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

MEMORANDUM FOR Area Counsel (LMSB), Area 1
Financial Services & Healthcare

FROM: Associate Chief Counsel
Passthroughs and Special Industries CC:PSI

SUBJECT: Lease Stripping Transaction

This Chief Counsel Advice responds to your memorandum dated January 23, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

DISCLOSURE STATEMENT

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

LEGEND:

Taxpayer	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
J	=
K	=
L	=
M	=
Promoter A	=
Promoter B	=
Bank A	=

Bank B	=
Country 1	=
Country 2	=
State	=
$n1	=
$n2	=
$n3	=
n4	=
$n5	=
n6	=
n7	=
$n8	=
$n9	=
$n10	=
$n11	=
$n12	=
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$n28	=
$n29	=
$n30	=
$n31	=
$n32	=
$n33	=
n34	=
n35	=
p1%	=
p2%	=
p3%	=
Date 1	=
Date 2	=
Date 3	=

Date 4	=	
Year 1	=	
Year 2	=	
Year 3	=	

ISSUES:

1. Whether the lease stripping transactions lack economic substance.

2. Whether section 482 applies to the lease-stripping transactions at issue, and if so, the consequences of applying section 482.

CONCLUSIONS:

1. The lease stripping transactions lack economic substance because the transactions had no objective economic substance, there was no business purpose for the transactions, and the parties entered into the transactions for tax avoidance purposes.

2. Section 482 applies to Taxpayer and the other parties to this transaction. Because the participants acted in concert pursuant to a common plan to shift deductions to Taxpayer, they are part of the same controlled group for purposes of applying section 482. Accordingly, section 482 may be applied to reallocate the rental income and deductions among the participants to prevent the evasion of taxes and clearly reflect the income of the participants. Section 482 may be applied under three alternative theories:

   (a) Disregarding the Master Lease to D and the Sublease to E, so that Taxpayer never acquires the obligation to pay rent to B, which would prevent Taxpayer from taking rental deductions;

   (b) Allocating the $n1 prepayment to Taxpayer or allocating Taxpayer's rental deductions to D, so that the income and deductions attributable to the payments due under the Master Lease are not artificially separated; or

   (c) Allocating Taxpayer's rental deductions to D on the basis that section 482 may be applied to allocate deductions attributable to property received in a section 351 transfer from the transferee corporation back to the contributor to clearly reflect income.

FACTS

Introduction

This case involves a lease-stripping transaction with one party realizing rental income from property and another party or parties claiming deductions for rental expenses and/or depreciation on the equipment. The Service has defined and described forms of lease-stripping transactions and the code sections and doctrines that are applicable to such transactions. Notice 95-53, 1995-2 C.B. 334. Depending upon the facts of the case, the Service may apply the following provisions to the transaction: sections 269, 382, 446(b), 482, 701 or 704, 7701(l), and the underlying regulations. It may also recharacterize certain assignments or accelerations of future payments as financings or apply the assignment-of-income principles, the business-purpose doctrine, or the substance-over-form doctrines (including the step transaction and sham doctrines). Notice 95-53.

Purported Sale and Leaseback of Computer Equipment

B, a wholly-owned subsidiary of C, leases computer equipment to various end users pursuant to existing user leases (the "User Leases"). On Date 1, B leased the computer equipment (the "Master Lease") to D, a limited life company organized in Country 1, making D the lessor to the original end users.[1] D was owned by three individuals. The three individuals were all residents of Country 2, and none had any computer leasing experience. D had no rights to the computer equipment until the expiration of the User Leases.

On Date 2, D subleased the equipment ("the Sublease"), subject to the User Leases and Master Lease, to E, a State limited partnership.[2] The general partners of E are F and G. F is a wholly-owned subsidiary of Promoter A, a promoter of these transactions. G is a wholly-owned subsidiary of H.

E prepaid D p1% of the present value of the rentals due under the Sublease by transferring approximately $n1 in cash.[3] This payment was partially financed through a loan by Bank A of p2% of the present value of the rentals due under the

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[1]Each User Lease corresponds to a separate Master Lease schedule with a term longer than the term of the corresponding User Lease. The term of the User Lease corresponding to the term of its relevant Master Lease schedule is referred to as the "Base Term." The remainder of that Master Lease schedule term is referred to as the "Supplemental Term."

[2]Each User Lease corresponds to a separate Sublease schedule with a term longer than the term of the corresponding User Lease. The term extending beyond the term of the corresponding User Lease is referred to as the "Extended Sublease Term."

[3]In determining the present value of the rentals due under the Sublease, payments due under the Extended Sublease Term were excluded from calculations.

Sublease. The remaining portion of the rent prepayment, $n2, came from capital contributed to E by its partners.

Both the loan repayments from E to Bank A and the rental payments from the payments from the User Leases to E were due semiannually, enabling E to make its loan repayments with the User Lease proceeds. The loan from Bank A, secured by the User Leases and $n3 cash, was guaranteed by B (the “Loan Guaranty”), with B’s obligations further guaranteed by its parent, C. In exchange for the Loan Guaranty, B received a semi-annual fee from E equal to n4 basis points of the outstanding loan principal. D and E gave B security interests in the User Leases to secure their obligations under the Master Lease and Sublease. In addition, each general partner of E agreed to indemnify B against losses that might be caused should E declare bankruptcy. Moreover, B agreed to indemnify D for any U.S. tax liability arising from its receipt of the rental income.

Under the terms of the Master Lease, D was required to use the proceeds of the prepayment from E either to prepay rent due under the Master Lease or to obtain a third party guaranty securing payment of rent under the Master Lease. D’s payment of a portion of the rent owed to B under the Master Lease was guaranteed by Bank B, an affiliate of Bank A (the “Rent Guaranty”). The Rent Guaranty was secured by a U.S. Treasury Security maturing Date 3, purchased by D for $n1 with the prepayment received from E. To induce Bank B to issue the Rent Guaranty, D agreed to place the proceeds of the Treasury Security on deposit with a Bank B affiliate. D (and subsequently K) were restricted from accessing either the E prepayment or the Treasury Security proceeds except to pay rent due to B.

B agreed to provide services to E relating to the leases, including the identification of remarketing opportunities. B’s fees came from B’s use of the rents that it collected from end users monthly before they were paid to E semi-annually (the “Fee and Reimbursement Agreement”).

B assigned its rights to receive payments under the Rent Guaranty and under the Fee and Reimbursement Agreement to J, a limited liability company of which B is the sole member. J also assumed B’s obligations under the Loan Guaranty.

In a series of related and prearranged steps, Taxpayer contributed approximately $n5 to K, a wholly-owned subsidiary of Taxpayer in exchange for n6 shares of Class A preferred stock and additional common stock in K. On Date 4, D and K entered an Exchange Agreement. Under the terms of the Exchange Agreement, D assigned its interest in the Master Lease, the Sublease, the Rent Guaranty, the U.S. Treasury Securities, and the prepaid rent to K in return for n7 shares of Class

B non-voting preferred stock of K, valued at $n8. Taxpayer, K, and D treated their transfers as qualifying for nonrecognition under section 351 of the Internal Revenue Code.

The exchange entitled K to receive rents for (1) the remaining p3% of the Sublease rents not prepaid by E for the periods of the User Leases, (2) the periods of the Sublease from the end of the User Leases to the end of the Sublease, and (3) the re-lease of the equipment after the expiration of the Sublease.

Pursuant to the Exchange Agreement, K was assigned the lease interests formerly held by D, becoming a sublessor on computer leases between B and end users. K assumed ownership of the $n1 rent prepayment (and $n9 accrued interest) held in an account with the Bank B affiliate, but also assumed an obligation to pay $n10 in supplemental rents. As with D, K was permitted to access the prepayment account solely to make rent payments to B under the Master Lease. Taxpayer included the $n1 prepayment in its income for financial accounting purposes, but not for U.S. tax purposes. Taxpayer relied on section 351 to exclude the prepayment from its gross income as a tax-free contribution to K's capital.

K's payment of rent under the Master Lease allowed Taxpayer to take rental deductions. Because the prepaid rent was taxable to D, Taxpayer only had to include in its income the p3% of the Sublease rent not prepaid by E along with any supplemental rent received from the re-leasing of the equipment to new end-users.

LAW AND ANALYSIS

Issue 1:

A. Lack of Economic Substance Generally

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752(1975); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978). When a transaction is treated as a sham, the form of the transaction is disregarded and the proper tax treatment of the parties to the transaction is determined.

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998). Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363. See also Notice 95-53, 1995-2 C.B. 334.

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

Recently, the Service was successful in showing that a series of prearranged transactions involving the purchase and sale of debt instruments in an attempt to shift accelerated installment sale gain to a tax-neutral partner and manufacture a loss for another partner lacked economic substance. ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in relevant part, rev'd in part, remanded, 157 F.3d 231 (3d Cir. 1998) cert denied, 1999 U.S. LEXIS 1899 (U.S. Mar. 22, 1999).

In ACM Partnership, the Commissioner argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance, and lacking in economic reality. The court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The court also stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transaction lacked economic substance and, therefore, that the taxpayer was not entitled to the claimed deductions. The opinion demonstrates that the court will disregard a series of otherwise legitimate transactions where the Commissioner is able to show that the facts, when viewed as a whole, have no economic substance. See also Rev. Rul 99-14, 1999-13 I.R.B. 3 (because lease-in/lease-out transactions have no economic substance, a U.S. taxpayer could not take deductions for rent or interest paid or incurred in connection with the transaction).

While the profit potential or economic risk, relative to the expected tax benefit, necessary to meet the objective economic substance test has not been quantified, a reasonable prospect or possibility for profit is required. See Horn, 968 F.2d at 1237-38 n. 10, 13; Rice's Toyota World, Inc., 81 T.C. at 202. Nominal or de minimis profit potential does not imbue a transaction with economic substance. Knetsch v. United States, 364 U.S. 361 (1960); Hines v. United States, 912 F.2d 736 (4th Cir. 1990), rev'g 89-9 USTC (CCH) ¶ 9523 (E.D.N.C. 1989); Krumhorn v. Commissioner, 103 T.C. 29, 55 (1994); Sheldon v. Commissioner, 94 T.C. 738, 767-68 (1990); Estate of Thomas v. Commissioner, 84 T.C. 412, 438 (1985).

B. Application to this Transaction of Lack of Economic Substance Doctrine

In the lease stripping transactions described above, there was no objective economic substance or business purpose for the sale and leasebacks, the subsequent sale of the right to receive lease payments, or the contribution of leasehold interests to the subsidiary. Rather, the sole purpose of the transactions was the creation of tax benefits. The tax opinion provided to Taxpayer by Promoter A assumes that K reasonably expects to realize an economic profit on the transaction. However, this assumption rests on an appraisal prepared by L and a letter from M, both of which were prepared for the promoter, Promoter A.

Based solely on an appraisal performed by L, Promoter A projected that if Taxpayer could find new end users for the supplemental leasing period, Taxpayer would report a book profit of $n11, computed as the difference between the $n12 in rent payments Taxpayer would receive from E under the Sublease less the $n13 in rent payments Taxpayer was obligated to make to B under the Master Lease, along with $n14, the cost of investing in the transaction. This investment cost was computed as the sum of the following amounts: (1) $n15 in rent payments to B in excess of the $n1 rent prepayment, (2) $n16 to redeem preferred stock, (3) $n17 in dividends on the preferred stock, and (4) $n18 in fees to promoters. Promoter A estimated that Taxpayer would obtain tax savings of $n19 from the investment, derived from an estimated taxable loss of $n20. The estimated book profit and tax savings were based on an anticipated value of the supplemental rent of $n21. Promoter A also provided an alternate estimation of book profit and tax savings which assumed Taxpayer's inability to find new supplemental end users. This alternate analysis projected a book loss to Taxpayer of $n14 and tax savings of $n22 derived from an estimated $n23 taxable loss.

Using Promoter A's anticipated value of the supplemental rents, Taxpayer projected that its pre-tax economic profit for financial purposes would equal $n24. For tax purposes, Taxpayer estimated tax savings of $n25 derived from a taxable loss from the transaction of $n26. Assuming that the equipment could not be leased at the expiration of the end-user leases, Taxpayer alternatively estimated tax savings from participating in the transaction equaling $n27. Thus, profitability of the transaction under both Promoter A's and Taxpayer's projections ultimately depended on the value and extent of supplemental leasing that occurred subsequent to the expiration of the original end-user leases.

Participation in the transaction would create net income for financial statement purposes despite creating a taxable loss for income tax reporting purposes because of income tax refunds and because the $n1 rent prepayment would be recognized as income over the lease term in accordance with generally accepted accounting principles. Thus, under either Promoter A's or Taxpayer's projections, participating in the transaction would allow Taxpayer to report a substantial amount of income for financial reporting purposes while simultaneously realizing significant tax savings.

The Service hired an outside expert to determine whether Promoter A's estimate of the supplemental rent was accurate. The Service's expert determined that the value of the supplemental rent would only equal $n28. Using this discounted value of the supplemental rent, participation in the transaction would have resulted in

Taxpayer's suffering a net economic loss of $n29, meaning that Taxpayer had no possibility of realizing an economic profit from this transaction.

Taxpayer was able to claim losses collectively amounting to $n30 for the taxable years Year 1 through Year 3 without having to include the $n1 prepayment from E in its gross income. These deductions were acquired at a cost to Taxpayer of only $n8 worth of preferred stock, plus dividends.

D received dividends from its K preferred stock and gains in Year 2 upon the transfer of the stock in exchange for a partnership interest which was subsequently redeemed. E retained rental income of approximately $n31. Bank A received fees for its participation in the transaction. B received a semiannual fee of n4 basis points of the outstanding principal amount of the loan to E as consideration for its guaranty. In addition, for the lessor services it performed, B received retention of the "float" between the monthly receipt of the end users' rent and the semiannual payments it was required to remit to E so E could make payments under its Sublease. Promoter A and another firm, Promoter B, received fees totaling $n32 for their roles as promoters.

Issue 2:

A. Section 482-Generally

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

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

For the reallocation rule of section 482 to apply to a transaction, the transaction must involve at least two entities owned or controlled by the same interests. Section 482 imposes two requirements: (1) ownership or control must exist in some manner among the participants, and (2) the same interests must possess the control. Regarding the first requirement, because none of the participants in the transaction are related to Taxpayer, the mutual ownership provision of section 482 will not apply. Therefore, at least two of the participants must be found to be controlled by the same interests if we are to apply section 482 to the transaction that took place between the four parties.

B. Legal Standard for Determining Control under Section 482

1. *Definition of control*

The regulations under section 482 define control to include any kind of control, regardless of whether such control is direct or indirect or legally enforceable. Treas. Reg. §1.482-1(i)(4). Case law supports the regulation's definition of control, indicating that it is actual and practical control which counts in the application of section 482 rather than record ownership or legally enforceable control,. Ach, 42 T.C. at 125; Grenada Industries, Inc. v. Commissioner, 17 T.C. 231, 254 (1951), *aff'd,* 202 F.2d 873 (5th Cir. 1953), *cert. denied,* 346 U.S. 819 (1953), *acq. in part* and *nonacq. in part,* 1952-2 C.B. 2, 5; 1972-2 C.B. 2. See also Appeal of Isse Koch & Co., Inc., 1 B.T.A. 624, 627, *acq.* 1925-1 C.B. 2 ("Control not arising or flowing from means legally enforceable may be just as effective in evading taxation as if founded on the most formal and readily enforceable legal instrument."); DHL Corp. v. Commissioner, T.C. Memo 1998-461 (1998) (holding that foreign investors did not have section 482 control over a corporation despite their ability to appoint a majority of its board of directors because domestic shareholders retained the ability to control day-to-day operations and major events); Charles Town, 372 F. 2d at 419 (holding that two shareholders were in control of a corporation in which they only owned two percent of the outstanding stock because of their possession of effective and practical control over the corporation).

Consequently, according to both the section 482 regulations and case law, none of the participants in this transaction is required to have legal control of another participant through majority ownership of that other participant's voting stock for control to exist as defined under section 482. The Service has the authority to determine whether control exists by considering the reality of the situation and examining whether the same interests effectively control the participants to the transaction involved, rather than basing the control determination solely on the taxpayer's percentage of ownership of voting stock or legal right to direct the participant's actions.

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

2. *Existence of control among B, D, E, and Taxpayer*

Under Treas. Reg. 1.482-1(i)(4) and the relevant case law, Taxpayer is not required to own an interest in any of the participants, majority or otherwise, for the requisite control to exist under section 482. Instead, the Service may consider whether Taxpayer effectively controlled any of the participants, despite Taxpayer's having no legal or contractual right to direct their actions. In making this determination, the Service may apply the presumption of control provided for in Treas. Reg. 1.482-1(i)(4) and in the applicable case law. For the presumption to apply, the Service has the burden of establishing that income or deductions have been arbitrarily shifted between Taxpayer and either B, D, or E. See Dallas Ceramic Co, 598 F.2d at 1389.

From the facts provided to us, it appears as though the participants acted pursuant to a common plan to arbitrarily shift substantial rental deductions from E to Taxpayer. Promoter A, the promoter of the transaction, brought all the parties together to engage in this lease stripping transaction, and each party played an integrated and predefined role pursuant to the preconceived plan developed by Promoter A. B provided the computer leases entered into with creditworthy lessees that were used for the lease strip; D and E were entities used to strip the rental income from the associated rental expense; Taxpayer was the recipient of the stripped rental expense and Bank A provided the financing for the transaction. In its promotional materials, Promoter A indicated that the transferee who acquired D's leasehold interest had the possibility of obtaining "material tax advantages" due to the prepayment by E. Promoter A also provided economic analyses in its promotional materials indicating that participating in the transaction would generate substantial taxable losses whether or not supplemental leasing took place. These facts and those set forth below lead us to conclude that the parties acted in concert with a common goal to separate rental income from rental expenses and to shift the rental expenses to Taxpayer.

- D was formed by three individual Country 2 residents shortly before the transaction at issue took place. The facts presented appear to indicate that D was not adequately capitalized to engage in the leasing business at the level anticipated by the transaction.

- The only business of D was to engage in this transaction and other similar transactions.

- The third-party lessees to whom B originally leased the equipment had excellent credit ratings. However, by assigning its right to receive rental payments from such parties to D in exchange for the right to receive rental payments from D, B substituted a lessee that was a poor credit risk for lessees who were excellent credit risks. It is highly unlikely that B would have participated in the lease strip transaction absent the Rent Guaranty issued by Bank B and the restrictions agreed to by D on the use of funds deposited with Bank B.

- The partners of D were three individuals, none of whom had any computer leasing experience. Thus, D did not have the ability to perform its duties as lessor to the third party lessees absent its agreement with B.

- A common plan appears to be the only plausible explanation for the agreement by B to guarantee the Bank A loan to E, a limited partnership formed only four months after Promoter A first approached Taxpayer about participating in the transaction. E was owned by Promoter A (and another company) and was capitalized with only $n33. Given E’s debt to equity ratio of approximately n34 to n35, B’s guaranty exposed it to significant risk in the absence of other components of the common plan.

- A common plan appears to be the only plausible explanation for the deposit agreement restrictions between Bank B and D which prohibited D from using the deposited funds for any purpose other than to pay rent to B.

- A common plan appears to be the only explanation for multiple roles played by B in the lease strip transaction. B provided the leases, guaranteed E’s loan and provided the services of lessor including rent collection, maintaining the equipment and other activities. In return, the deposit agreement between

> D and Bank B assured B of a stream of what was economically substitute rental payments and other aspects of the prearranged plan resulted in additional fee income.

In summary, D, E, and B acted pursuant to a design developed by Promoter A that was marketed to Taxpayer. The only business of D and E was to engage in the transaction (or in the case of D, other similar transactions). B was a willing accommodation party providing leases, guarantees and other services. D and E acted together to strip the lease income into the hands of D, an entity believed to be exempt from U.S. net income tax. Neither D nor E appear to be adequately capitalized to engage in a bona fide leasing business. When viewed as a whole, D and E received income analogous to fee income for their contributions to the plan of Promoter A. Similarly, in addition to payments that were economically substitute rental payments, B also received income in the form of the "float" on the rental payments forwarded to D. B, D, and E acted in conjunction with one another to effectuate the plan of Promoter A. Because each of the participants in the transaction acted in concert pursuant to a common plan to arbitrarily shift rental income away from Taxpayer to D and rental deductions away from E to Taxpayer. Taxpayer and B are presumed to control E and D for the purposes of section 482 pursuant to Treas. Reg. §1.482-1(i)(4) and the applicable case law. We fail to see any significant evidence that would rebut this presumption.

Once it has been determined that control exists among the participants, section 482 next requires that the same interests possess the requisite control for the Commissioner to make a reallocation.

C. Legal Standard for Determining "the same interests" under Section 482

The regulations provide no guidance as to what the term "the same interests" means under section 482. Case law has indicated that in using the term "the same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979) (holding that different persons with a common goal or purpose for arbitrarily shifting income can constitute "the same interests" for purposes of section 482). See also B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), *cert. denied*, 407 U.S. 934 (1972) (rejecting Tax Court's view that two independently owned corporations acting in concert together to make interest-free loans to a jointly owned corporation did not constitute the same interests within the meaning of section 482); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), *cert. denied,* 386 U.S. 1016 (1967). Cf. Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233-34 (1925). But see The Lake Erie and Pittsburg Railway Co. v. Commissioner, 5 T.C. 558 (1945), *acq.* 1945 C.B. 5, *acq. withdrawn* 1965-1 C.B. 5.

Case law indicates that the legal standard for determining whether "the same interests" control an entity is identical to the standard applied to determine whether control of an entity exists. Therefore, if different entities are found to have a common goal to shift income or deductions among each other, not only will control of the entities exist, but the entities will also constitute "the same interests" for the purpose of section 482. As previously discussed, there appears to exist a common plan among B, D, E, and Taxpayer to shift income to D and deductions to Taxpayer. Consequently, B and Taxpayer constitute "the same interests" under section 482, meaning that the Service may reallocate the rental deductions claimed by Taxpayer to prevent the evasion of taxes or to clearly reflect income.

D. Application of Section 482 to this Transaction

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

1. *Economic Substance/Tax Evasion Standards of Section 482*

The application of section 482 has been upheld where the challenged transaction was arranged without a valid business purpose and solely in order to avoid taxes. Eli Lilly and Co. v. Commissioner, 84 T.C. 996 (1985), *aff'd in part and rev'd in part,* 856 F.2d 855 (7th Cir. 1988). When analyzing potential tax avoidance aspects of a transaction, the Commissioner will respect the transaction's contractual terms if consistent with the true economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B). The economic substance standard of the regulations overlaps with the economic substance and sham transaction doctrines developed in case law which allow the Service to disregard transactions lacking a business purpose and a potential for economic profit.[4] However, the section 482 regulations expand upon case law guidance by providing additional guidance. Specifically, the regulations provide the following:

[4] See Gregory v. Helvering, 293 U.S. 465 (1935); Knetsch v. Commissioner, 364 U.S. 361 (1960) (interest deductions disallowed where nothing of substance could be realized from the transaction other than a tax deduction); Frank Lyon Co. v. U.S., 435 U.S. 561, 572 (1978) ("The simple expedient of drawing up papers" is not controlling for tax purposes when the objective economic realities of a situation are to the contrary) ; Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (transaction is a sham where taxpayer is motivated by no business purpose other than obtaining tax benefits in entering a transaction and where transaction has no economic substance because no reasonable possibility of profitability exists); ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), *cert. denied,* 526 U.S. 1017 (1999) (transaction devoid of economic substance cannot be the basis for a deductible loss).

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

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

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

a. *The actual conduct of the parties is inconsistent with the form of the transaction.*

As more fully discussed elsewhere in this memorandum, the conduct of the parties was inconsistent with the form of the transaction as a series of leases. Taxpayer was not in the leasing business and had no expertise in computer leasing. While the tax opinion obtained by Taxpayer indicated that the purpose of the transaction was to diversify its business activities, this view is not supported by the facts.

Taxpayer was marketed a package by Promoter A where the only “economic” benefits were the tax advantages to be derived from the lease strip. There is no evidence in the facts that a bona fide business diversification (which might include new employees; the development of leasing expertise in company employees; marketing activities; the purchase of supporting equipment such as computers; etc.) ever took place. D was a mere accommodation party--it too did not have leasing expertise and was inadequately capitalized to engage in a true leasing business. The agreement by B to guarantee the Bank A loan to E, a recently formed limited partnership with a debt to equity ratio of approximately n34 to n35, and the deposit agreement restrictions between Bank B and D, which prohibited D from using the deposited funds for any purpose other than to pay rent to B, are inconsistent with an arm’s length series of leases. These and other facts clearly indicate that when viewed as a whole, the actual conduct of the parties was inconsistent with the form of the transaction as a series of leases.

b. *Allocation of risks*

In considering whether the allocation of risks specified or implied by taxpayer’s contractual terms will be respected as consistent with the economic substance of a transaction, Treas. Reg. §1.482-1(d)(3)(iii)(B) describes the following three factors as relevant to this evaluation:

(1) Whether the pattern of the controlled taxpayer’s conduct over time is consistent with the purported allocation of risk between the controlled taxpayers;

(2) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk; and

(3) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized.

Applying the section 482 risk analysis standards described above to the facts of this case leads to the conclusion that the transfer of risk associated with the computer leases to D pursuant to the Master Lease and the loan to E did not satisfy the regulations and cannot be respected.

The lease strip transaction purported to allocate the risk of the end users’ default on their rental obligations to D pursuant to the Master Lease. Under the Master Lease, D was obligated to pay rent to B from the end users’ rental remittances. The subsequent conduct of the participants is not consistent with the allocation of the risk to D. D (and later K) never bore the risk that the ultimate lessees of the equipment would default on their lease obligation. The purported transfer of its rights under the Master Lease to E in exchange for a $n1 prepayment of rent insulated D from the risk of default since it had cash in hand representing the present value of the rental payments. The risk of default with respect to the end users remained where it started with B as a result of B's guarantee of E's loan from Bank A. E was thinly capitalized and in the event of a significant rental payment default by the end users, E would be unable to meet its obligation under the Bank A loan and B would be required to make such payment under the guarantee. Thus, the transaction did not result in a reallocation of lessee default risk from B to any party.

The initial allocation of risk to D does not comply with the second factor mentioned in the Regulations because D did not have the financial capacity to assume the credit risk of the end users. As set forth previously, D does not appear to have been adequately capitalized to take over the end users' payment obligations in the event of default. By participating in the transaction, B was substituting the risk of an undercapitalized company with no financial history for the end users' credit risk. This purported shifting of risk to a company lacking the financial capacity to bear the default risk would likely never have occurred in a transaction imbued with economic substance.

Finally, the risk allocation does not meet the third factor mentioned in the regulations relating to the extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of gain realized. Neither D nor E were engaged in the leasing business, and the facts do not indicate that either had any employees or officers that influenced whether a profit or loss would be made on the leasing of the computers to third parties. Furthermore, D and E relinquished all control over business relations with the end users by allowing B to perform all services relating to the leases, including collecting the rent. Therefore, neither D nor E exercised any managerial control over the business activities influencing the obtaining of the end user rents.

The transaction failed to transfer any significant risks to either D or E. Accordingly, the risk allocation standards of Treas. Reg. §1.482-1(d)(3)(iii)(B) have not been met, with the result that the transaction should be disregarded as lacking economic substance. The effect of disregarding the Master Lease and Sublease is to break the chain of transactions giving rise to K's obligation to pay rent to B. Consequently, Taxpayer's deductions for rental expenses should be denied.

2. *Clear Reflection of Income Standard of Section 482-*

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

Even in the absence of tax avoidance motives, the Commissioner may make a section 482 allocation if necessary to clearly reflect income. The clear reflection of income prong of section 482 has been applied to transactions where the expenses attributable to property have been artificially separated from the income earned from the property. For instance, in Central Cuba Sugar Co. v. Commissioner, 198 F. 2d 214 (2d Cir. 1952), *cert. denied*, 344 U.S. 874 (1952), the taxpayer transferred planted crops to another corporation in exchange for the corporation's stock. The profit from the harvested crop was included in the income of the transferee corporation while the transferor corporation deducted the expenses attributable to raising the crop prior to the transfer. Applying the predecessor statute to section 482, the Commissioner allocated the expenses of raising the crop from the transferor corporation to the transferee corporation. The court upheld the allocation, finding it necessary to clearly reflect income by matching the income with the expenses associated with producing it. Id. at 216. See also Rooney v. U.S., 305 F.2d 681, 686 (9th Cir. 1962).

Applying the clear reflection of income standards of section 482, either the $n1 prepayment should be allocated to Taxpayer or the rental deductions should be allocated to D. One of these alternative allocations must be made to prevent the artificial separation of the end user rental income and the deductions attributable to the payments due under the Master Lease. Allocating the prepayment to Taxpayer or the rental deductions to D would ensure that the income received from the end users would be matched with the expenses incurred in producing the income-the corresponding obligation to pay rent under the Master Lease.

b. *Allocations involving nonrecognition transactions*

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

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

Other cases are in accord with National Securities Corp. that section 482 may be applied to clearly reflect income despite apparent conflict with the provisions of another section of the Code. See Central Cuba Sugar Co., 198 F.2d at 215-16 (Commissioner properly applied section 482 to reallocate deductions associated with property acquired in a reorganization to transferee to clearly reflect income); Dolese v. Commissioner, 811 F. 2d 543, 546 (10th Cir. 1987) (Commissioner has broad discretion under section 482 to correct distortion of income occurring through the strict application of other provisions of the Code and may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction); Aiken Drive-In Theater Corp. v. U.S., 281 F.2d 7, 9-11(4th Cir. 1960); Foster v. Commissioner, 756 F.2d 1430, 1433 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986) (Commissioner may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction). See also Rooney v. U.S., 305 F.2d at 686 (Section 482 will control when it conflicts with section 351.); Eli Lilly and Co. v. Commissioner, 84 T.C. at 1116-1118 (Section 482 may be applied in circumstances involving section 351 transactions if necessary to clearly reflect income or prevent the avoidance of tax.); G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). But see Ruddick Corp. v. U.S., 643 F.2d 747, 226 Ct. Cl. 426 (1981), *aff'd without opinion,* 732 F.2d 168 (Fed. Cir. 1984) (In the absence of tax avoidance motives, the Commissioner may not disregard section 351 transactions to apply section 482, even if doing so would be necessary to clearly reflect income.).

In the instant case, D's transfer of its rights under the Master Lease to K in the section 351 transfer resulted in a distortion of income. The section 351 transfer allowed Taxpayer to acquire, free of tax, the right to claim rental deductions on the equipment as the new sublessee under the Master Lease (along with the cash to pay such rent). Because of the obligation to pay rent which D transferred to K under the section 351 transaction, Taxpayer was able to claim losses collectively amounting to $n30 from Year 1 through Year 3. Taxpayer effectively paid only $n8, the cost of the preferred stock transferred to D in exchange for the right to claim $n30 of losses, resulting in a significant distortion of the amount of taxable income Taxpayer reported in Year 1 through Year 3. Applying the analysis adopted in the National Securities Corp. line of cases, the Service may disregard the section 351 transfer and allocate Taxpayer's rental deductions back to D to clearly reflect income. A section 482 allocation may be made despite the fact that its application would result in a conflict with the provisions of section 351, which would treat the transferee corporation, K, as the true owner of the interests and allow Taxpayer to claim the losses.

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