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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
LMSB:HAR

FROM: Associate Chief Counsel
Passthroughs and Special Industries CC:PSI:1

SUBJECT: Lease Strip/Inflated Basis Transactions

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

LEGEND

A =

B =

Taxpayer =

Subsidiary1 =

Subsidiary2 =

X =

Y =

Promoter =

Entity A =

Entity B	=	
Corporation A	=	
Corporation B	=	
Corporation C	=	
Corporation D	=	
Corporation E	=	
Corporation F	=	
Corporation G	=	
Corporation J	=	
Corporation K	=	
Corporation L	=	
Individual A	=	
Individual B	=	
Individual C	=	
Individual D	=	
Individual E	=	
Individual F	=	
Individual G	=	
Individual H	=	
Individual I	=	
Individual J	=	
Individual K	=	

Individual L	=
Financial Institution A	=
Financial Institution B	=
Financial Institution C	=
Appraiser	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
D1	=
D2	=
D3	=
D4	=
D5	=
D6	=
D7	=
D8	=
D9	=
D10	=
D11	=

D12	=
D13	=
D14	=
D15	=
D16	=
D17	=
D18	=
D19	=
D20	=
D21	=
D22	=
P1	=
P2	=
P3	=
P4	=
$A	=
$B	=
$C	=
$D	=
$E	=
$F	=
$G	=

$H	=
$I	=
$J	=
$K	=
$L	=
$M	=
$N	=
$O	=
$P	=
$Q	=
$R	=
$S	=
$T	=
$U	=
$V	=
$W	=
$X	=
$Y	=
$Z	=
$AA	=
$BB	=
$CC	=

$DD	=
$EE	=
$FF	=
$GG	=
$HH	=
$II	=
$JJ	=
$KK	=
$LL	=
$MM	=
$NN	=
A%	=
B%	=
C%	=
D%	=
E%	=
F%	=
G%	=
H%	=
I%	=
J%	=
K%	=

L% =

#A =

#B =

#C =

#D =

#E =

#F =

#G =

#H =

#I =

#J =

#K =

ISSUES

1. Whether the basis of the preferred stock may be challenged because the underlying lease stripping transactions lacked economic substance.

2. Whether the series of transactions in which the taxpayer obtained and sold the preferred stock lacked economic substance.

3. Whether § 351 applies to the exchanges described below.

4. What is the transferor's basis in the stock acquired in the exchanges.

5. Whether the taxpayer failed to substantiate its entitlement to the capital loss.

6. Whether § 482 applies to the transaction.

7. Whether the accuracy-related penalty provided by § 6662 applies to deficiencies that resulted from adjustments to the losses reported by Taxpayer from its disposition of the stock received in the purported § 351 transaction.

CONCLUSIONS

1. The basis of the preferred stock may be challenged because the underlying lease stripping transactions lacked economic substance.

2. The series of transactions in which the taxpayer obtained and sold the preferred stock lacked economic substance.

3. Section 351 does not apply to the exchanges described below for numerous reasons, as discussed below.

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

5. It appears that Taxpayer failed to substantiate its entitlement to the capital loss.

6. Section 482 applies to the transaction.

7. The accuracy-related penalty provided by § 6662 applies to deficiencies that resulted from adjustments to the losses reported by Taxpayer from its disposition of the stock received in the purported § 351 transaction.

FACTS

Lease Stripping Transactions

This case involves a series of prearranged transactions whereby Taxpayer recognized a purported capital loss of $HH resulting from its wholly-owned subsidiary's sale of inflated basis preferred stock acquired in a lease stripping transaction. Between D2 and D3, X, a publically traded corporation, purchased A from an unrelated corporation for $EE. Between D1 and D4, X purchased B from another unrelated corporation for $KK. X paid a total of $NN for the A and B, hereinafter (the "Equipment").

On D5, X sold the Equipment to P1, a limited partnership, for $NN, the same amount paid by X for the Equipment. The partners of P1 are P2 (the C% general partner) and P3 (the K% limited partner). The partners of P3 are P2 (the C% general partner) and P4 (the K% limited partner). The partners of P4 (P3's general partner) are Entity A (the K% limited partner), a tax neutral entity, and Individual A (A%), Corporation A (A%), and Corporation B (B%) as general partners. The sole general partner of P2 was Corporation C, a corporation that was affiliated with Promoter, the promoter of the leasing transactions. Under this tiered arrangement, a substantial portion of P1's items of income were ultimately allocated to the tax neutral entity.

P1 issued to X a #G-day promissory note (the "Partnership Note") in the principal amount of $NN, which bore interest at D% per annum for its purchase of the Equipment. The Partnership Note was due on D9, provided for full recourse against P1, and was secured by a perfected first priority security interest in the Equipment and any proceeds therefrom, including basic rent under the User Lease described below.

P1 leased-back the Equipment to X under a "User Lease". The User Lease was for a term of #E months in the case of the A and for a term of #F months in the case of the B. Under the User Lease, X was obligated to pay rent to P1 in the amount of $Q per month for the A and $R per month for the B (collectively, the "User Lease Rent"). X did not have the right to acquire any Equipment at the end of the lease terms.

On the same day P1 purchased the Equipment, it sold the Equipment, encumbered by the User Lease, to Corporation K for $NN. Corporation K paid the purchase price with four notes (1) two short-term, recourse promissory notes in the aggregate amount of $W, due D9 (collectively, the "Transferee ST Notes"), (2) one nonrecourse promissory note in the amount of $BB, and (3) one nonrecourse promissory note in the amount of $JJ (collectively the "Transferee LT Notes".) The four notes together are the "Transferee Notes".

Immediately after it purchased the Equipment from P1, Corporation K leased-back the Equipment to P1 for an approximately #A year term commencing D5 and ending D20 with respect to the A, and for a #B year term commencing D5 and ending D22 with respect to the B under a triple net lease (the "Master Lease"). Under the Master Lease, P1 was obligated to pay rent to Corporation K in the same amounts and at the same times as the installments were due on the Transferee LT Notes. P1 had no right under the Master Lease to either acquire the Equipment or to renew the Master Lease with respect to any Equipment.

As lessee under the Master Lease, P1 was the sublessor under the User Lease, and would be the sublessor under any user leases during the portion of the term of the Master Lease that extended beyond the expiration of the User Lease. Consequently, P1 was entitled to receive all of the revenues from such leases from D19 through D20 for the A, and from D21 through D22 for the B.

On D6, P1 sold to Financial Institution A its right to receive all of the User Lease Rent (due from X) payable after D6 for $LL.[1] Under the tiered arrangement, a substantial portion of rental income related to the underlying leases was "stripped" from the Equipment and allocated to the tax neutral entity. On the same day, Financial Institution A transferred the funds directly to X. The funds were credited as a prepayment of P1's obligation on the Partnership Note.

On D7, in a purported § 351 transaction, P1 transferred to Y, a subsidiary of X, all of its ("Position Assets") which were X's interests in (1) the Transferee Notes in the amounts of: $W, $BB, and $JJ; (2) the agreement under the User Lease, whose rent stream had been stripped off to Financial Institution A, and (3) the Master Lease Agreement (Corporation K's lease back to P1), under which P1 was obligated to pay rent to Corporation K in the same amounts and at the same times as the installments due under the Transferree LT notes, in exchange for #I shares of preferred stock of Y. Y agreed to assume (the "Position Obligations") which were (1) all of P1's obligations as sublessor under the User Lease, (2) all of P1's obligations as lessee under the Master Lease (including the obligations to pay the Master Lease Rent), (3) all of the remaining obligations under the Partnership Note (of which $LL had already been credited towards the $NN due), (4) P1's obligation to pay the Fixed Consulting Fee to Promoter, $T, and (e) up to $D of P1's obligation to pay the Documentation Fee.

As part of the same transaction, X simultaneously contributed $U to Y in exchange for #J shares of Y's voting common stock. As a result of the contributions and stock issuance, P1 and X owned, respectively, L% of the total issued and outstanding preferred stock of Y and L% of the total issued and outstanding common stock of Y. No other classes of stock were outstanding on D7.

Thus, at the end of the day on D7, Y had notes equaling approximately $MM, with an offsetting liability to pay rents due at the same time as the installment payments due under the Transferee LT notes. Although it still had the Transferee ST notes worth approximately $V, Y also accepted the remaining liability on the original $NN Partnership Note, which had only been pre-paid to the extent of the $LL million received from Financial Institution A. Moreover, Y's obligation to pay the $T fee was essentially fulfilled by the transfer from X of $U contributed to Y by X in the purported § 351 transaction.

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[1] On D6, P1 and Promoter entered into a consulting agreement, whereby P1 agreed to pay Promoter a consulting fee of $T (the "Fixed Consulting Fee") in return for certain, unknown investment banking and consulting services performed by Promoter regarding the sale of the Equipment to Corporation K. It is our understanding that the Fixed Consulting Fee constituted Promoter's fee for this lease stripping promotion.

Taxpayer’s own documentation concludes that the net aggregate value of the assets and obligations was approximately $P and that the fair market value of the #I shares of the preferred stock was also allegedly approximately $P, and that the fair market value of the #J shares of common stock issued to X was approximately $U.

On D5, Appraiser conducted an appraisal of the Equipment in which it projected rental income from the Equipment for the #C-month periods beginning at the end of the User Lease and ending at the end of the Master Lease. We note that on the basis of the appraisal data summarized in the field memorandum, the expected total undiscounted value of this rental income from A and B during these periods was $CC. Appraiser also concluded that the residual value of the A and B was projected to be $X and $FF, respectively.

Taxpayer’s documentation asserts that (1) P1's contribution of the assets to Y in exchange for the preferred stock and Y’s assumption of obligations, and X’s contribution of $U to Y in exchange for #J shares of Y’s common stock, qualified as a nonrecognition transaction under § 351; (2) Y’s basis in the Position Assets was equal to the basis of the asset in P1's hands before the contribution. P1's basis in the Transferee ST Notes and the Transferee LT Notes immediately before the contribution was, in each case, equal to the original face amount of the Transferee Notes, reduced by any principal payments on such notes by P1 prior to the contribution ($NN). P1's basis in the User Lease Agreement immediately before the contribution was $A. P1's basis in the Master Lease Agreement immediately before the contribution was equal to the amount of the $T consulting fee, reduced by the amount of allowable amortization deductions beginning on the closing date of the sale of the Equipment to Corporation K and ending on the date of the contribution; (3) Y was not required to include in income any amounts received as principal payments on the Transferee ST Notes or the Transferee LT Notes, but must include in gross income as interest the amount of interest that accrues under the Transferee Notes during any taxable year in accordance with their terms. Y was required to include in gross income the amount of rental income received or accrued in respect of a sublease renewal rents payable to it. Y was entitled to claim rental deductions for rents paid or incurred under the Master Lease. Y was entitled to deduct amortization allowances, on a straight line basis over the remaining term of the Master Lease, in respect of the unamortized balance of the $T fee as of the date of the contribution. Y was not required to include in income any amounts in respect of the User Lease Rent; and (4) X would be entitled to claim a rental deduction for rents paid or incurred under the User Lease.

On D8, Corporation K sold the Equipment and its rights under the Master Lease to Financial Institution B subject to Corporation K’s obligations under the Master Lease for $NN in cash. Corporation K used the cash received to prepay the Transferee Notes in full. Financial Institution B and Y proceeded to make amendments to the Master Lease, which, among other things, provided Y with an option to purchase the

Equipment at the expiration of the Master Lease. After Financial Institution B acquired the Equipment and the Master Lease, the Master Lease was amended to grant Y the right to purchase the Equipment from Financial Institution B at fair market value.[2] Y's rights to acquire the Equipment was described in the "Clause". If Y declined to exercise its purchase option, Financial Institution B was to sell the Equipment to the highest third-party bidder. The amendment provided that at the expiration of the Master Lease term, an adjustment to the Master Lease Rent was payable according to a formula that ensured that Financial Institution B would retain exactly $Z[3] from the sale of the Equipment, regardless of whether that sale was to Y pursuant to its purchase option or to a third-party bidder. Any difference between the actual sales price and $Z was to be treated as a positive or negative adjustment to the Master Lease Rent. Thus, for example, if Y exercised its purchase option (or if the Equipment were sold to a third-party bidder) at a fair market value of $Y, Y would make a $C payment to Financial Institution B, which payment would be characterized as additional Master Lease Rent. Conversely, if the Equipment were sold for $AA, Financial Institution B would make a payment of $K to Y, which payment would be characterized as a refund of Master Lease Rent.[4]

Section 351 Exchange

Subsidiary 1 was a wholly-owned subsidiary of Taxpayer. Taxpayer also acquired Subsidiary 2 which was allegedly involved in the leasing business.

On or about D8, P1 borrowed $P from Financial Institution C. The loan was evidenced by a one-year, E% promissory note, payable quarterly. As collateral for the loan, P1 pledged the #I shares of preferred stock to Financial Institution C. On D8, P1 instructed Financial Institution C to remit the loan proceeds directly to Promoter. That same day, P1 also instructed X to remit all preferred stock dividends to Financial Institution C.

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[2] If Y and Financial Institution B could not agree on a fair market value, an appraisal was to be conducted.

[3] This amount is exactly G% of $NN, i.e., the original purchase price of the Equipment, the sales price under both sale-leaseback transactions described above, and the aggregate amount of the Transferee Notes.

[4] If the fair market value of the Equipment at the termination of the Master Lease were equal to its appraised expected value on that date, as set forth in the original appraisal dated D5, Financial Institution B would be obligated to pay $DD to Y as a rent refund. This is based on an estimated fair market value for the A of $X on D20 and for the B of $FF on D22. The accuracy of these numbers should be verified because, if correct, they would indicate that Y possessed considerable future profit potential.

Notwithstanding the stock pledge, on D11, P1 transferred #H shares of the preferred stock, with a fair market value of $I and an adjusted basis of $II to Subsidiary2 in exchange for #D shares of Subsidiary2 common stock in a purported § 351 transaction. There is no evidence that Financial Institution C or X were notified of the transfer of preferred stock. At the time of the purported § 351 exchange with Subsidiary2, P1 agreed to be responsible for any then-existing liens on the stock. In the same purported § 351 transaction Taxpayer transferred a note with a face amount and alleged FMV of $M and with an adjusted basis of $A to Subsidiary2 for no consideration.

The remaining #H shares of Y preferred stock previously had been transferred by P1 to Entity B. To complete the prearranged transfer of the entire #I shares of preferred stock to Subsidiary2, on D12, Subsidiary2 purchased the remaining #H shares from Entity B for $G. Subsidiary2 paid for the shares with a promissory note, which remains outstanding.

On D14, X advised Subsidiary2 that it had been informed by P1 of the transfer and assignment of P1's right, title, and interest in the preferred stock. X further indicated in its letter that it wished to redeem the #I shares for $B per share. On D15, Subsidiary2 accepted X’s redemption offer, and advised that the preferred stock was in the possession of Financial Institution C as collateral for certain loans. Subsidiary2 further directed X to remit all redemption proceeds directly to Financial Institution C. Because the proceeds were used to satisfy P1's obligation to the Bank, P1 (and P1's managing partner) became indebted to Subsidiary2 in the amount of the liabilities. Subsidiary2 claimed a capital loss of $HH as a result of its acceptance of the redemption offer. Taxpayer was able to utilize $GG of the loss in Year 3, Year 4, Year 5, and Year 6.

Taxpayer explained that it entered into the transactions because it believed that it would facilitate future investment banking fees with Y.

<u>Relationships Among the Parties</u>

As with most, if not all of the lease stripping transactions examined to date, many of the parties to the transaction in this case are either owned, related to, or controlled by other participants. These relationships are as follows:

The partners of P1 are P2 (the C% general partner) and P3 (the K% limited partner). The partners of P3 are P2 (the C% general partner) and P4 (the K% limited partner).

The partners of P4 (P3's general partner) are Entity A (the K% limited partner), and Individual A (A%), Corporation A (A%), and Corporation B (B%) as general partners.

Corporation A is a subsidiary of Corporation L, which is owned K% by Individual A. Corporation B is owned by Corporation D, another promoter of lease stripping transactions. Corporation D is a wholly-owned subsidiary of Corporation E, which also owns L% of the common stock of Corporation F and Corporation G. Corporation E is owned by Individual B (H%) and Individual C (J%), who is married to Individual D. Individual B admitted during an interview relating to the examination of another lease stripping transaction that she acts only on Individual D's instructions. According to Corporation E' Year 1 return, Individual E, Individual F, and Individual G were compensated officers of Taxpayer, of which Individual E was the L% shareholder.

P2's sole general partner is Corporation C. It's executive vice president is Individual L, who is a I% stockholder of Promoter. The remaining stock of Promoter is owned by Individual H.

Corporation K, which purchased the Equipment from P1, has the same corporate address as Taxpayer, whose subsidiary (Subsidiary2) acquired the inflated basis preferred stock in Y from P1. Taxpayer is owned L% by Individual E. The officers of Taxpayer are Individual E, Individual F, and Individual G, all former employees of Corporation D.

Taxpayer's chairman of the board is Individual I, who is also the L% common stockholder of Corporation J. Corporation J is a preferred stockholder of Taxpayer. Corporation J's Year 1 return is signed by Individual J, an employee of Individual D. As noted above, Individual D's wife is the majority shareholder of Corporation E, which controls Corporation B. The officers of Corporation F, another subsidiary of Corporation E, are Individual D, Individual K, and Individual J.

The preferred stock of Taxpayer is owned by Corporation B, Corporation F and Corporation G The officers of Corporation B are Individual D and Individual K. The officers of Corporation F are Individual D and Individual K. Individual B is a director. The officers of Corporation G are Individual D and Individual K, with Individual B as a director. The name "Corporation G" appears on the door to the offices of Entity B.

Entity B, which sold #H shares of Y preferred stock to Subsidiary2 on D12, is represented by Individual K. Subsidiary1, a subsidiary of Taxpayer, reported the following fee income from Entity B in Year 3: (1) $J on D10; (2) $H on D17; and (3) $F on D17.

Subsidiary1 also reported fee income of $S in Year 3 from Corporation A for a different transaction, and the following fee income from Corporation G during that year: (1) $L on D13; (2) $E on D16, and (3) $N on D18. In Year 3, Subsidiary1 also deducted referral fees of $O paid to Individual D.

LAW AND ANALYSIS

Issue 1: The Lease Stripping Transactions Lacked Economic Substance

A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Nicole Rose v. Commissioner, 117 T.C. 27 (2001); 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. 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 primarily 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).

In ACM Partnership, 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, 526 U.S. 1017 (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 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, 1999-1 C.B. 835 (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). See also, Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999). The Eleventh Circuit recently affirmed the Tax Court's determination that the transaction entered into by the taxpayer was a substantive sham. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001). But see, United Parcel Service of America, Inc. v. Commissioner, T.C. Memo. 1999-268[5].

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[5]In United Parcel Service of America, Inc., the Eleventh Circuit recently reversed the Tax Court on the issue of economic substance finding that UPS's restructuring of its excess-value business had both real economic effects and a business purpose. The Court reasoned that setting up a transaction with tax planning in mind is permissible as long as there is a bona fide, profit seeking business purpose. United Parcel Service of

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 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 U.S.T.C. (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).

Recently, in Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001), the Tax Court found that petitioner's acquisition of certain stripped lease interests to shelter gain in an intermediary transaction lacked economic substance. Petitioner stepped into the transaction by purchasing the shares of a corporation and merging that corporation into petitioner. Petitioner then sold assets it had acquired in the merger, generating an approximately $11,000,000 gain. Pursuant to a series of prearranged transactions including several § 351 transactions, petitioner acquired the purported interests and obligations relating to certain leases. The majority of the income relating to these interests had been stripped off and placed into a trust fund. Upon petitioner's subsequent transfer of these interests, petitioner claimed, inter alia, an ordinary business expense deduction of approximately $21,000,000.
In holding that the transactions lacked economic substance the court noted that "no credible business purpose and . . . no viable economic substance existed" for petitioner's transfer of the lease interests. Further the court noted that the prearranged transactions leading up to petitioner's acquisition of the purported interests created a circular flow of funds. In imposing the accuracy related penalty, the Court held that the participation of highly paid professionals did not provide petitioner any protection, excuse, justification, or immunity.

In this case, because the inflated basis stock was traceable to a lease stripping transaction, the economic substance inquiry focuses first on whether the initial lease stripping transactions lacked economic substance, and secondly, whether the Taxpayer's subsequent transfer of the inflated basis stock lacked economic substance. We believe that this series of prearranged lease stripping transactions, taken as a whole, lacks business purpose and was entered into primarily to reduce taxes.

A transaction involving a sale and lease-back transaction would reasonably be expected to be tax-neutral over its normal life expectancy. Typically the lessee would report rental deductions with respect to its payments for use of a particular property, and the lessor would realize corresponding income with respect to its grant

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America, Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001).

of a lease of the property. Here, the parties, according to a prearranged plan, artificially divided the transaction into an income leg and a loss leg. The allocation of the income through the tiered partnership structure, to a tax neutral entity, created a division of the transaction into an income and a loss leg and does not appear to be rationally related to a useful nontax purpose that is plausible in light of the economic situation. Rather, the structure of the transactions appears to be shaped principally by tax avoidance.

The offsetting legal obligations and circular cash flows among the parties reinforces the conclusion that the lease stripping transactions lacked economic substance. X purchased the equipment for $NN, sold the Equipment to P1 for $NN and leased back the Equipment from P1 for rental payments equaling the payments on the note it received for its original sale to P1. Simultaneously, P1 sold the Equipment to Corporation K for $NN in notes and leased back the Equipment from Corporation K for rental payments equaling the payments on the Transferee LT notes. These offsetting legal obligations and circular flows of cash left the parties in the same economic positions that they were in prior to the transactions. Both subjectively and objectively the parties could not have anticipated a profit from these transactions. However, the structure of the transactions allowed the parties to strip the income from the transactions to the tax neutral entity.

The prearranged nature of the transaction is revealed by the subsequent participation of X’s subsidiary Y. X entered into a transaction with P1 in which it sold the Equipment and simultaneously leased it back for a period of #E months and #F months for lease payments which offset the payments due X on the Partnership Note. This wash transaction theoretically deprived X of the residual value of the property, even though X had paid an identical amount for its original full ownership of the Equipment. The circle of both money and equipment is completed, however, when X’s subsidiary ultimately acquires a purchase option on the equipment.

Further evidence of prearrangement is evidenced by the fact that many of the parties to these transactions are either owned, related to, or controlled by other participants, and have a history of involvement in lease stripping transactions. The relationships among the parties and their participation in a pre-determined plan in carrying out the above-described steps establishes that they had no regard for the economic implications of the steps, but rather intended to pursue the steps primarily to receive the resulting tax benefits.

Based upon these facts, there is no economic substance to the lease stripping transactions. Because the lease stripping transactions in which P1 acquired the preferred stock lacked economic substance, P1's basis in the preferred stock is limited to the value of the property P1 contributed in exchange for that stock.

Issue 2: Lack of Economic Substance to the Inflated Basis Transactions

After the purported § 351 transaction on D7, Y had notes equaling approximately $MM, with an offsetting liability to pay rents due at the same time as the installment payments due under the Transferee LT notes. Although it still had the Transferee ST notes worth approximately $V, Y also accepted the remaining liability on the original $NN Partnership Note, which had only been pre-paid to the extent of the $LL received from Financial Institution A. Moreover, Y's obligation to pay the $T fee was essentially fulfilled by the transfer from X of $U contributed to Y by X in the purported § 351 transaction. There is no credible subjective or objective business purpose for acquiring these offsetting assets and liabilities. Moreover, at this juncture, X had not acquired a purchase option for the Equipment, and could not claim a theoretical profit in the future on the Equipment. Accordingly there was no credible business purpose either subjectively or objectively for Y to acquire these assets in a purported § 351 transaction in return for #I share of its preferred stock.

Any claim by P1 to value in the Y shares lacks validity in the face of P1's subsequent transfer of #H shares in a purported § 351 transaction on D11 to Subsidiary2. Only a few months later, Subsidiary2 purchased the remaining shares for $G. Shortly thereafter, X redeemed the shares at $B per share. Taxpayer's subsidiary had no business purpose for acquiring and selling the preferred stock, and those transactions lacked economic substance. Consequently, Subsidiary2 would have a cost basis in the preferred stock. As a result, Taxpayer, through the consolidated group, is not entitled to the loss generated from this transaction.

Issue 3: The Exchange of the Leasehold Positions for Stock is Not a § 351 Exchange.

A. Control Requirement

Section 351 provides nonrecognition treatment for transfers "by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred." § 1.351-1(a)(1). "Control" requires ownership of stock possessing at least 80 percent of the 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. §§ 351(a) and 368(c).

The transaction in which the transferee stock is received (here, the transfer by P1 to Y) must be carefully analyzed to determine that it does in fact satisfy the technical requirements of § 351. Transferors who contribute property to a corporation at different times may be considered part of a single control group if their "rights have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." § 1.351-1(a)(1). For example, under the facts presented, a pre-existing shareholder or shareholders must join with the transferor (P1) in transferring property to the transferee corporation (Y) in order for the exchange in the first purported § 351 transaction to satisfy the control requirement of § 351(a). An existing shareholder will not be considered part of a transferor group if the property it transfers "is of relatively small value in comparison to the value of the stock and securities already owned" by the transferor and "if the primary purpose of the transfer is to qualify under [§ 351] the exchanges of property by other persons transferring property." § 1.351-1(a)(1)(ii). The property transferred will not be considered to be of relatively small value, within the meaning of § 1.351-1(a)(1)(ii), if the fair market value of the property transferred is equal to, or in excess of, 10 percent of the fair market value of the stock and securities already owned by such person. Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568, 570.

In the instant case, both the first purported § 351 transaction and the second purported § 351 transaction appear to have included transfers of property by pre-existing shareholders intended to qualify the exchanges under § 351. In order to meet the control requirement in the first purported § 351 transaction between P1 and Y, X simultaneously transferred $U in cash to Y in exchange for #J shares of Y's voting common stock. An argument can be made that the primary purpose of the transfer by X was to qualify P1 for § 351 treatment. However, because the value of the #J shares of voting common stock issued by Y to X in the first purported § 351 transaction does not appear to be relatively small compared to the value of the old stock owned by X (100 shares), it appears that an argument can not be made that the first purported § 351 transaction did not meet the control requirement of § 351.

In the second purported § 351 transaction, Taxpayer transferred a note in the face amount of $M to Subsidiary2 for no consideration on the same day that P1 transferred #H shares of the Y preferred stock to Subsidiary2 in exchange for #D shares of Subsidiary2 common stock. The taxpayer will argue that the control requirement of § 351 has been met because the ownership interest of all transferors participating in a single transaction are aggregated. A careful factual determination of the value of the $M note is required. The value of the note must be compared to the value of the Subsidiary2 common stock previously owned by Taxpayer to determine if § 1.351-1(a)(1)(ii) will apply to negate the transfer of the note by Taxpayer, and thus prevent § 351 from applying to the second purported § 351 transaction.

B. Business Purpose Requirement

In addition to satisfying the technical requirements of § 351, a transfer must have a bona fide business purpose in order to qualify as a § 351 exchange. See Rev. Rul. 55-36, 1955-1 C.B. 340; Caruth v. United States, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), aff'd on other issues, 865 F.2d 644 (5th Cir. 1989); Stewart v.

Commissioner, 714 F.2d 977, 992 (9th Cir. 1983); Kluener v. Commissioner, T.C. Memo. 1996-519, aff'd, 154 F.3d 630 (6th Cir. 1998) .

Determining whether a bona fide non-tax business purpose motivated, at least in part, a § 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 § 351 transaction. These factors include:

1. whether the transfer achieved its stated business purpose,

2. whether the transfer primarily benefitted the transferor or the transferee,

3. the amount of potential non-tax benefit to be realized by the parties,

4. whether the transferee corporation is a meaningless shell,

5. whether the transferee's existence is transitory,

6. whether the transferee corporation has any other assets of the type transferred,

7. the number of times the property was transferred, both prior to and after the § 351 transaction,

8. the amount of time each party held the property, both prior to and after the § 351 transaction,

9. whether there were any pre-arranged plans concerning future dispositions of the property, and

10. whether there were independent parties (such as creditors) that requested a specific structure for the transaction.

Taxpayer's explanation that it entered into this transaction because it believed that it would facilitate future investment banking fees with Y does not appear to be a valid business purpose. The facts, as currently developed, do not suggest a plausible business purpose for the transactions. It appears there was no real purpose for the transactions apart from the creation of an asset (the Y preferred 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.

Other considerations Re: the § 351 business purpose requirement

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.

Disqualifying the transaction under § 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 § 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 § 351. Since these cases present a particularly compelling case for a business purpose argument, we encourage the argument be made.

C. Summary

The transfers by P1 and X to Y in the first purported § 351 transaction do not qualify under § 351. Therefore, the transactions are taxable exchanges under § 1001 and, under § 1012, P1 takes a cost basis in the Y 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 Y preferred stock received in the transaction).[6]

Note that this argument applies equally to the transfer of Y preferred stock to Subsidiary2 in exchange for Subsidiary2 common stock in the second purported § 351 transaction.

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 § 351 business purpose requirement, therefore the following arguments must also be developed.

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[6]According to Taxpayers documentation, the fair market value of the #I shares of Y preferred stock issued to P1 was approximately $P.

Issue 4: Even if the transfers qualify under § 351, the basis in the stock is reduced by the amount of the obligations to make rental payments.

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

Section 357(a) provides in relevant part that except as provided in §§ 357(b) and (c), if the taxpayer (i.e., the transferor) receives property that would be permitted to be received under § 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 § 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 § 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 § 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 § 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 § 357(c)(1) shall not apply to any exchange to which § 357(b)(1) applies.

Section 357(c)(3)(A) provides that if a taxpayer transfers, in an exchange to which § 351 applies, a liability the payment of which either would give rise to a deduction, or would be described in § 736(a), then, for purposes of § 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 § 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 § 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 § 358, be treated as money received by the taxpayer on the exchange.

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

The assumption of the transferor's (P1'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 § 357 and, under §§ 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.[7]

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

Congress enacted § 357(c)(3) to prevent inappropriate gain recognition resulting from the application of § 357 to certain liabilities. In general, the assumption of a deductible liability in a § 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 § 357(c)(1), Congress enacted § 357(c)(3). See § 103(a)(12) of

[7]It is noted that, for transactions on or after October 19, 1999, the basis of the Y stock, irrespective of any other provisions of the Code or regulations, would be reduced by the amount of the liability (but not below fair market value) under § 358(h). The transactions in the instant case occurred before October 19, 1999, and, therefore, § 358(h) does not apply.

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, to the extent the User Lease term and the Master Lease term are identical, the transfer of the leasehold position in the first purported § 351 transaction includes no corresponding right to use property subject to the lease or to receive income from the property transferred. Under these circumstances, *i.e.*, where the User Lease term and the Master Lease term are identical, 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 (Y), the deduction for the rental payments, when made, may accrue to the transferor (P1).[8] In such a case, the purpose of § 357(c)(3)(A)(i) is not served by the exclusion of a liability (because the transferor will not be denied the tax benefit for the satisfaction of the liability). Therefore, it is our position that, to the extent the terms of the User Lease and the Master Lease overlap, the associated rental obligations are not within the intended scope of § 357(c)(3) because the deduction remains with the Transferor. Accordingly, § 358(d)(2) has no application to such liabilities and the transferor's basis in the transferee stock must be reduced by the amount of the liabilities assumed.

In the first purported § 351 transaction, however, the transferee corporation (Y) received both a right and an obligation, to use the Equipment (including the right to lease out the Equipment) and to pay rent, respectively, for the term beginning with the expiration of the User Lease and ending with the expiration of the Master Lease (the “residual lease term”). As a result, we believe the transferee may be entitled to a rent deduction for the Equipment during the residual lease term. Generally, when

[8] This assumes the rental payments (during the term of the User Lease) are an ordinary and necessary expense paid or incurred by the Transferor in carrying on a trade or business. A threshold question in determining whether an activity is in a trade or business is whether there is a bona fide objective of making a profit. The submission from the Field suggests that the Transferor had a substantial profit motive, and thus may have been entitled to a rental deduction for the User Lease term because, as stated in the appraisal, the Transferor expected to recover its original investment plus receive a substantial return on its investment. Because of the participation of this Appraiser in a majority of lease stripping cases, we have reason to doubt the appraisal’s conclusions. This should be substantiated through further factual development.

a taxpayer has the right to use property and the obligation to pay rent, such taxpayer would be allowed to claim a rental deduction provided the taxpayer's activity has been undertaken in good faith, with the dominant hope and intent of realizing a profit. To the extent the taxpayer establishes that it had a valid, non-tax profit motive, a corresponding portion of the liability may be within the scope of §§ 357(c)(3) and 358(d)(2).[9]

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

As stated above, § 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 § 357(a) was not a bona fide business purpose, then such assumption shall, for purposes of § 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 (P1) with respect to the assumption was simply to create an asset with a basis far in excess of its value (viz., the Y preferred stock) that could be sold to generate a substantial loss, for tax purposes, with no real economic cost to the parties. This is not a bona fide business purpose.

Accordingly, the liability assumption in this case is squarely within the scope of § 357(b)(1)(B) and is to be treated as a distribution of money to the transferor on the exchange. Consequently, under § 358(a)(1)(A)(ii), the basis in the transferee stock (i.e., the Y preferred stock) is reduced by the amount of the assumed obligations.

Note that § 357(b)(1) takes precedence over both §§ 357(a) and 357(c). Section 357(a) provides for application of the general rule of § 357, "[e]xcept as provided in subsection (b) and (c)". Section 357(c)(2)(A) expressly provides that § 357(c)(1) shall not apply to any exchange to which § 357(b)(1) applies. This necessarily extends to § 357(c)(3), which simply excludes certain liabilities "for purposes of" applying § 357(c)(1). Thus, in an exchange to which § 357(b)(1) applies, § 357(c)(1) does not apply and therefore § 357(c)(3) is rendered moot. Accordingly, neither the

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[9] This argument assumes that the transfer of the Positions Assets (including the Master Lease) to Y, the transferee, in the first purported § 351 transaction resulted in a transfer of the right to either use or re-lease the Equipment during the residual lease term.

general rule of § 357(a), nor § 357(c)(1) and (3), apply to an exchange to which § 357(b)(1) applies.

Other Considerations Re: treating the leasehold obligations as within the scope of § 357.

In terms of our analysis of the § 351 exchange, the taxpayer may argue that the leasehold obligations are contingent liabilities and therefore not "liabilities" within the scope of §§ 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 § 351 exchange, such a contingent liability should not be taken into account (or is not a "liability") for purposes of §§ 357 and 358. It also finds some support in the case law (cited below) and the legislative history of § 357(c)(3). Nevertheless, we disagree with this position.

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

Congress enacted § 357(c)(3) in response to several court cases that had developed different approaches to prevent the application of § 357(c)(1) to an assumption of a liability that had not produced a Financial Institution B 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 § 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 § 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 § 357(c) or § 357 in general. Rather, under § 357(c)(3), Congress excluded certain "liabilities" from the

§ 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 § 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 §§ 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 § 358(h), enacted as § 309 of the Community Renewal Tax Relief Act of 2000, P.L. 106-554. While taking the position that § 358(h) does not apply to their particular transaction, taxpayers may nevertheless argue that the legislative history of § 358(h) indicates Congress did not view contingent liabilities as within the scope of §§ 357 and 358 (i.e., prior to the enactment of § 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 § 357(c)(3), we do not believe that § 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 § 358(h) and its legislative history, if and when that occurs.

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. §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).

Immediately after the second purported § 351 exchange (in which P1 transferred to Subsidiary2 #H shares of Y preferred stock in exchange for #D shares of Subsidiary2 common stock), and after Subsidiary2 purchased the other #H shares of Y preferred stock for $G, Subsidiary2 possessed #I shares of Y preferred stock worth approximately $P. Immediately thereafter, X redeemed Subsidiary2's #I shares of Y preferred stock for $P. Subsidiary2's economic position never declined. Accordingly, Subsidiary2 has had no loss and so it is not entitled to a § 165 deduction. In fact, arguably Subsidiary2 recognized a gain of $D on the redemption of the #H shares of Y preferred stock that it purchased for $G and sold to X for $I

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

Issue 5: It appears that Taxpayer failed to substantiate its entitlement to the capital loss.

Based upon the facts, as currently developed, we believe that Taxpayer's claimed loss should not be allowed without Taxpayer providing evidence of its basis. However, for purposes of tax administration, we believe substantiation and evidentiary issues are better suited for field determination, and, therefore we defer to the field's determination on this issue.

Issue 6: Section 482 applies to the transaction.

I. Discussion of the Requirements of § 482

1. Section 482-Generally

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. Taxpayers who act in concert or pursuant to a common design or plan may be treated as controlled by the same interests with respect to the transactions that they collectively control. B. Forman v. Commissioner, 453 F.2d 1144, 1160-61 (2nd Cir. 1972), cert denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq., 1975-2 C.B. 3 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).

2. Legal Standard for Determining Control under § 482

1. *Definition of control*

a. *Court decisions*

The regulations under § 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 the reality of control, that is, actual and practical control which is determinative in the application of § 482 rather than record ownership or legally enforceable control. 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); 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) (foreign investors did not have § 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, Inc. v. Commissioner, 372 F. 2d 415, 419 (4th Cir. 1967), cert denied, 389 U.S. 841 (1967) (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 § 482 regulations and the applicable 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 § 482. The Service has the authority to determine whether control exists by considering the reality of the control situation and examining whether the same interests effectively control the participants to the transaction, rather than basing the determination of control solely on the taxpayer's percentage of ownership of voting stock or legal right to direct the participant's actions. See B. Forman at 1160-1161.

b. *§1.482-1(i)(4)[10]: Acting in concert or with a common goal or purpose and the presumption of control*

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[10] For the tax year covering the D11 transfer by P1 of #H shares of Y to Subsidiary2 in a § 351 exchange for common shares, the control standard is governed by Temp. Reg. §1.482-1(h)(4).

The regulations governing the years covered by this case provide that when control does not exist through a taxpayer's majority ownership of a participant's voting stock or a legally enforceable agreement delegating the power to direct an entity's actions, control may result from the actions of two or more taxpayers acting in concert or with a common goal or purpose. Treas. Reg. §1.482-1(i)(4).[11] See also DHL Corp., T.C. Memo 1998-461 at 100. By its terms, the regulation does not require taxpayers to be related to each other by overlapping ownership to effect § 482 control by "acting in concert" or "pursuant to a common goal or purpose."

In addition, a presumption of control arises under the regulations if income and deductions have been arbitrarily shifted. Id. Case law is in accord with the regulation's presumption of control through the arbitrary shifting of income or deductions. See Hall v. Commissioner, 294 F.2d 82, 85 (5th Cir. 1961) (finding presumption of control under § 29.45-1 of Regulation 111, predecessor to current § 482 regulations). However, by its terms, the existence of control by acting in concert or with a common goal or purpose may be found separately under the final regulations whether or not a presumption of control is found through an arbitrary shifting.

From the facts, a loss deduction has been artificially created by the lease-stripping transaction in which P1 participated and the subsequent contribution of the Transferee Notes to Y in a tax-free § 351 transaction. The only apparent purpose for contributing the Transferee Notes to Y was for the purpose of inflating the basis on its stock so that a built-in loss could be facilitated through another § 351 transaction.

This basis inflation occurred in four steps. First, immediately after purchasing the Equipment from X, P1 sold the Equipment to Corporation K Holding for $NN. Second, P1 sold the User Lease Rent to Financial Institution A for $LL. The sale of the User Lease Rent resulted in a $LL taxable gain to P1, almost all of which was allocated to a tax-exempt partner. Third, when P1 made its capital contribution to Y, the earlier sale of the User Lease Rent had the effect of "stripping" a significant portion of the value from the contributed assets while leaving the basis of those assets unchanged at $NN. Finally, under § 351, P1 claimed a transferred basis in the Y preferred stock.

Once the loss deduction had been built into the Y stock, the parties acted in concert to shift it to a party who could make use of the loss. The #H shares of Y preferred stock contributed by P1 to Subsidiary2 in the purported § 351 transaction of D11

[11] The final regulation applies during the Year 3 year in which the built-in loss was realized by Subsidiary2's redemption of it shares in Y.

had a built-in loss representing the difference between a claimed basis of $II and a claimed fair market value of $I. Shortly thereafter, on D15, Subsidiary2 accepted an offer for the redemption of these #H shares of Y preferred stock, together with an additional #H shares it allegedly purchased from Entity B. The resulting capital loss recognized by Subsidiary2 offset a total of $GG in gains during the taxable years Year 3 through Year 6. This loss did not correspond to any economic loss by Subsidiary2, and may be viewed as arbitrary.[12] Significantly, P1 had little use for a capital loss deduction because its K% limited partner was a partnership, P3, whose K% limited partner was yet another partnership, P4, whose K% limited partner was not subject to U.S. income taxation. To preserve the tax benefit from the built-in loss that was the counterpart to the rent strip, the parties to this transaction sought to shift the built-in loss to the Taxpayer's consolidated group, a taxable party.

c. The presumption of control among the parties

In making the § 482 control 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. The regulations do not require the Service to also establish that the parties acted in concert or with a common goal or purpose for the presumption to be applicable. The Service must only establish that income or deductions have been arbitrarily shifted between the parties for the presumption of control to arise.

From the facts provided to us, and in addition to the "acting in concert" control theory discussed above, it appears as though a loss deduction has been arbitrarily shifted from P1 to Subsidiary2. In particular, no plausible business purpose has been offered as to why Subsidiary2 would accept stock with so little apparent worth in exchange for its own stock. The only apparent reason for the transfer was to facilitate Subsidiary2's use of the built-in capital loss which P1's ultimate indirect K% owner could not use. Similarly, no plausible reason has been offered as to why P1 would prefer to own common stock representing a small minority interest in Subsidiary2, a closely-held corporation, instead of preferred stock which paid cumulative dividends of F% in Y. One might expect that the possibility of receiving dividends on all of a company's preferred stock would offer a greater potential for profit than holding a small minority percentage of a shell company's common stock. The absence of credible non-tax reasons as to why Subsidiary2 would want Y preferred stock, and as to why P1 would want Subsidiary2 common stock, makes the shifting of the loss built into the stock appear to have occurred in an arbitrary manner.

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[12] Indeed, this loss did not correspond to any economic loss by any party, including to any party to the lease-stripping transaction that resulted in the manufacture of the high-basis, low-value Y preferred stock.

d. Legal Standard for Determining "the Same Interests" Under § 482

The regulations do not define what the term "the same interests" means under § 482. Case law indicates that in using the term "the same interests," Congress intended to include more than "the same persons" or "the same individuals." Under this approach, 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 § 482. See Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967), cert denied, 389 U.S. 841 (1967); B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), cert denied, 407 U.S. 934 (1972); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), cert denied, 386 U.S. 1016 (1967). Cf. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979) (stating that different persons with a common goal or purpose for arbitrarily shifting income can constitute "the same interests" for purposes of § 482); 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 1965-2 C.B. 7.

As previously discussed, the facts show the apparent existence of a common plan between P1 and Subsidiary2 to shift a substantial capital loss to Subsidiary2. On the basis of these facts, we conclude that P1 and Subsidiary2 constitute "the same interests" under § 482. Assuming the transfer of Y preferred stock by P1 to Subsidiary2 is respected as a valid nonrecognition transfer under § 351, we conclude that adequate grounds exist under § 482 to reallocate the loss deduction claimed by Subsidiary2 to prevent the evasion of taxes or to clearly reflect income.

II. Application of § 482 to Subsidiary2's Redemption Transaction

The § 351 transaction immediately follows a lease stripping transaction of the type described in Notice 95-53, 1995-2 C.B. 334. The Notice indicates that lease stripping transactions effected through a transferred basis transaction will result in the exercise of the Service's authority to reallocate gross income, deductions, credits, or allowances between the participants in the transaction. At this stage of development, the facts indicate that the contribution and sale of the stock were part of a prearranged transaction to avoid taxation through the creation and transfer of a capital loss.

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

Section 1.482-1(f)(1)(iii) adopts the same rule reflected in the Third Circuit's holding in National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd 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 § 351. The subsidiary in form 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 instead by the parent of the subsidiary under § 45 of the Revenue Act of 1936, the predecessor to § 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 § 45 was applied, its application would result in a conflict with the literal provisions of some other provision. Id. The court held 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 § 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. v. Commissioner, 198 F.2d 214, 215-16 (2nd Cir. 1952), cert denied, 344 U.S. 874 (1952) (Commissioner properly applied § 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 § 482 to correct distortion of income occurring through the strict application of other provisions of the Code and may invoke § 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 § 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 681, 686 (9th Cir. 1962) (Section 482 will control when it conflicts with § 351.); Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1116-1118 (1985), aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988) (§ 482 may be applied in circumstances involving § 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., 226 Ct. Cl. 426 (1981), 643 F.2d 747, aff'd without opinion, 732 F.2d 168 (Fed. Cir. 1984) (In the absence of tax avoidance motives, the Commissioner may not disregard § 351 transactions to apply § 482, even if doing so would be necessary to clearly reflect income.).

On the facts provided, we conclude that Subsidiary2's redemption of its Y stock is subject to allocation under § 482 in accordance with §1.482-1(f)(1)(iii), National Securities and its progeny. We also conclude that the facts show that Subsidiary2 and P1 engaged in the § 351 transaction primarily to further tax avoidance motives and that the subsequent disposition of the Y preferred stock acquired by Subsidiary2 in the § 351 transfer resulted in a distortion of income. By disposing of the inflated basis, low value Y preferred stock at a substantial loss, Subsidiary2 was able to shelter significant capital gains income for the cost of twenty shares of its stock.

Given that (1) Subsidiary2 held the stock for only a short time before accepting the redemption offer[13] and (2) the loss generated upon the redemption of the stock offset gains of $GG during the taxable years Year 3 through Year 6, it is apparent that the pre-contribution loss attributable to the stock properly belongs to P1. Accordingly, under the analysis adopted in National Securities Corp. and its progeny, the Service may disregard the § 351 transfer and allocate the losses Subsidiary2 claimed on the sale of the Y preferred stock back to the transferor entity, P1, to clearly reflect income of the parties who acted in concert and pursuant to the common plan to shift income and deductions. We also recommend that the facts may appropriately demonstrate a lack of business purpose with respect to the § 351 transfer by P1 and the redemption of Y shares within #K months after Subsidiary2 received the stock. Accordingly, we believe that sufficient evidence of tax avoidance is present and conclude that the result in Ruddick would not apply to this transaction if the case were to be appealable to the Federal Circuit.

Issue 7: The accuracy-related penalty provided by § 6662 applies to deficiencies that resulted from adjustments to the losses reported by Taxpayer from its disposition of the stock received in the purported § 351 transaction.

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

[13] The Y stock was held for a shorter period than the stock was held by the transferee in National Securities.

accuracy-related penalty provided by § 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663. Section 6662(b).

1. Negligence

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. Sections 6662(c) and 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g, 43 T.C. 168 (1964). Section 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. If the facts establish that a taxpayer reported losses from a transaction that lacked economic substance or reported losses or deductions from assets with bases traceable to lease stripping transactions that would have seemed, to a reasonable and prudent person, to be "too good to be true," then the accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed losses or deductions.

The facts, as currently developed, support the view that the accuracy-related penalty attributable to negligence applies to the deficiency that results from the disallowance of the built-in losses from the inflated basis assets, because Taxpayer appears to have disregarded the economic substance of the transactions from which the losses were claimed and has failed to offer evidence that there was reasonable cause for its return position for the losses or that it acted in good faith in claiming them. There is no evidence that they thoroughly investigated the bona fide economic aspects of the lease stripping transactions or reasonably relied on professional advice that the losses are allowable. See Freytag v. Commissioner, 904 F.2d 1011, 1017 (5th Cir. 1990); § 1.6664-4(c). We accordingly conclude that the facts, as developed, support the conclusion that Taxpayer was negligent and that the penalty provided by § 6662(a) should therefore be imposed.

2. Substantial Understatement of Income Tax

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($D in the case of corporations other than S corporations or personal holding companies). Section 6662(d)(1). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. Section 6662(d)(2)(B). In the case of items of taxpayers other than corporations attributable to tax shelters, exception (2) above does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. Section 6662(d)(2)(C)(i). In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) above applies. Section 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to the understatement unless the reasonable cause exception applies. See Section 1.6664-4(e) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation. The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. Section 6662(d)(2)(C)(iii). For transactions entered into before August 6, 1997, the relevant standard was whether tax avoidance or evasion was the "principal purpose" of the entity, plan, or arrangement. Section 1.6662-4(g)(2)(i). If the facts establish that an understatement attributable to the disallowance of losses or deductions from assets with bases traceable to lease stripping transactions exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($D in the case of corporations other than S corporations or personal holding companies), a substantial understatement penalty may be applicable.

We believe that the facts, as currently developed, support the position that the series of transactions in which Subsidiary2 acquired and sold the inflated basis stock to recognize the built-in losses was a tax shelter. Consequently, any understatement that resulted from the disallowance of the loss claimed from the preferred stock would, if substantial, be subject to the penalty provided by § 6662(a). If the series of prearranged transactions in which Taxpayer acquired and sold the preferred stock to recognize the built-in losses was not a tax shelter, we believe that any understatement that resulted from the disallowance of the loss claimed from the inflated basis assets would, if substantial, be subject to the penalty provided by § 6662(a), because neither of the exceptions contained in § 6662(d)(2)(B) seem to apply in this case. As discussed below, the facts as developed, do not support the conclusion that Taxpayer had a reasonable basis for claiming the inflated basis. In addition, it does not appear that the relevant facts affecting the items' tax treatment were disclosed in the return of Taxpayer or in attached statements.

3. Substantial Valuation Misstatement

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $5,000 ($D in the case of a corporation other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. Section 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." Section 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20% penalty under § 6662(a) is increased to 40%. Section 6662(h)(1). This penalty does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664-4. Section 1.6662-5(a). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992).

We believe that the facts, as currently developed, support the position that the accuracy-related penalty attributable to a substantial valuation misstatement applies to these transactions. If the facts establish that the adjusted basis of the preferred stock, an asset with a basis traceable to a lease stripping transaction, is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the facts establish that the adjusted basis of the preferred stock is 400 percent or more of the correct amount, then a gross valuation misstatement exists. As discussed below, the facts developed do not support the conclusion that the Taxpayer had a reasonable basis for claiming the inflated basis.

4. The Reasonable Cause Exception

The accuracy-related penalty and fraud penalty do not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. Section 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Section 1.6664-4(b)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Id.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Id.; See also United States v. Boyle, 469 U.S. 241 (1985) (reasonable cause is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney). In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. Section 1.6664-4(b)(1).

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. Section 1.6664-4(c)(1)(i).

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Section 1.6664-4(c)(1)(i). Further, where a tax benefit depends on nontax factors, the taxpayer also has a duty to investigate such underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true). Moreover, if the tax advisor is not versed in these nontax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000) (taxpayer's reliance on tax advisor was not reasonable given the cautionary language in offering memoranda and the tax advisor's lack of adequate knowledge to evaluate essential aspects of underlying investment); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (reliance on tax advice not reasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994) (taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was not reasonable where accountant lacked industry knowledge); Collins v. Commissioner, 857 F. 2d 1383 (9th Cir. 1988) (penalties upheld where advisor " knew nothing firsthand" about the venture).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. Section 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a section 6662(a) accuracy-related penalty, the Tax Court in Neonatalogy Associates P.A. v. Commissioner, 115 T.C. 46 (2000) stated that the taxpayer has to satisfy the following three-prong test: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave to the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the adviser’s judgment.

With respect to reasonable cause for the substantial understatement penalty attributable to tax shelter items of a corporation, special rules apply; see section 6662(d)(2)(C)(iii) for the definition of a tax shelter. The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Section 1.6664-4(e)(1). A corporation’s legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Section 1.6664-4(e)(2)(i).

The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in § 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Section 1.6664-4(e)(2)(i)(B)(2). Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met.

Although satisfaction of the "substantial authority" and "belief" requirements is necessary to a reasonable cause finding, this may not be sufficient. For example, reasonable cause may still not exist if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. Section 1.6664-4(e)(3).

The facts, as developed, do not support the conclusion that the Taxpayer had reasonable cause or acted in good faith with respect to any portion of its underpayment. There is no indication that Taxpayer thoroughly investigated the bona fide economic aspects of the transactions or reasonably relied on professional advice that the losses were allowable. As previously discussed, we believe that the transactions in which Subsidiary2 acquired and sold the inflated basis stock to recognize the losses was a tax shelter. We believe that the facts, as developed, do not support the conclusion that the Taxpayer acted with reasonable cause under the special rule for the substantial understatement penalty attributable to tax shelter items of a corporation. Taxpayer has not attempted to satisfy the authority requirement of § 1.6664-4(e)(2)(i), or show that it reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment.

CASE DEVELOPMENT AND OTHER CONSIDERATIONS

[redacted]

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In the course of working a particular case, additional arguments or counter arguments may be raised by individual taxpayers, 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 have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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