured so as to maximize tax benefits, (d) the buyer/lessor was unrelated and uncontrolled by the seller/lessee, and (e) a valid business purpose motivated the taxpayer to enter into the transaction). Below is a discussion of courts' application of these factors.

i. **<u>Arm's Length Negotiations</u>**

Not surprisingly, a lack of arm's length negotiations concerning the terms of a sale-leaseback transaction suggests a lack of economic substance. *See Stacom, supra*, at 2698; *Southeastern Canteen Co. v. Commissioner*, 410 F.2d 615, 620 (6th Cir. 1969), *cert. denied*, 396 U.S. 833 (1969); *W.B. Lasher Co. v. Commissioner,* 51 T.C.M. (CCH) 1234, 1241-2 (1986). Also, where the property that is subject to a sale-leaseback transaction between related parties would not have been sold by a seller/lessee to an unrelated party at arm's length, may also be suggestive of a transaction lacking economic substance. *See W.H. Armston Co., Inc. v. Commissioner*, 188 F.2d 531, 533 (5th Cir. 1951), *aff'g*, 12 T.C. 539 (1949).[9] Likewise, also relevant is whether the buyer/lessor, at arm's length, would be willing to buy and lease the type of assets at issue. *See Unger v. United States*, 61-1 U.S.T.C. ¶ 9163, p. 79,309-10 (N.D. Tex. 1960). Other factors include whether the

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[9] State A was part of the 5th Circuit at the time of the *W.H. Armston* opinion, and the case arose out of State A.

assets were inspected by the buyer/lessor;[10] whether the buyer/lessor had experience in leasing or dealing with assets of the type at issue;[11] and whether the change in ownership was properly recorded on the parties' internal books and records, and whether these records were made available to third parties.[12]

We suggest that the District ascertain whether (a) B Corp and D Corp negotiated at arm's length, (b) the assets at issue in the Transaction would have been sold and leased back between unrelated parties, (c) B Corp had experience in leasing such assets, and (d) B Corp inspected the assets before their purchase.

ii. **Relationship Between Sales Price & Fair Market Value**

A difference between the sales price and the fair market value of the assets at issue also suggests a dearth of economic substance. *W.H. Armston Co., supra,* 188 F.2d at 532; *Miles v. Commissioner*, 41 T.C. 165, 172, 179-80 (1963) (dealing with a sale-leaseback of patent rights);*Grodt & McKay Realty, supra,* 77 T.C. at 1238-9; *Milbrew, Inc., supra*. On this point, we note that the assets appeared to have been appraised before their sale. If these appraisals reflected the fair market value of the assets, then it would militate toward a finding of economic substance. *But see, infra,* section C.2.a.v. of this memorandum (discussing the factors that are relevant in determining whether an appraisal will be respected by a court and whether it reflects dealings between parties acting at arm's length).

iii. **Financing Structure of the Transaction**

Like the first two factors, structuring the financing of a sale-leaseback transaction so as to maximize the intended tax benefit (objectively determined), or the fact that none of the funds extended by the buyer/lessor went to the seller/lessee, may suggest a lack of economic substance. *See Stacom, supra*, at 2698; *Hilton, supra,* 74 T.C. at 359-60; *Shaffer Terminals, Inc., supra,* 16 T.C. at 364. *But see Broun v. United States*, 70 A.F.T.R.2d (RIA) 5962, 5964 (M.D. Ga. 1992) (The structuring of a sale-leaseback so as to avoid adverse consequences under I.R.C. § 465 where there was a valid business purpose for engaging in the transaction will not cause the transaction to be a sham). However, the fact that favorable tax consequences

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[10] *See Unger, supra,* 61-1 U.S.T.C. at 79,309-10.

[11] *Id.*

[12] *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1238 (1981); *Milbrew, Inc. v. Commissioner*, 42 T.C.M. (CCH) 1467 n. 20 (1981), *aff'd*, 710 F.2d 1302 (7th Cir. 1983).

arising from the transaction are considered by the parties will not, alone, render the transaction a sham. *Sacks v. Commissioner*, 69 F.3d 982, 991 (9th Cir. 1995), *citing*, *Frank Lyon, supra,* at 580.

By contrast, the following transaction structures may suggest economic substance:

- If a sale-leaseback transaction is structured in a manner that exposes one of the parties to the transaction to potential liability vis-á-vis third parties. *See Frank Lyon*, *supra*, at 576-7.

- The treatment of the sale-leaseback transaction in a manner consistently for tax and accounting purposes, and in a manner that may adversely affect the taxpayer for non-tax purposes (increased balance-sheet debt, for example). *Frank Lyon, supra*, at 577. *But see Id.* (tax and accounting characterization need not be the same).

- A capital investment by the seller/lessee. *Frank Lyon, supra*, at 581.

- A seller/lessee's particular financing needs for the sale-leaseback transaction and the revenue received therefrom. *Hilton*, *supra*, 74 T.C. at 346 (referring to *Frank Lyon*).

- A method of payment by the buyer/lessor for the assets, where the payment is expected to "yield an equity [investment] which the buyer/lessor [w]ould not prudently abandon." *Hilton, supra,* 74 T.C. at 350, 360 (adopting the analysis of *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1098 (9th Cir. 1976), *aff'g*, 64 T.C. 752 (1975)). Equity is built, for example, where the purchase price for declining value assets, such as computer equipment, is such that equity will nevertheless be earned. *See W.B. Lasher Co.,* 51 T.C.M. at 1242.

- Recourse financing. *Hilton, supra,* 74 T.C. at 363 (referring to *Frank Lyon*).

The *Frank Lyon* and *Hilton* factors, discussed above, that suggest economic substance seem to be inapposite to the facts of the Transaction. This is because (a) the immediate section 301(c) distribution by B Corp to A Corp of an amount equal to D Corp's rent prepayment prevented B Corp from benefitting from the leaseback and the funds received therefrom; and (b) the Transaction was not financed by debt of B Corp.

Further, in light of the financing structures that militate against a finding of economic substance, the District may consider that because (a) after all the steps of the Transaction, D Corp retained only Z%[13] of the proceeds from the asset sale; and (b) A Corp retained none of the funds from the rent prepayment (after the section 301(c) distribution), the Transaction was without substance. In bolstering this argument, the District should seek to ascertain whether the rent prepayment was intended by the parties as a way to prevent the expiration of SRLY losses, and concomitantly increase A Corp's equity in D Corp, or whether there was a business purpose behind the rent prepayment.

iv. **Adherence to Contractual Terms**

Similar to the first factor (considering the presence or absence of arm's length negotiations) in this analysis, the lack of compliance with the contractual terms of a sale-leaseback transaction, including, *inter alia*, late or non-payments, suggests an absence of economic substance. *See Stacom, supra*, at 2698; *See Unger, supra*, at p. 79,310; *Riverpoint Lace Works, Inc., supra*, 13 T.C.M. at 466-7. *But see Carroll, supra,* at 743 (where the seller/lessee does not pay rent timely under a sale-leaseback transaction and similarly does not pay third parties timely on their debts, the seller/lessee's tardy payments to the buyer/lessor will not cause the transaction to be a sham).

Concerning the Transaction, we are uncertain whether the terms of the leaseback were complied with and suggest factual development accordingly. We also suggest an inquiry be made as to whether the advance payment of rent accounted for all the rent due under the lease term, as partial rent prepayments were contractually not allowed. Also relevant would be D Corp's practice of advance paying its obligations.

v. **Reasonableness of Income & Residual Value Projections**

Another factor in the sale-leaseback, economic substance analysis focuses on the reasonableness of the income and residual value projections. Unreasonable projections are suggestive of a lack of economic substance, and may be inferred from (a) failure to account for new product innovations that negatively affect the value of the assets at issue; (b) the lack of independence of the asset appraisal and the identity of the participant that paid for the appraisal; (c) an inaccurate methodology, or absence thereof, used to determine residual value; (d) the lack of consistency between the appraisal at-issue and other appraisals issued by the appraiser; (e) failing to consider the particular characteristics of the assets at-issue, such as the make, model, location, installation, and reputation/quality of the end

[13] This figure is computed as follows: 1 - [($R rent prepayment) ÷ ($Q payment on asset purchase)].

user; (f) an unrealistic return would be required on the investor's funds (including accounting, legal, brokerage, and similar costs) before it would realize a profit on the transaction; (g) the fact that only one appraisal was obtained -- particularly since a buyer and a seller often have converse interests in valuing the property. *See Stacom, supra*, at 2698, 2700; *Hilton, supra,* 74 T.C. at 352-5; *W.B. Lasher Co.,* 51 T.C.M. at 1234. *See also Rice's Toyota World*, *supra*, 752 F.2d at 92 (It may be indicative of a sham transaction if the taxpayer fails to obtain independent, expert estimations of the residual value of the property at the end of the lease term in order to determine whether a profit can be made on the transaction.).

Further, where there is no reasonable opportunity for profit -- exclusive of tax benefits -- a sale-leaseback transaction may be viewed as a sham. *Levy*, *supra*, at 853-4; *Estate of Thomas v. Commissioner*, 84 T.C. 412, 438-9 (1985); *Rice's Toyota World, supra*, 752 F.2d at 91-92. *See also Stacom, supra*, at 2699-700 (Where the residual value and/or income projections of assets subject to a sale-leaseback transaction are not sufficient to yield an appropriate return on a taxpayer's investment (exclusive of tax benefits), such a finding will support a conclusion that there was no business purpose behind the transaction and therefore that it was a sham). Also relevant to the objective "for profit" test are (a) the reasonableness of rent payments under the leaseback, and (b) whether the buyer/lessor assumes the risks associated with the possibility that the property will not yield the anticipated revenue. *See Milbrew, Inc., supra; Sacks, supra,* 69 F.3d at 989. If the buyer/lessor assumes the business risks of owning the property, such as whether the purchased asset will yield the anticipated revenue, then the sale-leaseback may be respected. *Compare Sacks, supra,* (risk shifting present) *with Casebeer v. Commissioner*, T.C. Memo. (CCH) 1987-628 (no risk shifting present). *See generally Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973); *Watts Copy Systems, Inc. v. Commissioner*, 67 T.C.M. (CCH) 2480 (1994). We note that D Corp retained all risk of loss with respect to the leased property which would be a factor indicating a lack of economic substance.

Concerning the facts of the Transaction, we are aware that the property transferred under the Transaction was evaluated by an appraiser. We are uncertain, however, whether the appraiser was independent, who paid for the appraisal, whether both A Corp and B Corp relied on the same appraiser, what methods were used to value the property and the residual value(s), and about the other details of the appraisal and property. We suggest facts be developed that assist in the application of this factor. *See DHL Corp. v. Commissioner*, T.C. Memo. 1998-461, pp. 202 - 208.

b. **<u>Business Purpose</u>**

An analysis of the business purpose underlying a sale-leaseback transaction must be made in conjunction with an analysis of the potential for economic profit. *Frank Lyon, supra; Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989), *aff'g*, *sub nom*, *Glass v. Commissioner*, 87 T.C. 1087 (1986). Carroll*, supra,* at 741-2. Like the objective for profit analysis, a business purpose analysis should be made from both the seller/lessee's and the buyer/lessor's perspective.

From a seller/lessee's perspective, examples of business needs that have supported a sale-leaseback transaction in the face of a business purpose challenge include a seller/lessee's need to do the following: construct a building for business operations to attract clients and better respond to competition (*Frank Lyon*, *supra*, at 563, 576); increase performance bonding capacity in order to bid on certain construction projects (*Carroll, supra,* at 737, 742); preserve capital for merchandising activities (*Sanderson v. Commissioner*, 50 T.C.M. (CCH) 1033 (1985)); generate cash due to financial difficulties (*West v. Commissioner*, 48 T.C.M. (CCH) 796, 801 (1984)); and expand physical facilities in the near future but being unable to find an adequate site currently (*Standard Envelope Mfg. Co., supra,* 15 T.C. at 49).

From the buyer/lessor's perspective, the buyer/lessor must have possessed an actual and honest profit objective for engaging in the transaction. *Rice's Toyota World, supra*, 752 F.2d at 92; *Rose v. Commissioner*, 88 T.C. 386, 411, *aff'd*, 868 F.2d 851 (6th Cir. 1989). Where the taxpayer has a reasonable expectation of profit on the transaction – considering the rent income, financing obligations, and residual value of the leased assets – the sale-leaseback transaction may not be a sham. *Broun, supra,* 70 A.F.T.R.2d at 5964. This is despite the fact that as long as there is a business purpose and a profit potential, the transaction may have been structured to maximize its intended tax effect. *Id.*

Courts have considered numerous sale-leaseback transactions between related parties as shams where there has been no business purpose, or where the business purpose was "conjured up" or "artificial." *Berry, supra,* 23 T.C.M. at 1077; *Chace v. United States*, 303 F. Supp. 513, 516 (M.D. Fla. 1969); *Riverpoint Lace Works, supra*, 13 T.C.M. at 466 (citations omitted); *Shaffer Terminals, Inc., supra*, 16 T.C. at 362; *Southeastern Canteen Co., supra*; *W.B. Lasher Co., supra*; *Unger, supra*; *W.H. Armston Co.*, *supra*. Similarly, a court may look past a stated business purpose and deem a sale-leaseback to be a sham where the objective indicia indicate a lack of a business purpose. *See Smoot v. Commissioner,* T.C. Memo. (CCH) 1991-268 (claims of a business purpose may be defeated where the taxpayer did not investigate the crucial aspects of the transaction as would a "prudent business[person]"); *Alpha Tank & Sheet Metal Mfg. Co.*, 116 F. Supp. at 724 (holding that there was "no material substance" behind the taxpayer's stated business purposes that the sale-leaseback was effected to remove the assets from a related entity's books (so the plant could not be taken by creditors) where the taxpayer remained financially liable and responsible for the sold/leased assets despite the sale-leaseback).

Moreover, where the sale and leaseback are integral parts of the same transaction between related persons, where there is no real change in ownership, and where the transaction was entered into in order to reduce the income tax of one of the related parties, a business purpose will not be found that will require the Service to respect the transaction for tax purposes. *Alpha Tank & Sheet Metal Mfg. Co., supra*, 116 F. Supp. at 724; *Unger*, *supra,* 61-1 U.S.T.C. at 79,310; Rev. Rul. 68-430, 1968-2 C.B. 44. Further, the Service may be able to sham the sale-leaseback transaction in such an instance despite the fact that the buyer/lessor may make a profit on the sale-leaseback transaction where the funds used to finance the sale-leaseback transaction are simply recycled between a group of related persons. *See Unger, supra* (Taxpayer's mother borrowed funds from taxpayer's controlled company in order to purchase assets and then lease them back to her son. Monthly rents of $2,000 were paid by the son and deposited in the mother's bank account (which the son controlled). Also, the $1,500 monthly loan payments were withdrawn from the account and paid to the son's controlled company. The mother had no business experience in operating the assets at-issue, there did not appear to be a business purpose for the son to engage in the sale-leaseback transaction, and the sale-leaseback transaction did not change the son's possession and use of the assets -- although legal title was vested in the mother. The court held that the sale-leaseback transaction was a sham.). Note, sale-leaseback transactions between family members are relevant in analyzing the economic substance of sale-leaseback transactions between taxpayers and their related corporations. *Carroll*, *supra,* 37 T.C.M. at 741.

With respect to the A Corp case, it is unclear what business purposes B Corp and D Corp, as opposed to A Corp, sought to achieve. The business purposes indicated in your Date M memorandum relate to the business purposes of A Corp, rather than business purposes of B Corp and D Corp. However, the sale-leaseback transaction must be supported by the business purposes of B Corp and D Corp rather than that of their shareholder(s). *Southeastern Canteen Co., supra,* 410 F.2d at 619 (agreeing with the reasoning of the Tax Court); *W.B. Lasher Co., supra,* 51 T.C.M. at 1241. Where the sole business purpose behind a sale-leaseback is that of a shareholder, the Service will not be required to respect the transaction. *Southeastern Canteen Co.,* at 619-620. We recommend additional development of the motivation of D Corp and B Corp.

3. **Sale vs. Secured Financing Analysis**

Sale-leaseback transactions may be structured so that, in substance, they are financing transactions, *i.e.*, loans, rather than shams. Both sham and financing transaction treatment result in disregarding a transaction as a sale-leaseback. However, in the sham context, the transaction is unwound and the rental deductions/income and depreciation deductions are disallowed for tax purposes. *See* IRS EXAMINATION TAX SHELTER HANDBOOK, I.R.M. 4326 (hereinafter "TAX SHELTER HANDBOOK"), Ch. 800 at 844. By contrast, financing treatment results in a treatment of a transaction as a secured loan. *See Lazarus & Co. v. Helvering*, 308 U.S. 252, 255 (1939) (holding that a sale-leaseback transaction was a secured financing where taxpayer sold depreciable property to a Trust and leased it back for ninety-nine years with an option to renew and purchase). *See generally* TAX SHELTER HANDBOOK, *supra,* Ch. 300 at 3(20)0, Ch. 800 at 844, and, Sandra L. Randleman, *Sales and Leasebacks*, 36 TAX MANAGEMENT (BNA), worksheet 2 (1989) (hereinafter "*Sales and Leasebacks*"*)* (discussing factors to be considered in determining whether a sale-leaseback is a financing device).

Thus, an argument may be made that the Transaction was a secured financing, *i.e.*, a loan, rather than a sale-leaseback. In such an instance, D Corp's $R advance payment would not be treated as an advance payment of rent to B Corp. Rather, the rent prepayment would be treated as loan repayment, which would not cause income to be realized by B Corp (as buyer/lessor).

The consideration of a sale-leaseback transaction as a secured financing transaction is exemplified by *Illinois Power Co. v. Commissioner*, 87 T.C. 1417 (1986), *acq.in result in relevant part*, 1990-2 C.B. 1, *action on decision,* 1990-04 (Feb. 5, 1990), where the court addressed the issue of whether a corporation could disavow the form of a sale-leaseback transaction entered into with a controlled subsidiary and treat the transaction as a financing transaction. The court focused on the benefits and burdens of ownership of the property at-issue (nuclear fuel), and determined that because the taxpayer (the parent) had submitted "strong proof" that it retained the benefits and burdens of ownership, the transaction should be considered a financing transaction. *Id.* at 1442. Factors relevant to the court's conclusion included the following: the taxpayer treated the transaction as a financing for both tax and accounting purposes; represented to third parties that the transaction was, in substance, a financing transaction; the transaction was properly classified as a financing transaction under Rev. Rul. 55-540, 1955-2 C.B. 39, and Rev. Proc. 75-21, 1975-1 C.B. 715; the payment terms under the transaction reflected a financing transaction rather than a sale; the profits, losses, taxes, and risks arising from the possession and use of the property were the parent's, rather than the putative purchaser (the subsidiary); the subsidiary had no equity interest in the property; funds for the purchase of the property came from (or were guaranteed by) the parent; the rents had no visible connection with the economic value of the property. *Id.* 1432-42. *See generally Lazarus, supra; Torres v. Commissioner*, 88 T.C. 702 (1987).

In addition, the Tax Court has identified the following factors in considering whether a sale-leaseback transaction is a financing transaction: (1) Whether legal title passes; (2) Whether the parties treat the transaction as a sale; (3) Whether an equity interest was acquired in the property; (4) Whether the seller was obligated to execute and deliver a deed and the buyer is obligated to make payments; (5) Whether the purchaser had a vested right to possession; (6) Which party paid property taxes; (7) Which party received profits from operation or sale; (8) Whether the seller had unrestricted control of the funds received from the sale; (9) Whether the purchaser can recoup its investment from the income producing potential and residual value of the property; (10) Whether there is a purchase option at less than fair market value; (11) Whether the lease term is in excess of the useful life of the property; (12) Whether the renewal rentals at the end of the lease term are set at their fair market value rate; (13) Whether payment for the property is at its fair market value; (14) Whether net tax savings for investors (purchasers) are less than their initial investment; and (15) Whether the buyer/lessor bears the risk that the lessee will not make future rent payments. *See Watts Copy Systems, supra*; *Mapco, Inc. v. Commissioner*, 214 Ct. Cl. 389, 394-5, 405 (1977); *Grodt & McKay Realty, supra,* 77 T.C. at 1237-8, 1243; *Torres, supra*, 88 T.C. at 720-21; *Estate of Thomas, supra*; *Van Roekel v. Commissioner*, 56 T.C.M. (CCH) 1297 (1989), *appeal dismissed and remanded*, 905 F.2d 80 (5th Cir. 1990). If the buyer/lessor does not possess that risk, then the transaction may be considered a loan.

As is more fully discussed under section C.5 of this memorandum, consideration of the Transaction as a financing transaction may be factually inapposite due to the presence of the substantial rent prepayment. This prepayment, coupled with the immediately preceding contribution to B Corp's capital by A Corp, and B Corp's simultaneous section 301(c) distribution to A Corp appears to have the net economic effect of a deemed section 301(c) distribution by B Corp to A Corp and a contribution to the capital of D Corp by A Corp, rather than a loan. This is because in a loan, the funds transferred by the buyer/lessor (B Corp) would be in the hands of seller/lessee (D Corp) and be akin to loan proceeds. Under the Transaction, however, the would-be loan proceeds were immediately circulated back to B Corp, thus taking away from the appropriateness of a loan characterization for the $Q asset purchase price.

Nevertheless, we note that rather than viewing the Transaction as a section 301(c) distribution and a contribution to capital, it may be possible to consider the Transaction as a $P loan from B Corp to D Corp. This figure is the difference between the asset purchase price ($Q) and the advance rent payment ($R).

Accordingly, we suggest that the District develop facts that may be considered under the Tax Court's analysis in *Illinois Power Co.,* and fifteen factors outlined above. These factors will be relevant regardless of how the economic substance analysis is approached, *i.e.,* from both the financing transaction perspective, and from the sham (denial of deductions) perspective, as the economic substance inquiry is a facts and circumstances inquiry under which all relevant facts should be considered.

4. **Economic Substance & The Step Transaction Doctrine**

Thus far, we have discussed two applications of a sham analysis -- (1) lack of economic substance, and (2) sale-leaseback vs. secured financing. Another application of an economic substance analysis is the step transaction doctrine, which may also be used to analyze the substance of a sale-leaseback transaction. *See generally Louis A. Del Cotto*, *Sale Leaseback: A Hollow Sound When Tapped*, 37 TAX L. REV. 1, 28-32 (1981) (discussing the application the step-transaction doctrine to sale-leasebacks).

Under the step transaction doctrine, if an interrelated series of steps are taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole -- from the commencement of the transaction to the consummation of the transaction. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987); *Kirchman, supra,* at 1493-4; *Packard, supra*, at 420-1, *citing*, *D'Angelo Associates, Inc. v. Commissioner*, 70 T.C. 121, 129 (1978); *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 658 (5th Cir. 1968); *Atlee v. Commissioner*, 67 T.C. 395 (1976), *acq.*, 197-2 C.B. 1; *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969); *Century Electric Co. v. Commissioner*,192 F.2d 155, 159 (8th Cir. 1951), *aff'g,*15 T.C. 581 (1950), *cert. denied*, 342 U.S. 954 (1952). *See also Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

There is no universal test in applying this doctrine, but courts have applied three alternative tests: the binding commitment test, the end result test, and the interdependence test. *Penrod, supra*, at 1428-30. Under the binding commitment test, a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step. *Id.* at 1429 (citations omitted). Under the end result, a series of formally separate steps that are really prearranged parts of a single transaction intended from the outset to reach the ultimate result are collapsed. *Id.* at 1429-30 (citations omitted). Under the third test, the interdependence test, steps that are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series are collapsed. *Id.* at 1430 (citations omitted).

Although any of these tests may apply to a sale-leaseback transaction, the end result test may be most well suited to apply to the facts of the Transaction. This is because we are not aware of any binding commitment for each step of the Transaction, and we not aware that any of the steps of the Transaction would have been fruitless without the completion of all the steps in the Transaction. Further, the end result test is well suited to apply to situations, such as the Transaction, where the funds used in a sale-leaseback transaction are those that are circulated among related parties that are also parties to the transaction:

> Whether the `[s]ale and [l]ease [a]greement' which gave rise to [an] obligation to pay `rent' is such a [sale-leaseback] transaction as is recognizable for tax purposes depends, we think, upon the practical effect of the end result. The various steps [in the sale-leaseback transaction] were not separate, independent transactions, but integrated parts of a single plan and`in determining tax consequences we must consider the substance rather than the form of the transaction.'

Shaffer Terminals, Inc., supra, 16 T.C. at 363, *quoting*, *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949). *See Murry v. Commissioner*, 601 F.2d 892, 899 (5th Cir. 1979) (J. Tuttle dissenting and quoting *Kanawaha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685, 691 (5th Cir. 1954)). *See also Century Electric Co.*, *supra* (applying this principle to a sale-leaseback between unrelated parties). Where the end result of the sale-leaseback transaction involves a shifting of funds between related parties, a court may determine that the end result of sale-leaseback transaction is inconsistent with its treatment as such. *Shaffer Terminals, Inc.,* at 364-5. Likewise, where the seller/lessee has a continued need of the assets subject to a sale-leaseback between related parties, it may be inappropriate to consider the asset transfer and lease separately. *Carroll, supra,* at 741.

The step transaction doctrine also considers the business reason behind the formally discrete steps in the overall transaction. *Packard*, *supra,* at 421. *But see United States v. General Geophysical Co.*,296 F.2d 86, 90 (5th Cir. 1961), *rev'g*, 175 F. Supp. 208 (S.D. Tex. 1961), *cert. denied*, 369 U.S. 849, *reh'g denied*, 369 U.S. 891 (1962) ("Intent is often relevant in questions of taxation, particularly where the bona fides of a transaction is called into question, but in most cases[,] tax treatment depends on what was done, not why it was done."). This aspect of the Transaction needs to be further developed. We suggest that you investigate whether each of the steps was undertaken for the purpose of realizing certain tax benefits, and whether there was a business reason for the formally discrete steps in the overall transaction. *Packard*, *supra,* at 421-2.

Concerning the facts of the Transaction, the internal documents surrounding each cash transfer, *i.e.,* Bank M's loan to A Corp, the rent prepayment, B Corp's distribution to A Corp, etc., should be analyzed to ascertain A Corp's intended end result from the completed steps of the Transaction. If A Corp's intended end result was to withdraw funds from B Corp and transfer funds to D Corp while absorbing B Corp's SRLY losses, the step transaction doctrine may be applied to disregard the Transaction. The fact that the was no binding commitment to each step of the transaction, particularly the rent prepayment, will not prevent the application of the step transaction doctrine to the Transaction. *See General Geophysical Co., supra*, (A corporation distributed depreciable property (tax-free under section 311(a) as it existed at the time) to its shareholders, then purchased the property back from the shareholders for corporate notes. The corporation subsequently claimed a stepped-up basis and increased depreciation deductions as a result of the transaction. The shareholders were under no obligation to sell the property back to the corporation, even though it was sold back the same day as the transfer. The court held that the sale by the shareholders would be disregarded for tax purposes, because (a) the corporation made no physical delivery of the assets; (b) parted with legal title only for a few hours; (c) had uninterrupted use and control of the property; and (d) there was little likelihood that the shareholders would not sell the property back to the corporation.).

5. **Alternative Characterizations**

When an economic substance analysis is applied, a transaction must be viewed as a whole -- from commencement to consummation. *ACM Partnership, supra,* 157 F.3d at 247; *Court Holding Co. supra,* 324 U.S. at 334. Accordingly, the Transaction must be considered in conjunction with the other transactions occurring on the same day -- (a) the Bank M $S loan to A Corp, (b) the A Corp capital contribution to B Corp of $S, (c) the B Corp section 301(c) distribution to A Corp of $R, and (d) A Corp's repayment of the $S Bank M loan.

Where a sale-leaseback transaction between related parties is not respected for tax purposes, the Service may treat actual transfers of cash as I.R.C. § 301(c) distributions. *Shaffer Terminals, Inc., supra,* 16 T.C. at 363, *citing*, *Ingle Coal Corp. v. Commissioner*, 174 F.2d 569 (7th Cir. 1949). This may be particularly true where the sale-leaseback transaction did not affect the seller/lessee's right to use the assets. *See W.H. Armston Co.*, 188 F.2d at 533.

Accordingly, rather than its purported form, the District may view the substance of the Transaction as a $T section 301(c) distribution by B Corp to A Corp and a $L contribution to capital by A Corp to D Corp. The $L figure is the difference between (a) the asset purchase price of $Q and (b) the $R rent prepayment. This accounts for the $L net increase in the cash position of D Corp. The $T figure is the difference between (a) the $S contribution to capital by A Corp to B Corp and (b) the $R section 301(c) distribution from B Corp to A Corp. This accounts for the $T net decrease in the cash position of B Corp attributable to the combination of the contribution to capital and the section 301(c) distribution. The tax effect of such a characterization would be to increase B Corp's SRLY NOLs by the amount of the rent prepayment, reduce B Corp's e&p (if any) by the amount of the section 301(c) distribution, increase A Corp's basis in D Corp, and decrease D Corp's e&p in the year that the Transaction occurred (assuming D Corp sold the assets at a gain). This reduced e&p could increase any I.R.C. § 902 foreign tax credits that A Corp may have taken with respect to dividends (assuming sufficient e&p) declared by D Corp.

Alternatively, as indicated above, another characterization of the Transaction would be to treat the $P difference between asset purchase price ($Q) and the rent prepayment ($R) as a loan from B Corp to D Corp. This would also have the effect of disregarding the rent prepayment and increasing B Corp's SRLY losses. Other ancillary tax consequences could exist, such as deemed interest income and deductions, currency gain and/or loss, and e&p adjustments to both D Corp and B Corp.

D. **Other Theories**

1. **Section 1031 -- Like Kind Exchanges**

Section 1031(a)(1) provides that no gain or loss is recognized when property used in a trade or business is exchanged solely for like kind property. Courts have analyzed sale-leasebacks under section 1031 where the sale gives rise to a loss and the Service seeks to disallow a loss incurred on the sale of property in a sale-leaseback transaction, and where the transaction involved relates to real property where the lease term is 30 years or more. *Century Electric Co., supra*; Rev. Rul. 76-301, 1976-2 C.B. 241; Treas. Reg. § 1.1031(a)-1(c). *See generally Sales and Leasebacks*, *supra,* A-11 *et seq.*

Because the lease terms in the Transaction are less than 30 years, and absent evidence that the lease terms for the non-real property items transferred in the Transaction were equivalent to their useful lives, we do not believe a section 1031 analysis is appropriate on the facts of the Transaction.

2. **Section 482**

Section 482 allows the Service to allocate income, deductions, etc. arising from transactions between related parties. I.R.C. § 482. Accordingly, sale-leasebacks between related parties are subject to section 482. *See*, *e.g., Southeastern Canteen Co., supra*. Thus, where an amount paid pursuant to the sale-leaseback transaction differs from that which would have been paid at arm's length, the Service may allocate income and/or disallow deductions to the extent that the payments are not arm's length. *Id.* at 619-20.

Section 482 may also be applied by performing an economic substance analysis of the Transaction. *See* Treas. Reg. § 1.482-1(d)(3)(ii)(B); *Medieval Attractions N.V. v. Commissioner*, T.C. Memo. 1996-455 (RIA) 3277, 3322. See also *B. Forman v. Commissioner*, 453 F.2d 1144, 1160-1 (2nd Cir. 1972), *rev'g,* 54 T.C. 912 (1970), *cert denied*, 407 U.S. 934 (1972), *reh'g denied*, 409 U.S. 899 (1972) (Section 482 may overlap with section 162 and result in the denial of deductions where the lack of arm's length dealings results in payments between parties with a "close relationship" in an attempt to avoid taxes.). However, given the well-developed, economic substance case law relating to sale-leaseback transactions, currently we suggest developing the facts of the Transaction pursuant to the case law considerations outlined previously in this memorandum. To date, we have not determined whether an analysis of the Transaction under section 482 will differ from an analysis under the economic substance case law outside of section 482. When the facts of the case are more fully developed, we will consider the potential application of section 482 at that time.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

A. **Sale Leaseback**

As indicated above, in order to perform a more complete economic substance analysis, further information needs to be developed. In addition to these items, we suggest the following items for factual inquiry:

[redacted]

[redacted].

B. **<u>Assignment of Royalties</u>**

As a final point, your Date M memorandum notifies us of a similar transaction engaged in by B Corp and E Corp, a foreign subsidiary of A Corp. You state that B Corp assigned to E Corp rights to collect certain royalties, and that this assignment further accelerated income of B Corp and thereby unlocked SRLY net operating losses. We do not have sufficient information to adequately analyze this transaction. Accordingly, because (as you state) this royalty-acceleration transaction is similar to the Transaction, we suggest that you develop the analysis of the royalty-acceleration transaction pursuant to the case law outlined for the Transaction. In performing your analysis, *Martin v. Commissioner*, 56 T.C. 1255 (1971), *aff'd,* 30 A.F.T.R.2d (RIA) 5396 (5th Cir. 1972) (holding that a transaction structured as a sale of future rent payments was a loan rather than a sale of future rents); *Watts Copy Systems, Inc., supra; Mapco, Inc., supra;* and *Estate of Stranahan, supra* (dealing with the issue of whether a sale of future dividend rights was a sale or a financing arrangement) are particularly relevant.

Indeed, the economic substance inquiry regarding sale-leaseback of assets may be substantially similar to the assignment/sale of royalty rights. *See, e.g., Miles v. Commissioner*, 41 T.C. 165 (1963) (holding that a sale-leaseback of patent rights between related parties was devoid of economic substance where*, inter alia*, there was a substantial difference between the fair market value and the sales price, the transaction was undertaken to minimize taxes (although the taxpayer proffered non-tax business reasons as to why the transaction was effected), and the sale-leaseback did not affect the operation of the business as it existed before the transaction).

* * * * *

If you have any further questions, please call 202-622-3870.

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