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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE

MEMORANDUM FOR DISTRICT COUNSEL BROOKLYN
CC:NER:BRK
Attn: Andrew Mandell

FROM: Associate Chief Counsel (Corporate)
CC:CORP

SUBJECT: Lease Stripping Transactions

DISCLOSURE STATEMENT

This Chief Counsel Advice responds to your memorandum dated March 1, 2000. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

ISSUES

In your incoming memorandum, you requested guidance on several issues arising in transactions detected by the lease stripping ISP. Your questions concerning whether the transactions should be disregarded because they lack economic substance and transferee liability were addressed in an FSA dated October 16, 2000. Your question concerning the application of section 482 is being addressed separately by CC:INTL and CC:APJP, respectively. Your remaining questions, addressed in this TA are:

1. Do the transactions qualify as section 351 exchanges?

2. If the transactions are section 351 exchanges, what is the transferor's basis in the stock acquired in the exchange?

CONCLUSIONS

1. In addition to meeting the technical requirements of section 351, a transaction must have a bona fide non-tax business purpose to qualify as a section 351 exchange. The facts of each particular case will determine whether the transaction qualifies as a section 351 exchange.

2. The basis in the stock is limited to its fair market value, for several reasons set out in this memorandum.

BACKGROUND

These situations involve transactions that are structured to separate the right to rental income (and the realization of that income) from the obligation to pay related rental expenses (and the deduction of those expenses). The transactions are Lease Stripping Transactions described in Notice 95-53, 1995-2 C.B. 334. As stated in Notice 95-53, the Service will disallow deductions for losses and expenses generated by the transactions under the provisions of sections 269, 382, 446(b), 482, 701 or 704, 7701(l), and the underlying regulations. The Service may also recharacterize the transaction under assignment-of-income principles, the business-purpose doctrine, or substance-over-form principles (including step transaction and sham).

In addition, the exchange considered in this memorandum, viz., the transfer of an asset to a corporation in exchange for the transferee corporation's stock and its assumption of a transferor liability that (i) had not been taken into account for tax purposes by the transferor and (ii) is only slightly less in amount than the basis and value of the asset transferred, is substantially similar to that described in Notice 2001-17, 2001-09 I.R.B. 1. As provided in Notice 2001-17, the Service will disallow losses generated by the exchange for reasons that include sections 351, 269(a), and 357 of the Code, sections 1.1502-20(e) and 1.165-1(b) of the Income Tax Regulations, and because the transactions lack economic substance.

FACTS

X, a corporation, owns depreciable equipment subject to a pre-existing user lease with a 4-year term. P, a partnership, purchases the equipment from X in exchange for a $100x note; P immediately leases the equipment back to X for a term of four years and total lease payments due of $99x. P then sells the property (subject to the user leases) to Y, another corporation, in exchange for Y's $100x note; Y immediately leases the property back to P for a term of four years and total lease payments due of $99x. The residual value of the equipment is zero.

P then sells its right to receive the rent payments from X, accelerating the income due under the lease. P uses the sale proceeds to satisfy its note to X. P's 99% majority partner, FP, is exempt from United States taxation. P allocates 99% of the income to FP.

Next, P transfers its Y note to Z, a corporation, in exchange for Z preferred stock and Z's assumption of P's obligation to make lease payments to Y. P takes the position that this exchange qualifies as a section 351 exchange and that its basis in the Z stock is equal to its basis in the Y note ($100x), unreduced by the amount of the obligation to pay rent to Y.

Immediately thereafter, P transfers its Z stock to Sub, a member of the Parent consolidated group, in exchange for Sub preferred stock. The fair market value of the Sub stock received by P is $1x. Parent makes a simultaneous transfer of property to Sub in order to satisfy the control requirement of section 351(a). The parties take the position the transaction qualifies as a section 351 exchange with the result that Sub's basis in the Z stock is the same as P's basis in the Z stock ($100x). Sub then sells the Z stock to an unrelated party for its fair market value ($1x), claiming a $99x loss.

The entire series of transactions were proposed and arranged by a tax shelter promoter. Other than Parent and Sub, the parties are all unrelated.

LAW AND ANALYSIS

I. Overview of Relevant Code Provisions

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and, immediately after the exchange, such person or persons are in control of the corporation. For purposes of section 351, control is defined as ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation. Sections 351(a) and 368(c).

Section 351(b) provides that if section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under section 351(a), other property or money, then gain (if any) to such recipient shall be recognized, but not in excess of the amount of money received plus the fair market value of such other property received, and no loss to such recipient shall be recognized.

Section 357(a) provides in relevant part that except as provided in sections 357(b) and (c), if the taxpayer (i.e., the transferor) receives property that would be permitted to be received under section 351 without the recognition of gain if it were the sole consideration (i.e., the stock of the transferee corporation) and, as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption or acquisition shall not be treated as money or other property and shall not prevent the exchange from being within the provisions of section 351.

Section 357(b) provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in section 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange. Section 357(b)(2) provides that the burden is on the taxpayer to prove by the clear preponderance of the evidence that such assumption is not to be treated as money received by the taxpayer.

Section 357(c)(1) provides in relevant part that, in the case of an exchange to which section 351 applies, if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

Section 357(c)(2)(A) provides that section 357(c)(1) shall not apply to any exchange to which section 357(b)(1) applies.

Section 357(c)(3)(A) provides that if a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either would give rise to a deduction, or would be described in section 736(a), then, for purposes of section 357(c)(1), the amount of such liability shall be excluded in determining the amount of liabilities assumed.

Section 357(c)(3)(B) provides that section 357(c)(3)(A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or increase in, the basis of any property.

Section 358(a)(1) provides in relevant part that, in the case of an exchange to which section 351 applies, the basis of property permitted to be received under such section without the recognition of gain or loss (i.e., the stock of the transferee corporation) shall be the same as that of the property exchanged, decreased by the fair market value of any other property received by the taxpayer, the amount of money received by the taxpayer, and the amount of loss to the taxpayer that was recognized on the exchange, and increased by the amount that was treated as a dividend and the amount of gain to the taxpayer which was recognized on such exchange (other than the dividend amount).

Section 358(d)(1) provides that where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of section 358, be treated as money received by the taxpayer on the exchange.

Section 358(d)(2) provides that section 358(d)(1) shall not apply to the amount of any liability excluded under section 357(c)(3).

Section 358(h) provides, inter alia, that for transfers on or after October 19, 1999, if the basis of stock (determined without regard to section 358(h)) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduce the transferor's basis of the stock by reason of the assumption. § 358(h)(1). However, except as provided by the Secretary of the Treasury, section 358(h)(1) does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets with which the liability is associated are transferred to the corporation as part of the exchange. Section 358(h)(2).

II. Analysis

1. The Exchange of the Leasehold Position for Stock Is Not a Section 351 Exchange.

The transaction in which the transferee stock is received (here, the transfer by P to Z) must be carefully analyzed to determine that it does in fact satisfy the technical requirements of section 351. For example, under the facts presented, a pre-existing shareholder or shareholders must join with the transferor (P) in transferring property to the transferee corporation (Z) in order for the exchange to satisfy the control requirement of section 351(a). See § 1.351-1(a)(1)(ii) (negating transfers by a previous owner of the transferee stock if the value of the new stock issued to that transferor is relatively small compared to the value of the old stock owned by that transferor and the primary purpose of the transfer by that transferor was to qualify other transferors for § 351 treatment). See also Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568, 570.

In addition to satisfying the technical requirements of section 351, a transfer must have a bona fide business purpose in order to qualify as a section 351 exchange. See Rev. Rul. 55-36, 1955-1 C.B. 340; see also Caruth v. United States, 688 F.Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989) and the cases cited therein. Determining whether a bona fide non-tax business purpose motivated, at least in part, the section 351 transaction requires intensive factual development of the motives and intent of the parties, as gleaned through their written communications, contracts and agreements, their expertise on tax matters in general, as well as their conduct throughout the transaction. The Service and the various courts have distilled several factors that aid in determining whether a valid non-tax business purpose is present in a purported section 351 transaction. These factors include:

- whether the transfer achieved its stated business purpose,
- whether the transfer primarily benefitted the transferor or the transferee,
- the amount of potential non-tax benefit to be realized by the parties,
- whether the transferee corporation is a meaningless shell,
- whether the transferee's existence is transitory,
- whether the transferee corporation has any other assets of the type transferred,
- the number of times the property was transferred, both prior to and after the section 351 transaction,
- the amount of time each party held the property, both prior to and after the section 351 transaction,
- whether there were any pre-arranged plans concerning future dispositions of the property, and
- whether there were independent parties (such as creditors) that requested a specific structure for the transaction.

Based on the facts as we understand them, it appears there was no real purpose for the transactions apart from the creation of an asset (the Z stock) with a basis far in excess of its value in order to generate a substantial tax loss. That is not a bona fide business purpose. Accordingly, the transfers do not qualify as section 351 exchanges. The transactions are therefore taxable section 1001 exchanges and, under section 1012, P takes a cost basis in the Z preferred stock (i.e., a basis equal to the fair market value of the leasehold position transferred, which might reasonably be argued to equal the fair market value of the preferred stock received in the transaction).

Note that this argument applies equally to the transfer of Z stock to Sub in exchange for Sub stock, as well as any subsequent transfers replicating the initial exchange.

Although the present transaction presents a very strong case for disqualification for lack of a business purpose, courts have not required a strong showing in order to satisfy the section 351 business purpose requirement, therefore the following arguments must also be developed.

2. Even if the transfers qualify under section 351, the basis in the stock is reduced by the amount of the obligations to make rental payments.

A. Transactions on or after October 19, 1999.

For transactions on or after October 19, 1999, the basis of the Z stock, irrespective of any other provisions of the Code or regulations, will be reduced by the amount of the liability (but not below fair market value) under section 358(h). Note that section 358(h) provides exceptions for liabilities assumed in connection with the transfer of a trade or business and for liabilities assumed if they are related to an asset received in the exchange. In some cases, e.g., those involving the transfer of post-employment retirement obligations of an inactive corporation, taxpayers may claim that the transfer is within the scope of section 358(h)(2)(A) (exceptions for the transfer of a trade or business) because they have transferred all that remains of the business. Our position is that the exception applies only to an ongoing trade or business, not to the remnants of a now inactive trade or business.

B. Application of section 358(d)(1) reduces basis by the amount of the liability assumption.

The same result follows, however, for transactions not within the scope of section 358(h) because the assumption of the transferor's (P's) obligation to pay rent on its leasehold position is an assumption that would, if made by a purchaser of the leasehold position in a taxable exchange, be included in the seller's amount realized. Thus, the assumption of this liability is within the scope of section 357 and, under sections 357(a), 358(a)(1)(A)(ii), and 358(d)(1), the basis of the stock received must be reduced by the amount of the liability assumed.

Taxpayers will take the position that the obligation to pay rent (as part of the leasehold position) is a liability described in section 357(c)(3)(A), and that, therefore, the assumption of the liability does not reduce the stock basis by reason of section 358(d)(2). We disagree with this position.

Congress enacted section 357(c)(3) to prevent inappropriate gain recognition resulting from the application of section 357 to certain liabilities. In general, the assumption of a deductible liability in a section 351 exchange should be a nonrealizable event because it is improper to treat the assumed liability as income to the transferor and deny him the tax benefit for its satisfaction. Focht v. Commissioner, 68 T.C. 223, 237 (1977). Otherwise, the transferor is taxed on an amount which never was, and never would be, received by him as an economic gain. Id. To prevent such inappropriate gain recognition under section 357(c)(1), Congress enacted section 357(c)(3). See section 103(a)(12) of the Technical Corrections Act of 1979 (P.L. 96-222, 1980-1 C.B. 499, 509); S. Rep. No. 96-498, 1980-1 C.B. 517, 546.

In the case under consideration, the transfer of the leasehold position includes no corresponding right to use property subject to the lease or to receive income from the property transferred. Under these circumstances, the transferor cannot be considered to have transferred a trade or business. Accordingly, Rev. Rul. 95-74, 1995-2 C.B. 36, does not apply to the transfers and, under Holdcroft v. Commissioner, 153 F.2d 323 (8th Cir. 1946), the payment of the rent obligation will be a capital expenditure, not a deductible expense, with respect to the transferee corporation.

Because the payment of the rent obligations will not be a deductible expense of the transferee corporation (Z), the deduction for the rental payments, when made, should accrue to the transferor (P). In such a case, the purpose of section 357(c)(3)(A)(i) is not served by the exclusion of a liability (because the transferor would not be denied the tax benefit for the satisfaction of the liability). Therefore, it is our position that the liabilities at issue here are not within the intended scope of section 357(c)(3). Accordingly, section 358(d)(2) has no application to the present exchange and the transferor's basis in the transferee stock must be reduced by the amount of the liabilities assumed.

Please note that the above discussion is based on our understanding that the leasehold positions assumed by the respective transferees did not include corresponding rights to either use property or receive income from property transferred as part of the leasehold interest. To the extent such a right was transferred (if, for example, P's leasehold interest in the property were greater than the leasehold interest that it gave to Y), the corresponding portion of the liability may be within the scope of Rev. Rul. 95-74 and therefore within the scope of sections 357(c)(3) and 358(d)(2).

3. Even if the assumption of the lease obligations would otherwise be within the scope of sections 357(c)(3) and 358(d)(2), the assumption is treated as a distribution of money under section 357(b) and therefore reduces stock basis under section 358(a).

As stated above, section 357(b)(1)(B) provides that if, taking into consideration the nature of the liability and the circumstances under which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to an assumption described in section 357(a) was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange.

Based on the facts presented, and as discussed above, it appears the principal purpose of the transferor (P) with respect to the assumption was simply to create an asset with a basis far in excess of its value (viz., the Z stock) that could be sold to generate a substantial loss, for tax purposes, with no real economic cost to the party. This is not a bona fide business purpose.

Accordingly, the liability assumptions in each of these cases are squarely within the scope of section 357(b)(1)(B) and are to be treated as distributions of money to transferor on the exchange. Consequently, under section 358(a)(1)(A)(ii), the basis in the transferee stock is reduced by the amount of the assumed obligations.

Note that section 357(b)(1) takes precedence over both sections 357(a) and 357(c). Section 357(a) provides for application of the general rule of section 357, "[e]xcept as provided in subsection (b) and (c)". Section 357(c)(2)(A) expressly provides that section 357(c)(1) shall not apply to any exchange to which section 357(b)(1) applies. This necessarily extends to section 357(c)(3), which simply excludes certain liabilities "for purposes of" applying section 357(c)(1). Thus, in an exchange to which section 357(b)(1) applies, section 357(c)(1) does not apply and therefore section 357(c)(3) is rendered moot. Accordingly, neither the general rule of section 357(a), nor section 357(c)(1) and (3), apply to an exchange to which section 357(b)(1) applies.

4. The transaction does not represent a bona fide loss.

The facts presented do not indicate that, in reality, any of the parties have suffered a genuine economic loss.

Section 165 provides that "a taxpayer may deduct any loss sustained during the taxable year for which the taxpayer is not indemnified by insurance or otherwise." The loss must be a bona fide loss representing a real change of position in a true economic sense; substance rather than form governs in determining a deductible loss. Treas. Reg. §1.165(b). A deduction for a loss must be based on an actual economic loss. See, e.g., Scully v. U.S., 840 F.2d 478 (7th Cir. 1988).

With respect to the property involved in the second section 351 exchange (i.e., P's transfer of Z stock to Sub), immediately prior to the exchange, Sub possessed $1x in treasury stock. Immediately after the second section 351 exchange (in which Sub's stock was transferred to P in exchange for the Z stock), Sub possessed preferred stock of Z worth approximately $1x. Immediately thereafter, Sub sold the preferred stock to an unrelated party for $1x. Sub's economic position never changed. Accordingly, Sub has had no loss and so it is not entitled to a section 165 deduction.

Note that this argument is consistent with other arguments, such as sham transaction and lack of economic substance, that are addressed in other advice.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Further factual development in this case should be conducted with the foregoing arguments in mind. Other potential arguments/issues are set forth below:

I. Case Development.

Our suggestions for case development relate primarily to developing a business purpose argument under section 357(b) or section 351 because the other proposed arguments are inherently legal arguments. In general, Exam should confirm that any claimed business purposes were valid and in fact achieved, and whether they could have been achieved by means other than the assumption or exchange. Some specific points to pursue include the following:

1. How did the issuance and sale of the preferred stock implement the claimed business purpose?

2. What is the history of each of the respective transferees in the Lease Stripping Transactions to date (its former business, whether it ever made a profit, how is it supposed to make a profit, how "assuming" the liabilities helped the transferee earn a profit, etc.)?

3. Beyond obtaining the actual documents setting forth the terms of the transactions, Exam should develop the facts pertaining to how and why the terms of any documents were arrived at, such as were there negotiations, internal memoranda, financial analyses, etc., as well as a history of what has occurred with respect to the preferred stock.

4. How and why did Sub sell the preferred stock, and when did it decide to sell it (e.g., when an accounting firm proposed the shelter, or at a later date)?

In the transfers at issue here, a significant factor would be whether there was any reasonable expectation, at the time of the transfers of the leasehold positions to the respective transferees, of there being sufficient residual value in the rights transferred under the leases to justify the transaction on the basis of transferee profit or economic benefit motive.

II. Hazards.

Although there are litigation hazards in this case, legally and factually, with respect to each of the arguments presented above, these Lease Stripping Transactions are clearly abusive and must be challenged. It is important to note that our discussion of the hazards is not intended to dissuade you of the merits of the government’s case. To the contrary, based on our legal and factual arguments and the clear abuse, we believe that disallowance of the claimed loss will be sustained in court.

1. Re: the section 351 business purpose requirement.

Disqualifying the transaction under section 351 for lack of business purpose presents significant factual and legal hazards. Factually, it could be difficult to establish that the exchange is devoid of any business purpose. While courts have consistently acknowledged the doctrine, it has proven extremely easy for taxpayers to satisfy the requirement. In fact, we are unaware of a case in which an exchange otherwise meeting the requirements of section 351 was disqualified and rendered a taxable exchange solely for lack of sufficient business purpose. Nevertheless, the Service position is that there is a business purpose requirement in section 351. Since these cases present a particularly compelling case for a business purpose argument, we encourage the argument be made.

2. Re: treating the leasehold obligations as within the scope of section 357.

In terms of our analysis of the section 351 exchange, the taxpayer may argue that the leasehold obligations are contingent liabilities and therefore not "liabilities" within the scope of sections 357 and 358. The argument is based on the principle that "the net effect of a taxable sale of assets in exchange (in whole or in part) for the buyer's assumption of a contingent liability of the seller, that has not produced a financial or tax benefit to the seller before the asset sale, is that the seller's net income or loss with respect to the sale is not increased or reduced as a consequence of the buyer's assumption of such a contingent liability of the seller." Jerred G. Blanchard, Jr. and Kenneth L. Hooker, Fixing the Assumption of Liability Rules the Wrong Way and the Right Way, 89 Tax Notes 933, 937 (Nov. 15, 1999). Consequently, the argument goes, in a tax-free section 351 exchange, such a contingent liability should not be taken into account (or is not a "liability") for purposes of sections 357 and 358. It also finds some support in the case law (cited below) and the legislative history of section 357(c)(3). Nevertheless, we disagree with this position.

Furthermore, the argument that the very liabilities described by section 357(c)(3)(A) are not "liabilities," or are not to be taken into account, for purposes of sections 357 and 358 is circular. They necessarily are to be taken into account for purposes of sections 357 and 358, otherwise sections 357(c)(3) and 358(d)(2) are superfluous.

Congress enacted section 357(c)(3) in response to several court cases that had developed different approaches to prevent the application of section 357(c)(1) to an assumption of a liability that had not produced a financial or tax benefit for the transferor. See Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976), rev'g in part and aff'g in part 61 T.C. 28 (1973); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972), rev'g T.C. Memo. 1971-262 (reasoning that the term "liability" under section 357(c) was meant to be limited to what might be called "tax liabilities", i.e., liens in excess of tax costs); Focht v. Commissioner, 68 T.C. 223 (1977) (reasoning that the term "liability" under section 357 should be limited to those obligations which, if

transferred, cause gain recognition under Crane v. Commissioner, 331 U.S. 1 (1947), and an obligation should not be treated as a liability to the extent that its payment would have been deductible if made by the transferor).

In contrast to the approaches developed by the courts, however, Congress did not define (or redefine) the term "liabilities" for purposes of section 357(c) or section 357 in general. Rather, under section 357(c)(3), Congress excluded certain "liabilities" from the section 357(c)(1) determination; specifically "liabilities" the payment of which would give rise to a deduction, unless the "liability" had generated a tax benefit for the transferor. Further, the Senate Finance Committee Report accompanying the Revenue Act of 1978, which enacted section 357(c)(3), states that the provision "is not intended to affect the definition of the term liabilities for any other provision of the Code, including sections 357(a) and 357(b)." S. Rep. No. 1263, 95th Cong., 2d Sess. 185 (1978), 1978-3, Vol 1 C.B. 481, 483.

The taxpayer may also make an argument under section 358(h), enacted as § 309 of the Community Renewal Tax Relief Act of 2000, P.L. 106-554. While taking the position that section 358(h) does not apply to their particular transaction, taxpayers may nevertheless argue that the legislative history of section 358(h) indicates Congress did not view contingent liabilities as within the scope of sections 357 and 358 (i.e., prior to the enactment of section 358(h)). Although there is an indication in the legislative history that the present Congress was concerned whether contingent liabilities are within the scope of section 357(c)(3), we do not believe that section 358(h) or its legislative history precludes the arguments described above. It is well settled that "the views of one Congress as to the construction of a statute adopted many years before by another Congress have 'very little, if any, significance.'" United States v. Southwestern Cable Company, 392 U.S. 157, 170 (1968); see also Rainwater v. United States, 356 U.S. 590 (1958). We recommend the National Office be consulted with respect to the merits of any argument raised by the taxpayer under section 358(h) and its legislative history, if and when that occurs.

3. Re: treating the liabilities as not within the scope of section 357(c)(3).

The argument that the lease obligations are not section 357(c)(3) liabilities relies in large part upon the legal conclusion that the deductions that will arise from payment of the rental obligations remain with transferor (P). Certainly under the facts presented, there is a very strong argument under Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), that the respective transferees will not be entitled to claim any such deductions. It follows that the transferor remains entitled to claim, and will claim, the deduction.

However, we have found no legal authority directly on point for the latter conclusion. Possible theories considered have raised additional incongruities. For example, in substance, the transferee is performing a bill paying service for the transferor (P). From

that perspective, P unquestionably retains the deduction. This theory, however, arguably is inconsistent with an assumption of the liabilities by the transferee. More specifically (to the extent the leasehold position assumed by the transferee does not include a corresponding right to either use property or receive income from property transferred as part of the leasehold position), the transaction in substance is treated as a qualifying section 351 exchange of $1 in return for transferee preferred stock, and the creation of an agency relationship whereby the transferee administers the payment of the liabilities with funds provided by the transferor. While this argument has some potential, it suggests that the liabilities were not, in substance, assumed by the transferee. Thus, if this argument were made, it would have to be made in the alternative to the primary arguments employing sections 351, 357, and 358 in determining the proper basis of the preferred stock received from the transferee. This alternative argument would, of course, apply only to the portion of the leasehold position assumed by the transferee that did not include a corresponding right to either use property or receive income from the transferred property.

4. [redacted]

5. Re: inapplicability of section 165.

We note that, because the amount by which P's basis in the Z stock (and thus Sub's basis in the Z stock) exceeds its value reflects an unrealized and unrecognized loss (the payment of the obligation), this argument will be seriously undermined if the transferor is denied a deduction when the obligation is paid.

III. Other Considerations

We considered application of section 269 in the instant case. Section 269(a)(1) does not apply to the loss claimed on the sale of the preferred stock because the transferor did not acquire control of the transferee by virtue of the acquisition of the preferred stock. Nor does section 269(a)(2) apply to the loss claimed on the sale of the preferred stock because the transferor is a partnership, not a corporation.

While it is our understanding that the year in which the Lease Stripping Transaction occurred is frequently closed for purposes of the statute of limitations, the circumstances of those transactions determine the basis, and therefore the tax consequences, in subsequent years and subsequent transactions. Accordingly, factual development by necessity may need to be done with respect to years for which the statute has passed.

In addition, we note that there is a variation of this transaction in which the property transferred in the first purported section 351 exchange is the property subject to the leasehold interests (as opposed to the leasehold interests). Our tentative position is that the analysis would not differ, because we would treat the obligation to provide the use of the property no different from the obligation to make rent payments. We will, however, coordinate that issue with CC:ITA and provide supplemental advice as appropriate.

In the course of working a particular case, additional arguments or counter arguments may be raised by individual taxpayer, and the facts may suggest additional arguments to be made by the Service. In that event, please contact our office for additional information or advice.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views prior to any disclosure.

Assistant Chief Counsel (Corporate)

By: _____

Alfred C. Bishop
Branch Chief (CC:CORP:6)