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

OFFICE OF
CHIEF COUNSEL

January 11, 2000

Number: **200015024**
Release Date: 4/14/2000
CC:INTL
TL-N-1829-99
UILC: 482.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR NORTH TEXAS DISTRICT COUNSEL
CC:MSR:NTX:DAL

FROM: Roger Brown, Special Counsel to the Assistant Chief Counsel (International - Technical) CC:INTL

SUBJECT:

This Field Service Advice responds to your memorandum dated November 10, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Taxpayer =
B =
C =
D =
E =
F =
G =
H =
I Corp. =
J =
L =
M =
N =
O =
P =
Q =
R =

Appraiser	=
Period 2	=
Date 2	=
Date 3	=
Date 5	=
Date 6	=
Date 7	=
Date 9	=
Date 11	=
Year W	=
Year V	=
Amount 1	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Amount 9	=
Amount 10	=
Amount 12	=
Amount 13	=
Amount 14	=
Amount 15	=
Amount 16	=
Amount 21	=
Amount 22	=
Amount 23	=
Amount 24	=
Amount 25	=
Percentage 1	=
Percentage 3	=
Percentage 5	=

<u>ISSUE(S):</u>

Whether I.R.C. section 482 applies to Taxpayer and other parties to the lease-stripping transaction at issue, and if so, what are the consequences of applying section 482.

<u>CONCLUSION:</u>

From the facts provided, we conclude that section 482 may apply to Taxpayer and the other parties to the Transaction (collectively the "participants"). Because the participants acted in concert pursuant to a common plan to arbitrarily shift income and deductions, the participants will be treated as members of the same controlled group for purposes of section 482.

Section 482 may be applied to reflect clearly the income and deductions arising from the Transaction and/or prevent the evasion of taxes under the following alternative theories:

1. <u>*Economic substance standards of section 482*</u>

   (i) Disregard the multiple, simultaneous sale-leaseback transactions entered into by both D and B so that Taxpayer is treated as having acquired neither D's equipment interest nor indirect ownership of B's interest in certain leased equipment through its partnership interest in B. Therefore, Taxpayer's rental expenses and other deductions relating to the equipment interests would be disallowed and reallocated back to D. A further consequence of disregarding B's sale-leaseback transactions is ignoring the subsequent sale of the future rental stream by B because B would be viewed as never acquiring the right to the rents from the equipment; or

   (ii) Disregard the section 351 transaction due to a lack of economic substance, so that Taxpayer is treated as never having acquired D's equipment interest or a limited partnership interest in B. Accordingly, Taxpayer's deductions relating to these interests would be disallowed and reallocated to D;

2. <u>*Clear reflection of income and tax evasion standards of section 482*</u>

   (i) Allocate Taxpayer's deductions to D during the period D owned common stock of Taxpayer, so that income and deductions attributable to D's equipment interest as well as B's sale-leaseback transactions and sale of the stream of future rents from the equipment are not artificially separated; or

(ii) Allocate to Taxpayer the proportionate amount of the gain from B's sale of the future rental income, as well as gain earned by D or B from any other aspect of the Transaction, for the period of Taxpayer's participation in the Transaction;

3. *Application of section 482 to nonrecognition transactions*

Allocate Taxpayer's deductions to D, on the basis that section 482 may allocate income or deductions attributable to property acquired by a transferee corporation (Taxpayer) in a section 351 transaction back to the contributing shareholder (D).

FACTS:

E participated in a lease-stripping transaction (the "Transaction") marketed by Q that consisted of three separate transactions. We did not receive a fully developed factual or legal analysis of the Transaction from District Counsel. As stated by the National Office in a prior memorandum dated July 28, 1999 concerning other tax issues of this case, additional facts need to be developed before a more complete analysis of the Transaction's facts and application of the relevant law to these facts can be provided. Nevertheless, based on the limited information we have received, this memorandum contains our initial conclusions.

A summary of what we understand to be the facts of one of the three transactions follows. These facts also can be found in the July 28, 1999 memorandum referenced above, but we restate them here for your convenience. Where factual information is lacking or ambiguous, we identify our assumptions and recommendations for factual development.

Step 1 *Formation of D and B*

On Date 3, D, a limited partnership, was formed. Initially, its sole general partner was M, which had a Percentage 5 interest in the profits and capital of D. M was a wholly-owned subsidiary of Q, the Transaction's promoter. Subsequently, M transferred its interest in D to O, a partnership of which M was the sole general partner. D's sole limited partner, which had a Percentage 1 interest in the profits and capital of D, was N, a limited partnership. Percentage 1 of the capital and profits interest of N, a passthrough entity that was in turn owned by a tax-exempt entity.

Also on Date 3, B, a limited partnership, was formed. Like D, B's sole Percentage 5 general partner was initially M, which transferred its interest in B to O the next day. B's sole Percentage 5 limited partner was D.

Within seven months after their formation, D and B engaged in three multi-step transactions involving the sale and leasing of computer equipment subject to various liens and pre-existing user leases to unrelated third-party lessees. The interests and obligations of the two partnerships resulting from these transactions were ultimately transferred to the taxpayer. As noted previously, this memorandum analyzes only one of these multi-step transactions.

Step 2 *<u>B's first sale-leaseback of equipment</u>*

On Date 2, F purchased computer equipment for an unknown sum and leased it to H under a user lease. F financed the purchase by incurring $Amount 1 of nonrecourse debt ("senior debt"), which was secured by a senior lien on the equipment and an assignment of F's lessor rights to the rental income under the user lease.

On or about Date 5, F sold the equipment (subject to the senior debt and user lease) to I Corp for an unknown sum. I Corp incurred $Amount 3 of debt to F and J ("junior debt") to purchase the equipment, which was secured by a junior lien and an assignment of I Corp's lessor rights under the H user lease. Subsequently (presumably also on Date 5), I Corp transferred its interest in the equipment to L for an unknown sum.

On Date 5, B purchased L's equipment interest, which was subject to the user lease and senior and junior debt, for $Amount 7. It paid $Amount 5 in cash and gave L a nonrecourse installment note for the remaining $Amount 6 ("L Note"), secured by an interest in the equipment. According to an appraisal of the equipment, as of Date 5, the equipment had an estimated fair market value of $Amount 4 and an economic life of Period 2. Appraiser was hired by the promoter. We do not know whether Taxpayer sought an independent appraisal, or whether Appraiser's appraisal presents a reasonable or inflated estimate of the equipment's fair market value. We also do not know whether the sum of the senior and junior notes and I Corp's security interest exceeded the fair market value of the equipment.

On the same day of the Date 5 purchase, B leased back the equipment to L from Date 5 through Date 9. Under the lease agreement, L's rent payments were due in the same amounts and at the same times as B's payments under the L Note.

Step 3 *B's second sale-leaseback of equipment*

Also on Date 5, B engaged in another sale-leaseback of its equipment interest. It sold its equipment interest (which was now subject to the user lease, senior and junior debt, L lease, and L security interest) to P for $Amount 4. We do not know whether P was related to any of the participants. P paid $Amount 9 in cash and gave B a nonrecourse installment note for the remaining $Amount 10 ("P Note"), secured by an interest in the equipment.

Simultaneously, P leased back the equipment to B from Date 5 through Date 11. Because the equipment was subject to a pre-existing user lease, neither P nor B (nor L) actually used the equipment. Under the lease agreement, B's rent payments were due in the same amounts and at the same times as P's payments under the P Note. B had an option of reacquiring the equipment for its fair market value or leasing substitute equipment of the same value as the equipment. B could exercise this option at any time or if any third-party user/lessee exercised its own purchase option. If B exercised its option, P was obligated to pay the partnership a "buy-out fee" that would effectively pay the lesser of the equipment's fair market value or the balance outstanding on the junior and senior debt on the equipment.

Step 4 *Sale of rental income from L*

On Date 6, two weeks after Date 5, B sold its right to receive rents from L in lump sum to C, a lease factoring company ("L rent sale"). C purchased this right, which was encumbered by the senior and junior debt and L's security interest, for $Amount 12. C paid $Amount 22 in cash to B and assumed B's obligation to pay off the L note for the term it received L rents, which amounted to $Amount 23. We understand that the amount of the L rents sold to C equaled the principal and interest that C was obligated to pay on the portion of the L note that C assumed.

C would receive rents from L directly and appears to have been solely responsible for demanding and collecting these payments; B was under no obligation to take such action or pledge any collateral securing payment of L rents to C. In addition to lacking a security interest in the equipment and having apparently no recourse against B, C was required to pay its installments of principal and interest on the L note regardless of whether it received rent payments from L. Thus, C's obligations to pay interest and principal to L were offset by C's right to receive payments in the same amount from L. We do not know whether B's security interest arising from the equipment sale to P was transferred to C.

Step 5 *<u>Transfer of D's Interests in Exchange for Stock in Taxpayer</u>*

On Date 7, two weeks after Date 6, D and E, which owned all of the stock of Taxpayer, engaged in a transaction intended to qualify as a section 351 transaction. E contributed to Taxpayer $Amount 21 cash in exchange for additional shares of common stock of Taxpayer. D contributed its equipment interest and its partnership interest in B in exchange for Percentage 3 of the common stock of Taxpayer.

Taxpayer used the $Amount 21 cash contribution from its parent to pay off two "cash liens" that encumbered the equipment interest and the partnership interest in B. Q received $Amount 24 in promoter fees. We do not know whether this amount related only to this transaction or other transactions entered into by Taxpayer, and whether Taxpayer or E paid these fees.

Reported Tax Consequences

Taxpayer and its parent, E, file a consolidated return. For the Year V taxable year, B reported $Amount 13 of rental expenses (on notional rental payments to P), Percentage 1 of which was allocated to Taxpayer. For the Year W taxable year, B reported $Amount 15 of rental expenses (on notional rental payments to P), Percentage 1 of which was also allocated to Taxpayer. We do not know if, in addition to the rental expenses, Taxpayer claimed any depreciation or interest expense, or any other deductions related to its equipment interests. We also do not know if Taxpayer reported any rental or interest income in connection with the equipment.

Although the sale of the right to receive rent from L was a recognition event for U.S. tax purposes, it appears that no U.S. tax was imposed on most of the gain from the sale. B's Percentage 1 partner, D, reported the gain on its return for the Year V taxable year. D, in turn, passed the majority of this gain to its Percentage 1 partner, N, a passthrough entity owned by an entity not subject to U.S. taxation. Moreover, from Taxpayer's perspective, it was not required to recognize this gain because it was not yet the legal owner of the equipment and lease when the gain was required to be taken into account for U.S. tax purposes. Thus, apparently Taxpayer would claim that it was not liable for any tax on the gain on the L rent sale.

LAW AND ANALYSIS:

Generally, in order for section 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. I.R.C. § 482. To the extent that it can be shown that a transaction was carried out pursuant to a common design intended to effect an arbitrary shifting of income and deductions or to evade taxes, the participants in the common design may be treated for purposes of the transaction as "controlled by the same interests" for purposes of section 482. Accordingly, in the lease-stripping context, section 482 may be applied to prevent the evasion of taxes or the arbitrary separation of deductions (steered to the entity subject to the U.S.'s taxing jurisdiction, e.g., Taxpayer) from the income associated with those deductions (steered to an entity exempt from the U.S.'s taxing jurisdiction, e.g., the tax-exempt owner of N).

A. Section 482 -- Generally

Section 482 provides in relevant part:

> In any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary may distribute apportion, or allocate gross income, deductions... between or among such organizations...if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations. [Emphasis added].

Thus, in order for I.R.C. § 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. As there is no common ownership among the participants to the Transaction (other than E's ownership of Taxpayer), the primary question under I.R.C. § 482 becomes whether any of the participants, particularly B and D, are controlled by the same interests.

B. Legal Standard for Control

The section 482 regulations define control "to include any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(a)(3), 1968-1 C.B. 218; Treas. Reg. § 1.482-1T(g)(4), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4), 1994-2 C.B. 93.[1] See also Appeal of Isse Koch & Company, Inc., 1 B.T.A. 624, 627 (1925), acq., 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument."). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. Id. Accord Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert denied, 385 U.S. 899 (1966); Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; Rev. Rul. 65-142, 1965-1 C.B. 223, 224; Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967).

Moreover, the 1968 regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3) (1968). See Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on Treas. Reg. § 1.482-1(a)(3) (1968), the Service properly argued that proof of income shifting between two corporations establishes a presumption of common control). Accord Hall v. Commissioner, 294 F.2d 82 (5th Cir. 1961), aff'g, 32 T.C. 390 (1959), acq., 1959-2 C.B. 4 (referring to Reg. 111 § 29.45-1). The 1993 and 1994 regulations also contain this presumption, and add that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-1T(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). Accord DHL Corp. v. Commissioner, T.C. Memo. 1998-461 (in determining whether the control requirement is satisfied, "when the interests controlling one

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[1] At issue are the Year V and Year W taxable years. Accordingly, there are three sets of I.R.C. § 482 regulations that potentially apply to the years at issue: the 1968 regulations apply to taxable years beginning on or before April 21, 1993; the 1993 regulations apply to taxable years beginning after April 21, 1993; and the 1994 regulations apply to taxable years beginning after October 6, 1994, unless an election is made to apply them to all prior open years. Treas. Reg. § 1.482-1(j)(2) (1994). We are uncertain whether Taxpayer made an election to apply the 1994 regulations retroactively, and uncertain whether Taxpayer is a calendar year taxpayer. Consequently, we will distinguish between the regulations by referring to their year of promulgation (in parenthesis) when each set of regulations is referred to.

entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled").

Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of I.R.C. § 482 if income or deduction shifting is present, or if there is common goal to shift income or deductions. But see Lake Erie & Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq., 1945 C.B. 5, acq. withdrawn and substituted for nonacq., Rev. Rul. 65-142, 1965-1 C.B. 223; B. Forman v. Commissioner, 54 T.C. 912 (1970), rev'd in relevant part, 453 F.2d 1144 (2d Cir. 1972), cert denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972), nonacq, 1975-2 C.B. 3 (nonacquiescence relates to the Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 section 482 regulations).

We note that other countries who are members of the Organization for Economic Cooperation and Development (OECD) have adopted a similar approach to control in not requiring overlapping legal ownership before their section 482 counterpart may be applied. In some European countries, for example, two types of control -- *de jure* and *de facto* – exist under the local law counterparts to section 482. In France, for example, *de jure* control exists if the largest share of capital or voting power is owned by the same controlling person or entity.[2] On the other hand, *de facto* dependency can be deduced from contractual stipulations binding the parties or their financial and commercial relations, such as purchase of the majority of production, involvement in the management of a company, or use of a valuable commercial trademark owned by another.[3] It is our understanding that countries

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[2] See Documentation administrative, 4 A 1211, no. 3; S.A. Orore, Conseil d'Etat, November 15, 1992, No. 77015.

[3] See Conseil d'Etat, March 23, 1953, No. 75326; René Bizac, Transfers of Profits: The New Article 26 of the Belgian Income Tax Code and Article 57 of the French General Tax Code - Siamese Twins? (Part Two), INTERTAX 420, 430 (September 1993); Charles G. G. Campbell, Availability and Effects of Host Country Transfer Pricing Administrative Rulings (France), TAX MGM'T. INT'L FORUM 6-7, vol. 13, no. 4 (1992), citing inter alia, Conseil d'Etat, December 29, 1964, No. 47514, Droit Fiscal, no. 11 Comm. 3 98, Conseil d'Etat, June 2, 1976, No. 94758, Dupont 9/1976 no. 371. See also S.A. Sovemarco-Europe, Conseil d'Etat, March 18, 1994, No. 68799 - 70814 (French tax administration sought to apply its transfer pricing provisions to transactions between a French company and a Swiss company where no legal control or affiliation existed between them; French tax administration asserted that factual control existed between the two entities due to the existence of a source-of-supply

such as Greece,[4] Sweden,[5] Denmark,[6] Italy,[7] Germany,[8] and France embrace notions of *de facto* control (in addition to *de jure* control).

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of I.R.C. § 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., 598 F.2d at 1390. We believe that this burden is met by the "stripping" of income from the leases to an entity (D) whose Percentage 1 partner is itself a passthrough entity, Percentage 1 of which is owned by an entity exempt from U.S. tax, and the reporting of the deductions relating to that income by Taxpayer. See Notice 95-53, 1995-2 C.B. 334 ("[T]he parties to a stripping transaction are controlled by the same interests, because, among other factors, they act in concert with a common goal of arbitrarily shifting income and deductions between a transferor and a transferee.").

relationship).

[4] The Taxation of Companies in Europe (Greece) (Int'l Bureau of Fiscal Documentation) ¶13.2 (June 1998 supp.).

[5] Bertil Wiman, Swedish Transfer Pricing Rules, BULLETIN FOR INT'L FISCAL DOCUMENTATION 404, 405 (August/September 1990).

[6] Under Danish law, control not only includes shareholder relationships but also substantial lending or financing relationships. Unlike France, however, control is not based on market control or influence resulting from a monopolistic position or trademark dominance. Ulrik Fleischer-Michaelsen, Denmark's Transfer Pricing System is Attractive to Foreign Corporations, 4 J. INT'L TAX'N 226 (May 1993).

[7] Victor Uckmar & Federico Maria Giuliani, Interposition in Italian Taxation on Income and International Transactions, INTERTAX 440, 446 n. 23 (October 1994), citing Circular of the Ministry of Finance of September 22, 1980, No. 9-2267, in Diritto e pratica tributaria, 1980, I, 1204.

[8] Albert J. Radler & Friedhelm Jacob, GERMAN ADMINISTRATIVE PRINCIPLES CONCERNING TRANSFER PRICING 10 (1984).

C. Legal Standard for "Same Interests"

If control is found to exist, the Service may allocate income and deductions among members of the "controlled group." Treas. Reg. § 1.482-1(b)(1) (1968); Treas. Reg. § 1.482-1T(a)(2) (1993); Treas. Reg. § 1.482-1(a)(2) (1994). A controlled group or controlled taxpayer is defined to mean the entities owned or controlled by the "same interests," and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. § 1.482-1(a)(5) (1968); Treas. Reg. §§ 1.482-1T(4), (5) (1993); Treas. Reg. §§ 1.482-1(i)(5), (6) (1994). Unlike the term "control," the phrase "same interests" is not defined in the section 482 regulations. Case law as well as the legislative history of section 482 provide guidance, however.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, i.e., placing deductions in one entity and income related to those deductions in another entity. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing H. REP. NO. 2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. REP. NO. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also H. REP. NO. 350 and S. REP. NO. 275, 67th Cong., 1st Sess. (1921). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, 598 F.2d at 1379; South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), aff'g 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967); Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233 (1925). See also LXI-Part 6 CONG. REC. 5827 (1921) (statement of Sen. King referring to the "same forces" controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. South Texas Rice Warehouse, 366 F.2d at 894-95. See also Brittingham, 598 F.2d at 1378-79, citing Ach, 42 T.C. at 125-26 (The phrase, "same interests," should not be narrowly construed to frustrate the intent of I.R.C. § 482); Rishell Phonograph, 2 B.T.A. at 233 ("If `the same interests' was intended to mean only `the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). Accord Grenada Indus., supra.

Thus, it is not necessary that the same person or persons own or control each controlled business before I.R.C. § 482 can be applied. However, there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interests is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Consequently, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met.

D. Control by the Same Interests in the Transaction

1. Common Plan Theory

Further factual development may establish that the participants acted pursuant to a common plan to shift income and deductions in a manner that was beneficial to each participant. E (through its consolidated return with Taxpayer) stood to receive deductions for the Year W and Year V taxable years of at least of $Amount 14 and $Amount 16 (rental expenses allocated to Taxpayer for Year V and Year W respectively), which at a 35% Federal tax rate resulted in $Amount 25 of tax benefits. While E made a $Amount 21 investment in the Transaction, we understand that additional tax benefits were generated in later years from the Transaction as well as the other two transactions that are not discussed in this FSA. Accordingly, we believe that the tax benefits in the aggregate exceeded E's transaction costs. We recommend appropriate factual development.

These significant tax benefits could be realized only if all participants performed their pre-designed roles, for which they may have received other forms of compensation, which appears to have taken the form, in some instances, of the upfront payment accompanying the sale-leaseback transaction. We ask that the District obtain more information on the amount and manner in which each participant expected to be compensated for participating in the Transaction, e.g., the owners of D and B, L, P, and C, and who paid such compensation. In addition, we do not know who hired and compensated Appraiser. To date, we have information only on the promoter's compensation and the amount of the upfront payments. Essential in satisfying the common plan requirement is a demonstration of how each participant benefitted from the Transaction and whether these benefits hinged upon Taxpayer's willingness to pay cash for tax benefits that exceeded the amount of cash expended. In addition to the cash compensation that awaited each participant if it cooperated in the Transaction, certain uneconomic acts may demonstrate the existence of a common plan. For example, the fact that the same equipment was sold for different amounts on the same day to parties (B, I, L, and P) that likely knew of the other parties' existence and their purchase/sale transactions suggests that the parties acted pursuant to a common plan. Additionally, the close proximity in time between certain other steps of the Transaction suggest the existence of a common plan, as does the apparent presence of circular cash flows between the participants. In the last section of this memorandum, we suggest types of information that should be developed in order to bolster the application of the common-plan theory.

2. Alternative Control Theory -- Ability to Direct the Actions

The District may wish to establish control among the participants under an alternative theory that does not rely on evidence of a common plan. Specifically, if it can be shown that certain participants had the ability to direct the actions of other participants, control may be found to exist. See Hall, 32 T.C. at 409-10 (arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of section 482, whether or not ownership exists); DHL Corp. v. Commissioner, T.C. Memo. 1998-461 (foreign investors' potential ability to control the board of directors did not translate to actual, requisite control for section 482 purposes, and did not prevent applying section 482 to taxpayer and its subsidiary where taxpayer actually controlled the day-to-day operations of the subsidiary). Various facts, if they can be shown, may aid the Service in establishing control under such a theory, such as the following: (a) one or more key participants were "shell" entities; (b) entities that engaged in the sale-leaseback transactions had little or no experience in the leasing business and relied on other participants to craft their role in the Transaction; (c) other participants could direct the actions of other participants, either by legally enforceable means or by virtue of overlapping employees or officers; and (d) certain participants' involvement in the Transaction did not make economic sense. We ask that the District develop such facts accordingly.

E. Section 482's Application to the Transaction -- In General

Generally, we have considered applying section 482 to lease-stripping transactions under three alternative analyses. The application of these three analyses to a lease-stripping transaction, however, does not preclude the application of other theories, such as the sham and step-transaction doctrines, to the Transaction. The section 482 analyses should be applied in conjunction with these other theories, because section 482 applies whether or not a transaction is a sham or otherwise colorable where a transaction is merely a device to shift income or deductions. Treas. Reg. § 1.482-1(c) (1968); Treas. Reg. § 1.482-1T(d)(1)(i) (1993); Treas. Reg. § 1.482-1(f)(1)(i) (1994); G.D. Searle & Co. v. Commissioner, 88 T.C. 252, 367 (1987).

1. Economic Substance

Section 482 overlaps with the case law relating to economic substance and sham doctrines by allowing the Service, in certain instances, to disregard contractual terms and agreements and to recharacterize a transaction. See Treas. Reg. §§ 1.482-2T(a)(1)(ii)(B), -2T(a)(3) (1993); Treas. Reg. §§ 1.482-1(d)(3)(ii)(B)(1), -1(d)(3)(ii)(C) ex. 3, -1(f)(2)(ii), -2(a)(1)(ii)(B), -2(a)(3), -4(f)(3)(ii)(A) (1994). See also B. Forman, 453 F.2d at 1160-61; Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455 (RIA) 3277, 3322 (applying the 1968 section 482 regulations to analyze the economic substance of intercompany contracts). However, the section 482 regulations expand upon case law principles and provide additional guidance in specific areas. Specifically, the regulations provide the following:

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties.... If the contractual terms are inconsistent with economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994); Treas. Reg. § 1.482-1T(d)(1) (1993). Thus, section 482 provides an alternative approach to challenging the Transaction by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions. See G.D. Searle, 88 T.C. at 367. We note that in the context of the Transaction (and similar tax-shelter transactions), this allocation authority would exist only where there is a common tax avoidance scheme among the participants to shift income and/or deductions arbitrarily. (Note that the prior sentence does not apply to the alternative theory discussed above for establishing control (the ability to direct the actions of certain participants.))

Under the first section 482 analysis, the economic substance of a transaction is analyzed by focusing on the parties' actual conduct; the economic risks purportedly transferred; and whether, from a business perspective, the transaction makes objective business sense and would have been entered into by a "hard-headed business [person]."[9] See Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-1T(d)(1) (1993); Treas. Reg. § 1.482-1(d)(3)(ii)(B) (1994). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This

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[9] B. Forman, 453 F.2d at 1160-61 (section 482 may overlap with section 162 and result in the denial of deductions where a lack of arm's length dealings results in payments between parties with a "close relationship" in an attempt to avoid taxes).

treatment may result in a denial of deductions arising from the transaction at issue. See, e.g., B. Forman, 453 F.2d at 1160-61; Medieval Attractions, T.C. Memo. 1996-455 (RIA) at 3322 (royalty payments lacked economic substance under section 482 because the foreign payee was not the creator or developer of, nor in substance had the ability to, transfer intangibles).

Considering whether the participants' conduct was consistent with the Transaction's putative substance, relevant factors include, inter alia,

(1) whether any gain realized by B on the L rent sale was actually paid to the tax-exempt owner of N;

(2) if the equipment underlying Taxpayer's interest was subject to security interests of third-party creditors, whether for non-federal income tax purposes (e.g., state property taxes, UCC filings, and internal accounting records that were provided to credit agencies) the registrations of such creditors' security interests were changed to reflect the multiple sale-leaseback transactions;

(3) whether either partnership and/or other entities claimed deductions (e.g., for rent, interest or depreciation expenses) for the period they held title to the equipment;

(4) whether the third parties were permitted to sublease or relocate the equipment without B's or Taxpayer's consent, whether the third-party lessees were informed of the multiple transfers of title, whether they permitted the sale of the equipment without the prior consent of the lessees and whether such consent was obtained;

(5) prior to the Transaction, to whom did the third-party lessees pay rent, e.g., L or the holders of the junior and/or senior debt, and to whom did the third-party lessees pay rent after the Transaction;

(6) whether any third-party lessee defaulted on rental payments and if so, how such defaults impacted the flow of cash between the participants;

(7) regarding the terms of the common stock issued by Taxpayer to D, whether the terms of the stock were respected, if dividends were ever paid, what rate would the dividends accrue, what type of redemption rights did D have, and whether D exercised this right and how much consideration was paid;

(8) whether any "uneconomic" acts occurred, e.g., liabilities secured by equipment whose fair market value was less than the liabilities. If this were the case, the liabilities arguably would not constitute valid indebtedness. See Estate of Franklin

v. Commissioner, 64 T.C. 752, aff'd, 544 F.2d 1045 (9th Cir. 1976); Odend'hal v. Commissioner, 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985).

To compare further the consistency of the parties' conduct to their characterization of the Transaction, we identify in the last section of this memorandum other facts that should be developed.

From a business perspective, the Transaction would not make objective business sense if, for example, the participants did not independently analyze the cash flows or the creditworthiness of the counterparty to the particular transactions, or if the participants failed to obtain independent valuations of the equipment. These would suggest that the economic considerations normally concomitant to bona-fide uncontrolled transactions were not present. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985), aff'g in relevant part 81 T.C. 184, 204-207 (1983); Helba v. Commissioner, 87 T.C. 983, 1005-1011, aff'd per curiam, 860 F.2d 1075 (3rd Cir. 1988), cert. denied, 490 U.S. 1046 (1989); Karme v. Commissioner, 73 T.C. 1163, 1186 (1980), aff'd, 673 F.2d 1062 (9th Cir. 1982); Stacom v. Commissioner, 61 T.C.M. (CCH) 2691, 2700, aff'd per curiam, 987 F.3d 774 (11th Cir. 1993).

Accordingly, if the L - B equipment sale is found to be devoid of economic substance because the Transaction would not have been entered into by a hard-headed businessperson, the chain of transactions that gave rise to Taxpayer's deductions would be broken. Accordingly, its deductions would have to be denied. See Treas. Reg. § 1.482-1T(c)(3)(ii)(E) ex. 2 (1993); Treas. Reg. § 1.482-1T(d)(3)(iii)(C) ex. 2 (1994). See also Medieval Attractions, supra; B. Forman, supra.

2. Section 482's Role in Nonrecognition Transactions

The second section 482 analysis that may be applied to the Transaction relates to section 482's role in nonrecognition transactions, such as section 351 transactions. Specifically, section 482 may apply in nonrecognition transactions to prevent the avoidance of taxes or clearly reflect income. For example, section 482 may allocate income and deductions arising from an entity's disposition of built-in-loss (and gain) property, which it acquired in a nonrecognition transaction, to the shareholder (or partner) that contributed it in the nonrecognition transaction. See Treas. Reg. § 1.482-1(d)(5) (1968); Treas. Reg. § 1.482-1T(d)(1)(iii) (1993); Treas. Reg. § 1.482-1(f)(1)(iii) (1994); National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), aff'g, 46 B.T.A. 562 (1942), cert. denied, 320 U.S. 794 (1943); Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981), on remand, 3

Cl. Ct. 61, 65 (1983), aff'd without opinion, 732 F.2d 168 (Fed. Cir. 1984); Northwestern Nat. Bank of Minneapolis v. United States, 556 F.2d 889, 892 (8th Cir. 1977), aff'g, 37 A.F.T.R.2d ¶76-1400 (D. Minn. 1976); Dolese v. Commissioner, 811 F.2d 543 (10th Cir. 1987), aff'g, 82 T.C. 830 (1984); Foster v. Commissioner, 80 T.C. 34, 160, 172-77 (1983), aff'd in relevant part, 756 F.2d 1430, 1433-4 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986). See also Eli Lily & Co. v. Commissioner, 84 T.C. 996, 1119 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988) (restricting I.R.C. § 482's application to nonrecognition transactions in cases of tax avoidance).

Concerning the rental deductions claimed by Taxpayer, the section 482 built-in loss analysis applies by likening the contribution (in a nonrecognition transaction) of the obligation to pay rent after the income has been stripped off to a contribution of built-in-loss property. This is because the stripping off of income by the sale of rent payments to C, combined with the continuing obligation to pay rent to P, creates continuing tax deductions (losses). This is in spite of the fact that the transferee (in the nonrecognition transaction) will pay little, if any, out-of-pocket cash as the cash flows between B and P, and B and L, offset.

Thus, D’s transfer to Taxpayer of its partnership interest in B, focusing on B’s interests in the H equipment (from which the right to future (taxable) streams of rental income had been sold), is in substance a contribution of built-in loss property by D to Taxpayer. If it can be established based on further factual development that there was a tax-avoidance purpose underlying the Transaction, including the I.R.C. § 351 transaction between E, Taxpayer, and D, the rental deductions may be allocated to D. Because D is tax-exempt, in effect, these deductions appropriately disappear.

3. Clear Reflection of Income & Prevent the Evasion of Taxes

The third theory under which a lease-stripping transaction may be analyzed under section 482 also relates to the Service’s ability to allocate income and deductions in order to clearly reflect income and/or prevent the evasion of taxes. I.R.C. § 482; Treas. Reg. § 1.482-1(d)(1) (1968); Treas. Reg. § 1.482-1T(a)(1) (1993); Treas. Reg. § 1.482-1(a)(1)(1994). This analysis, and the case law affirming the Service’s exercise of this allocation authority, is not based upon an economic substance analysis. Rather, it focuses on the distortions in taxable income caused by the separation of income from deductions, and it is a simpler application of the preceding discussion relating to the application of section 482 in nonrecognition transactions. See Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1951), rev’g 16 T.C. 882, cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962).

As stated in Notice 95-53, the separation of income from deductions in lease-stripping transactions does not clearly reflect income, particularly where they are achieved through a transaction structured to evade taxes. Lease-stripping transactions are often effected by (a) creating an artificial separation of the rental income from the associated deductions by accelerating the rental income in the hands of an entity not subject to the U.S.'s taxing jurisdiction, and (b) by placing the deductions associated with the rental income in an entity subject to U.S. tax. See Notice 95-53. In such an instance, the Service may prevent this artificial shifting of income and deductions by (1) allocating the rental deductions from the U.S. taxpayer to the tax-exempt entity, or (2) allocating the rental income from tax-exempt entity to the U.S. taxpayer. See Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), aff'g T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967); J.R. Land Co. v. Commissioner, 361 F.2d 607, 609-10 (4th Cir. 1966), aff'g sub nom Brentwood Homes, Inc. v. United States, 240 F. Supp. 378 (E.D.N.C. 1965); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), rev'g 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Advance Machinery Exchange, Inc. v. Commissioner, 196 F.2d 1006 (2nd Cir. 1952), cert. denied, 344 U.S. 835 (1952).

Accordingly, it may be appropriate to either (1) allocate Taxpayer's deductions to D during the period D owned stock of Taxpayer, or (2) allocate income (i.e., a portion of the gain from the multiple sales of D's interest in equipment, leases, and its partnership interest in B) to Taxpayer in proportion to the period Taxpayer owned such interests. Such an allocation would match the income and the deductions associated with the income, and thereby constitute a clearer reflection of income than that which is represented by the Transaction. Concomitantly, the evasion of taxes would be prevented.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The following is a non-exclusive list of considerations that potentially have a significant impact on the application of section 482 to the Transaction and thus should be (if they have not already been) developed:

1. [redacted]

2. [redacted]

3. [redacted]

4. [redacted]

5. [redacted]

6. [redacted]

7. [redacted] See Corbin West Partnership v. Commissioner, 56 T.C.M. 153, T.C. Memo. 1988-436 (recourse loan made to undercapitalized obligor that is not likely to be paid may be disregarded as an economic sham).

8. [redacted]

9. [redacted]

10. [redacted]

11. [redacted]

In addition, where we have stated specifically throughout this memorandum that we do not know certain information, we suggest that the information be developed due to its potential relevance to the analysis. In the event insufficient formation is developed to establish control by the same interests under either (1) the common plan theory (see supra section D.1), or (2) the alternative theory that certain participants had the ability to direct the actions of other participants (see supra section D.2), then the prerequisites for applying section 482 may not exist. See Bransford v. Commissioner, 36 T.C.M. (CCH) 1262, T.C. Memo. 1977-314, acq. in result, 1978-136 (January 23, 1978).

Moreover, the District should ascertain which section 482 regulations apply to the years at issue. Finally, once an allocation of income and/or deductions is made under I.R.C. § 482, a secondary allocation must be made to account for the primary allocation. See Treas. Reg. § 1.482-1(d)(2) (1968); Treas. Reg. § 1.482-1T(e)(1) (1993); Treas. Reg. § 1.482-1(g)(2) (1994). A discussion of the appropriate secondary adjustment(s) is beyond the scope of this memorandum, and we will furnish the appropriate analysis upon request and after additional information has been developed.

If you have any questions, please contact (202) 622-3830.

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