DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
March 23, 2001

OFFICE OF
CHIEF COUNSEL

Number: **200134002**
Release Date: 8/24/2001
CC:PSI:1
TL-N-2773-00
UILC: 9214.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel (Natural Resources)
CC:LM:NR:DAL:2
Associate Area Counsel (Financial Services & Healthcare)
CC:LM:FSH:BRK

FROM: ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS AND SPECIAL INDUSTRIES
CC:PSI:1

SUBJECT: Partnership Transactions Involving Preferred Stock
Previously Acquired in Lease Stripping Transactions

This Field Service Advice responds to your memorandum dated December 6, 2000. 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.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

TL-N-2773-00

LEGEND

Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Year 5	=	
Year 6	=	
Month 1	=	
Month 2	=	
Month 3	=	
D1	=	
D2	=	
D3	=	
D4	=	
D5	=	
Promoter	=	
A	=	
B	=	
C	=	
D	=	
E	=	
F	=	

G	=
H	=
I	=
J	=
K	=
L	=
M	=
N	=
O	=
P	=
Q	=
R	=
S	=
T	=
Individual A	=
Individual B	=
Individual C	=
Individual D	=
Individual E	=
Individual F	=
Individual G	=

TL-N-2773-00

Bank A	=
Bank B	=
Bank C	=
Company A	=
Company B	=
Country A	=
Country B	=
Country C	=
P1	=
P2	=
GP	=
PRS	=
$n1	=
$n2	=
n3	=
$n4	=
$n5	=
$n6	=
$n7	=
$n8	=
$n9	=
$n10	=

$n11 =

p1% =

p2% =

ISSUES

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

2. Whether § 351 applies to the exchanges in which Company A received the preferred stock.

3. Whether Company A improperly computed its bases in the preferred stock under subchapter C.

4. Whether the transactions lack economic substance and should be recharacterized under the sham transaction doctrine.

5. Whether the losses reported by P2 from its disposition of the preferred stock may be challenged under § 1.701-2, the partnership anti-abuse regulation.

6. Whether § 482 applies to the transactions.

7. Whether a partnership proceeding is the appropriate forum for challenging the partnerships' inside basis in the preferred stock, the partners' outside bases in their interests in the partnerships under audit, and the allocation of partnership losses under § 482.

8. Whether the Service is precluded from challenging the partnerships' inside basis in the preferred stock and the partners' outside bases in their interests in the partnerships under audit if the partner who contributed preferred stock in the year under examination acquired such stock in a year for which the applicable period of limitations has or may have expired.

9. Whether it is appropriate to raise specified penalties as part of the TEFRA partnership proceedings for Year 4.

CONCLUSIONS

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

2. Section 351 does not apply to the exchanges in which Company A received the preferred stock.

3. Company A improperly computed its bases in the preferred stock under subchapter C.

4. The transactions lacked economic substance and should be recharacterized under the sham transaction doctrine.

5. The Service may apply § 1.701-2 to challenge the losses reported by P2 from its disposition of the preferred stock.

6. Section 482 applies to the transactions.

7. A partnership proceeding is the appropriate forum for challenging the partnerships' inside basis in the preferred stock, the partners' outside bases in their interests in the partnerships under audit, and allocation of the partnership losses under § 482.

8. The Service is not bound by reporting for prior tax years absent a TEFRA judicial proceeding for the prior years.

9. It is appropriate to raise specified penalties as part of the TEFRA partnership proceedings for Year 4.

FACTS

Lease Stripping Transactions

During Year 1, Year 2, and Year 3, Promoter arranged seven lease stripping transactions. See Notice 95-53, 1995-2 C.B. 334 (describing lease stripping transactions and stating the Service's intention to challenge the tax benefits arising from them). Promoter engaged in four A lease stripping transactions, one B lease stripping transaction, one combined A and B lease stripping transaction, and one C lease stripping transaction. Six of the lease stripping transactions were executed using Company A, and one of the lease stripping transactions was executed using Company B.

Company A was a Country A limited life company, managed in Country B and treated as a partnership for U.S. federal tax purposes. Company A was formed by

Individual A, Individual B, and Individual C with the intent of acquiring interests in leased property and transferring those interests to other investors. Individual A was the wife of Individual D, an attorney whose firm provided a legal opinion to Company A with respect to the lease stripping. Individual D also served as the Power of Attorney for Company A. Company A was formed with $n1.

Company A had no employees and no fixed assets. The directors did not receive any compensation other than dividends. Company A was liable for rent expense in the event that Promoter was not able to locate an investors to acquire the Company A lease interests. Therefore, Individuals A, B, and C signed agreements pledging to contribute additional cash if it became necessary for Company A to pay rent expense. In addition, Individual E, the managing director of Promoter, individually made a commitment to loan additional cash to Company A for rent payments if the lease interests were not assumed by an investor. However, Individuals A, B, and C were never required to contribute additional capital, nor did Company A receive loans from either Individual E or Promoter in order to complete the leasing transactions.

In the A transactions, Company A leased A from D, a subsidiary of E. D had already leased the A to end users. U.S. limited partnerships F, G, H, I, and J (the “U.S. Partnerships”) then subleased the A from Company A subject to the end user leases. The U.S. Partnerships prepaid to Company A a substantial portion of the rents due under the subleases. The U.S. Partnerships borrowed the funds used to prepay the rents to Company A from Bank C. The loan terms were negotiated between Promoter and Bank C. The Bank C office loaned the funds through S, a subsidiary located in Country C, and held the funds in accounts at T. D guaranteed the loans. Company A invested the prepaid rents in U.S. Treasury securities. Bank C guaranteed a portion of the rent Company A was obligated to pay D and took a security interest in the U.S. Treasury securities that Company A purchased with the prepaid rents. The deposit agreements setting up the T accounts stated that T was to disburse the proceeds to D as rent from Company A semiannually. During the lease period D, on behalf of the U.S. Partnerships, made payments on the loan from amounts it received as rent from the T accounts.

Promoter then marketed Company A’s leasehold positions to major U.S. corporations. In purported § 351 transactions, Company A purported to contribute its leasehold positions to L, M, N, and O, subsidiaries of major U.S. corporations in exchange for preferred stock, while the respective parent corporations (hereinafter “Transferee Shareholder” or “Shareholders”) of corporations L, M, N, and O purported to contribute property in exchange for common stock in L, M, N, and O. The respective parent corporations included corporations L, M, N, and O in their consolidated return group. Accordingly, in the context of each purported § 351 transaction, Company A purported to contribute the Treasury securities, together with its obligation to make the lease payments, and its right to re-lease the A following the termination of each end user's lease. The preferred stock required dividend payments at a rate of between p1% and p2% of its par value.

In the B transactions, Bank A and Bank B each purchased B and leased the B to Company A. Company A then subleased the B to K or a K subsidiary. K or one of its subsidiaries then prepaid to Company a substantial portion of the rents due under the sublease. Company A then deposited most of the prepayments into banks and pledged the deposits as security for the lease payments due to the banks that owned the B. Promoter then marketed Company A's leasehold position to major U.S. corporations. In purported § 351 transactions, Company A purported to contribute its leasehold positions to M and N, subsidiaries of major U.S. corporations, in exchange for preferred stock, while the respective parents of M and N purported to contribute property in exchange for common stock. The respective parent corporations included corporations M and N in their consolidated return group. The leasehold positions included the cash Company A had received from the rent prepayments, together with Company A's obligation to pay rent to either Bank A or Bank B.

In the C transaction, Company B, a Country A limited life company, leased C from one party and then subleased the C to another party. The sublessee prepaid a substantial portion of the rents due under the sublease to Company B. In a purported § 351 transaction, Company B contributed its leasehold position to P, a subsidiary of a major U.S. corporation, in exchange for preferred stock. The owners of Company B were individual A, Individual B, Individual C, and a fourth individual.

<u>Partnership Transactions</u>

P2 was a partnership . P1 was a member of a tiered group of partnerships (the "Tiered Group") through which the profits and losses from P2 flowed. GP was the general partner in P1. All of the investments of the Tiered Group were held in P2, and all activity of the Tiered Group was conducted in P2. P1 was the investment vehicle for U.S. investors in the Tiered Group. The typical investors in P1 were . P1 usually required a partner to invest a minimum of $n2. Company A provided financial statements to P1 which showed that Company A's total assets were significantly less than $n2. PRS was one of several investment vehicles for investors in the Tiered Group. GP was the entity that managed the Tiered Group for fees, and was owned by n3 individual partners and trusts and other entities related to them. Individual F was a principal in the tiered structure and was involved in the tax planning of the tiered structure. Individual G, an attorney and CPA, was GP's newly hired Director of Taxes and Tax Counsel.

In Month 2 of Year 3, Individual G learned of the preferred stock held by Company A from Promoter and the potential tax benefits that could be claimed by selling the preferred stock at a loss. Promoter and GP signed a retainer agreement under which Promoter would receive $n4 per month for one year. The agreement allowed Promoter to present additional proposals to GP, for which separate “success” fees would be paid to Promoter if the transactions were completed. In the course of their discussions, Promoter was also allowed to make an investment in GP in Month 3 of Year 3.

Individual G claims to have relied on tax opinions rendered by Q and R. However, Individual G knew that the Service had issued a notice stating that it intended to challenge lease stripping transactions such as those from which the preferred stock was derived. Individual G knew that Q had served as counsel on the underlying lease stripping transactions. P2 has declined to disclose to the Service the tax opinion it received from Q and R.

The preferred stock that GP was interested in acquiring had been pledged as security for an earlier loan to Company A. In order to remove the existing lien on the stock, Individual F arranged for Lender, a Country B partnership affiliated with P1, to lend funds to Company A on D1. On the same day, Company A contributed its stock in L and N, as well as the excess of the loan proceeds over the existing debt on the stock, to P1 in exchange for a partnership interest (First Partnership Interest), and P1 transferred the stock to P2. Company A transferred the First Partnership Interest to Lender as security for the loan.

The parties also entered into an agreement (“Put Agreement”) which granted Company A certain rights to cause GP to purchase Company A’s interest in P1 (“Put Options”). The first Put Option, which cost $n5, was allowed Company A to sell the First Partnership Interest for its net asset value on the exercise date. The second Put Option, which cost $n6, allowed Company A to sell the First Partnership Interest in P1 on D4 for the amount of its capital account on D1.

Although, according to P1, there was no agreement requiring Company A to dispose of the First Partnership Interest, Company A stated in its minutes that it intended to sell the First Partnership Interest pursuant to the Put Options. At the same time, the owners of Company A wanted to have the ability to invest in P1 in the event that Company A exercised a Put Option at a time when the fund was closed to new investors. Accordingly, as part of the transaction, the owners of Company A were given the opportunity to invest as individuals in PRS, one of the investment vehicles for investors in the Tiered Group. Individuals A, B, and C were allowed to invest in Month 1 of Year 5 or Year 6 a minimum of $n7 each, up to a combined maximum of $n8. Thus, Individuals A, B, and C would be able to continue their investments in GP after Company A exercised a Put Option, thereby selling the First Partnership Interest to GP.

On D2, Company A contributed its stock in M and O to P1 in exchange for a partnership interest (Second Partnership Interest), and P1 contributed the stock to P2. On D3, Company B contributed its stock in P to P1 in exchange for a partnership interest (Third Partnership Interest), and P1 contributed the stock to P2. The Second and Third Partnership Interests were both the subject of put options issued by GP that were later exercised by Company A and Company B, respectively.

As a result of the transactions occurring on D1, D2, and D3, P2 became the owner of preferred stock in L, M, N, O, and P (the "Subsidiaries"). P2 claimed to have a transferred basis in all of the preferred stock of $n9. The fair market value of all of the preferred stock was $n10. Thus, the basis that P2 claimed to have in the preferred stock far exceeded the stock's value.

On D4, Company A sold the First Partnership Interest to GP, under the Put Agreement. Company A used part of the sale proceeds to repay the loan from Lender. P1 did not have a § 754 election in effect at the time of the transfer.

On D5 (in Year 4), P2 sold a portion of the preferred stock that P1 had received on D1, to an outside party. P2 reported a $n11 capital loss from the sale. Allegedly consistent with §1.704-3(a)(7), the loss was allocated to GP as the transferee-owner of the First Partnership Interest originally held by Company A. The claimed losses were used to offset part of the gains that were allocated to P1 from P2's activities.

<u>LAW AND ANALYSIS</u>

The preferred stock that was sold on D5 was acquired by Company A in lease stripping transactions occurring in prior years. Therefore, it is necessary to apply the relevant law to these lease stripping transactions in order to ascertain Company A's basis in that stock. In each of the lease stripping transactions engaged in by Company A, it could be argued that, as a result of the income strips, the leased property was bifurcated into two distinct property interests - a term of years interest corresponding to the lease term for which rent was prepaid, and a remainder interest corresponding to any interest retained by Company A in the leased property following the expiration of the lease term. Under this potential argument, only the interest corresponding to the remainder interest would be transferred in exchange for stock, and only a portion of the transferor's basis in the leased property would be allocated to this interest. As a result, the transferee corporation would have a carryover basis in the transferred property, and the transferor would have a substituted basis in the preferred stock. However, we do not support the application of this argument to the purported § 351 transactions. Rather, the arguments contained in the discussion of Issues 1, 2, and 3 below should be used to determine the tax consequences of these transactions.

Issues 4 through 6 address alternative theories that would disallow P2's claimed losses on such stock if Company A's claimed basis in its preferred stock were correct.

Finally, Issues 7 through 9 address procedural and penalty issues relevant to the examination of the partnerships in the Tiered Group.

Issue 1

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

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

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); Rice's

Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363. See also Notice 95-53, 1995-2 C.B. 334.

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

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

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

While the profit potential or economic risk, relative to the expected tax benefit, necessary to meet the objective economic substance test has not been quantified, a reasonable prospect or possibility for profit is required. See Horn, 968 F.2d at 1237-38 n. 10, 13; Rice's Toyota World, Inc., 81 T.C. at 202. Nominal or de minimis profit potential does not imbue a transaction with economic substance. Knetsch v. United States, 364 U.S. 361 (1960); Hines v. United States, 912 F.2d 736 (4th Cir. 1990), rev'g 89-9 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).

In the lease stripping transactions described above, there was no objective economic substance or business purpose for the sale and leasebacks, the subsequent sale of the right to receive lease payments, or the contribution of leasehold interests to the Subsidiaries. Rather, the sole purpose of the transactions was the creation of tax benefits. Because the lease stripping transactions in which Company A acquired the preferred stock lacked economic substance, Company A's basis in the preferred stock is limited to the value of the property Company A contributed in exchange for that stock.

Issue 2

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

The transaction in which the transferee stock is received must be carefully analyzed to determine that it does in fact satisfy the technical requirements of § 351. For example, in each exchange involving Company A, a pre-existing Transferee Shareholder or Shareholders must join with Company A in order for the exchange to satisfy the control requirement of § 351(a). Thus close scrutiny should be given regarding the application of the provisions of § 1.351-1(a)(1)(ii) (negating transfers by a previous owner of the transferee stock if the value of the new stock issued to that transferor is relatively small compared to the value of the old stock owned by that transferor and the primary purpose of the transfer by that transferor was to qualify other transferors for § 351 treatment). See also Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568, 570.

In addition to satisfying the technical requirements of § 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; see also Caruth v. United States, 688 F.Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989) and the cases cited therein. Determining whether a bona fide non-tax business purpose motivated, at least in part, the § 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:

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

While the Courts have consistently acknowledged the business purpose requirement, 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, these cases present a particularly compelling case for a business purpose argument, and so we encourage the argument be made.

Based on the facts submitted, it does not appear that there was a purpose for the transactions apart from the creation of an asset (the stock) with a basis far in excess of its value in order to generate a substantial tax loss. That is not a bona fide business purpose. Accordingly, the transfers do not qualify as § 351 exchanges. The transactions are therefore taxable § 1001 exchanges and, under § 1012, Company A takes a cost basis in the preferred stock received (i.e., a basis equal to the fair market value of the leasehold position transferred, which might reasonably be argued to equal the fair market value of the preferred stock received in the transaction).

The following suggestions relate to developing a business purpose argument. In general, Exam should confirm that any claimed business purposes were valid and in fact achieved, and whether they could have been achieved by means other than the assumption or exchange. Some specific points to pursue include the following:

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

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

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

Issue 3

If, notwithstanding the above analysis, the subject transfers are treated as § 351 exchanges, the basis in the stock received in each exchange is reduced by the amount of the liabilities assumed, for the reasons set forth below.

A. Sections 357 and 358

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(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)(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 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.

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 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, Congress stated that it was not defining (or redefining) the term "liabilities" for purposes of § 357(c) or § 357 in general and simply enacted § 357(c)(3) to exclude deductible "liabilities" from the § 357(c)(1) determination (except "liabilities" that had generated, or would generate, 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.

While the legislative history is in some ways unclear, 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 seems circular and would lead to the conclusion that §§ 357(c)(3) and 358(d)(2) are superfluous.[1]

In each of the transactions under consideration, the assumption of the transferor's obligation to pay rent on its leasehold position is an assumption that would, if made

---

[1] The taxpayer also may argue that § 358(h), enacted as § 309 of the Community Renewal Tax Relief Act of 2000, P.L. 106-554, although not applicable to its instant case (because it is effective only for transfers on or after October 19, 1999), indicates that Congress did not view contingent liabilities as within the scope of §§ 357 and 358. 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.

by a purchaser of the leasehold position, 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), and 358(d)(1), the basis of the stock received must be reduced by the amount of the liability assumed.

B. Section 357(c)(3)

The taxpayers will presumably 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 the gain recognition that would result if the general rule of § 357(c)(1) were applied to liabilities which, if satisfied by the transferor in a § 351 exchange, would have given rise to a deductible expense (or basis) to the transferor. The reason is that, if the assumption were treated as a recognition event, the transferor would recognize taxable income without the corresponding tax benefit upon satisfaction of the liability. See Focht v. Commissioner, 68 T.C. 223, 237 (1977); § 103(a)(12) of the Technical Corrections Act of 1979 (P.L. 96-222, 1980-1 C.B. 499, 509); S. Rep. No. 96-498, 1980-1 C.B. 517, 546. Section 358(d)(2) was enacted to preserve the transferor's position in the stock basis, preventing inappropriate gain on the disposition of the stock.

In the present cases, the leasehold position has been stripped of substantially all the right to use the property subject to the lease or to receive income from the property. Under the circumstances, the transferor cannot be considered to have transferred a trade or business. Accordingly, Rev. Rul. 95-74, 1995-2 C.B. 36, does not apply to the transfers and, under Holdcroft v. Commissioner, 153 F.2d 323 (8th Cir. 1946), the transferee's 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, the deduction for the rental payments, when made, would accrue to the transferor.

Where a transferor is entitled to a deduction upon the satisfaction of a transferred liability, treating that liability as within the scope of § 357(c)(3)(A)(i) is inappropriate because it would distort the transferor's income. Accordingly, it is our position that, in such a case, the liability is not described in section § 357(c)(3) for purposes of § 358(d)(2), with the result that, under § 358(d)(1), the transferor's basis in the transferee's stock is reduced by the amount of the liabilities assumed.
However, even if the liabilities are considered within the scope of §§ 357(c)(3) and 358(d)(2), the basis in the transferee stock is reduced by the amount of the liabilities assumed by reason of § 357(b).

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.

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

However, we have found no legal authority directly on point for the latter conclusion. Possible theories considered have raised additional incongruities. For example, in substance, the transferee is performing a bill paying service for Company A with Company A's funds. From that perspective, Company A unquestionably retains the deduction. This theory, however, arguably is inconsistent with an assumption of the liabilities by the transferee. More specifically (to the extent the leasehold position assumed by the transferee does not include a corresponding right to either use property or receive income from property transferred as part of the leasehold position), the transaction in substance is treated as a qualifying § 351 exchange of $1 in return for transferee preferred stock, and the creation of an agency relationship whereby the transferee administers the payment of the liabilities with funds provided by Company A. While this argument has some potential, it suggests that the liabilities were not, in substance, assumed by the transferee. Thus, if this argument were made, it would have to be made in the alternative to the primary arguments employing §§ 351, 357, and 358 in determining the proper basis of the preferred stock received from the transferee. This alternative argument would, of course, apply only to the portion of the leasehold position assumed by the transferee that did not include a corresponding right to either use property or receive income from the transferred property.

C. Conclusion

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

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

Issue 4

The losses reported by P2 from its disposition of the preferred stock may be challenged under the theory that the transactions resulting in the losses reported by P2 lacked economic substance. The contribution by Company A of the preferred stock in L and N to P1, and the subsequent sale of the First Partnership Interest in P1 to GP under the Put Agreement were in substance a sale by Company A of the preferred stock to GP and a subsequent contribution by GP of the preferred stock to P1.

See supra, Issue 1 for a discussion of the doctrine of economic substance.

Company A was formed by Individuals A, B, and C with the intent of acquiring interests in leased property and transferring those interests to other investors. Individuals A, B, and C formed Company A with only $n1 in capital. Although Individuals A, B, and C agreed to pledge and contribute additional cash if it became necessary for Company A to pay rent expenses, the maximum amount at risk to Individuals A, B, and C, was nominal. Moreover, Individuals A, B, and C were never required to contribute additional capital. Individuals A, B and C's risk was further limited because the lease stripping transactions were completed sequentially. Promoter negotiated on behalf of Company A and Individuals F and G who were principals in the tiered structure and represented GP for the contribution of Company A's preferred stock to P1. Pursuant to the Put Options, Company A was entitled to sell the First Partnership Interest to GP. Promoter received $n4 per month for one year and was allowed to make an additional investment in GP in Month 3 of Year 3 while Individuals A, B, and C were given the opportunity to invest in GP.

Company A's investment was transitory and lacked economic substance. Moreover, the Put Options effectively protected Company A from any decrease in the value of the First Partnership Interest during its contemplated period of ownership. Promoter, an entity closely related to Company A, received fees and additional consideration for Company A's contribution of the preferred stock to P1. Individuals A, B, and C received the opportunity to individually continue their investment in P1, while GP claimed the purported losses resulting from the sale of the preferred stock.

Upon the exercise of Company A's Put Option, GP purchased the First Partnership Interest and purportedly consistent with § 1.704-3(a)(7), GP as the transferee-owner of the First Partnership Interest, was allocated the $n11 of capital losses upon the sale of the preferred stock. Although GP received an additional interest in P1, this interest had only a nominal effect on GP's net economic position in P1. GP did not sustain an economic loss corresponding to the tax losses it reported, and as a result the tax losses claimed by GP were not bona fide. The tax consequences of the transactions did not accurately reflect the economic consequences of the transactions.

Company A's contribution of the preferred stock to P1 cannot avoid the result that the substance of the transactions was a sale by Company A of the preferred stock to GP. The form of the transactions did not serve any useful non-tax purpose. The only purpose for the sale of the First Partnership Interest to GP was to reduce the taxable income of GP and GP's partners.

Accordingly, we conclude that the transactions resulting in the losses reported by P2 lacked economic substance. The contribution by Company A of the preferred stock to P1, and the subsequent sale of the First Partnership Interest to GP under the Put Agreement were in substance a sale by Company A of the preferred stock to GP and a subsequent contribution by GP of the preferred stock to P1. Consequently, GP, P1, and P2 would have a cost basis in the preferred stock and in any partnership interest acquired in exchange for the preferred stock.

Issue 5

The Service may apply § 1.701-2 to challenge the losses reported by P2.

Section 1.701-2, the partnership anti-abuse rule, in pertinent part provides that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements: (1) the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (3) except as otherwise provided, the tax consequences under subchapter K to each partner of the partnership operations and of transactions between the partnership and the partner must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement is treated as satisfied with respect to a transaction that satisfies requirements 1 and 2 to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by the provision.

Section 1.701-2(b) provides that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of subchapter K. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K: (1) the purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Section 1.701-2(c). Section 1.701-2(c) lists various factors that may be considered in making the determination.

Section 1.701-2(d), Example 8, provides an example of a plan to duplicate losses through the absence of a § 754 election through the use of a partnership that is not consistent with the intent of subchapter K. In Example 8, A wanted to sell land to B with a basis of $100x and a fair market value of $60x. A and B devised a plan a principal purpose of which was to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. A, C, and, W formed a partnership ("PRS"). A contributed the land and C and W each contributed $30x. PRS invested the $60x in an investment asset. In year 3, at a time when the values of the partnership's assets had not materially changed, PRS agreed with A to liquidate A's interest in exchange for the investment asset held by PRS. Under § 732(b), A's basis in the asset was $100x. A sold the investment asset to X, an unrelated party, recognizing a $40x loss.

PRS did not make an election under § 754. Accordingly, PRS's basis in the land contributed by A remained at $100x. PRS sold the land to B for $60x, its fair market value. Thus, PRS recognized a $40x loss that was allocated equally between C and W, and they each reduced the bases in their partnership interests to $10x. Thus, upon liquidation of PRS (or their interests therein), each of C and W would recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely.

In § 1.701-2(d), Example 8, PRS was used with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under §707), the Commissioner can recast the transaction as appropriate under § 1.701-2. Compare, § 1.701-2(d), Example 9, in which the use of a partnership for which no election under § 754 had been made is consistent with the intent of subchapter K.

Here, Company A's contribution of the preferred stock to P1 and the sale of Company A's interest in P1 to GP were part of a plan to duplicate losses through the absence of a § 754 election. Company A contributed cash and its preferred stock with an adjusted basis of $n9 and a fair market value of $n10 to P1 in exchange for an interest in P1. Pursuant to the Put Agreement, Company A sold the First Partnership Interest to GP and presumably recognized a tax loss. Since neither P1 nor P2 made an election under § 754, P2's adjusted basis in the preferred stock remained at $n9. Upon the sale of the preferred stock, P2 reported a loss of $n11, which was allocated to GP through the Tiered Group. GP used the losses to offset gains that were allocated to GP from P2's trading activities.

As in Example 8, the transactions here are subject to recharacterization under § 1.701-2, based on the following factors: First, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. See Issue 4 for a discussion concluding that the transactions resulting in the losses reported by P2 lacked economic substance and were in substance a sale of the preferred stock by Company A to GP. If the transactions were respected for federal tax purposes, GP would be allocated $n11 in capital losses (resulting from transactions in which GP did not sustain a corresponding economic loss) which GP would use to offset capital gains resulting from the activities of P2. Accordingly, any purported business purpose for the transactions is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes.

Second, the present value of the partner's aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. If Company A and GP had conducted the activities directly rather than through P1, Company A would have sold the preferred stock directly to GP rather than contributing the preferred stock to P1. Upon the sale of the preferred stock by GP Company A would have recognized a tax loss. GP would have taken a cost basis in the preferred stock equal to the fair market value of the preferred stock. Upon the subsequent sale of the preferred stock at fair market value, GP would not have recognized the $n11 of capital loss which it claimed through the partnership. Conducting the activities through P1 allowed GP to claim the $n11 in capital losses, which it used to offset capital gains from P2 that were allocated to Company A through the Tiered Group. Because Company A and GP conducted the activities through P1, GP's aggregate federal tax liability was substantially less than it would have been if Company A and GP had dealt directly.

Third, the present value of the partner's aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. As discussed above, the present value of GP's federal tax liability was substantially less than would be the case if the transactions were integrated into a direct sale of Company A's preferred stock to GP. It was contemplated that Company A, whose First Partnership Interest was necessary to allocate the purported built-in loss in the preferred stock to GP, would hold the interest only until D4, when Company A exercised a Put Option.

Accordingly, we conclude that the contribution by Company A of the preferred stock to P1, and the subsequent sale of the First Partnership Interest to GP under the Put Agreement were in substance a sale by Company A of the preferred stock to GP and a subsequent contribution by GP of the preferred stock to P1. Consequently, GP, P1, and P2 would have a cost basis in the preferred stock and in any partnership interest acquired in exchange for the preferred stock.

<u>Issue 6</u>

Section 482 applies to the transactions.

A. <u>Section 482 -- Generally</u>

Section 482 provides the following:

> 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 § 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 the Tiered Group, and Company A's relatively small partnership interest in P1) the primary question under § 482 becomes whether Company A and the Tiered Group are controlled by the same interests.

B. Legal Standard for Control

The § 482 regulations[2] define control "[to include] any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." § 1.482-1(i)(4). 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 regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." § 1.482-1(i)(4). 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 § 1.482-1(a)(3) (1968) (which contained language similar to § 1.482-1(i)(4) of the current regulation), 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 regulations also state that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." § 1.482-1(i)(4). Accord DHL Corp. v. Commissioner, T.C. Memo. 1998-

---

[2] The applicable regulations are the current regulations, which were finalized in 1994. T.D. 8552, 1994-2 C.B. 93.

461 ("[W]hen the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled [in determining whether the control requirement under the 1968 regulations is satisfied]."). Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of § 482 if income or deduction shifting is present, or if there is a 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 (2nd 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 Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 § 482 regulations).

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 § 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., at 1390. We believe this burden is met by Company A and the Tiered Group acting in concert to intentionally shift the loss on the preferred stock from Company A to P1, and GP. In this vein it must be noted that notwithstanding any slight profit motive the Tiered Group may have had to invest in the preferred stock, it is clear that the major impetus for acquiring the preferred stock was to acquire the unrealized loss. Accordingly, a presumption of control arises since the loss on the preferred stock had been arbitrarily shifted. See § 1.482-1(i)(4).[3]

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." § 1.482-1(a)(2). 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. §§ 1.482-1(i)(5), (6). Unlike the term "control," the phrase "same interests" is not defined in the § 482 regulations. Case law as well as the legislative history of § 482 provide guidance, however.

---

[3] The theory that Company A and the Tiered Group are controlled by the same interests, a prerequisite for the application of § 482, has not yet been decided in a similar case. It is possible that a court will not find the requisite control, since in fact Company A and the Tiered Group were unrelated at the time the capital loss was realized from the disposition of the preferred stock. None of the precedents relied on had unrelated parties, but the "acting in concert" language of § 1.482-1(i)(4) is the primary authority which evolved from the case precedent.

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., moving losses to a taxable entity. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing H. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also H. Rept. No. 350 and S. Rept. No. 275, 67th Cong., 1st Sess. (1921); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff’d, 358 F.2d 342 (6th Cir.), cert denied, 385 U.S. 899 (1966). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham, at 1379; South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-5 (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, at 894-5. See also Brittingham, at 1378-9, citing Ach, 42 T.C. at 125-6 (The phrase, “same interests,” should not be narrowly construed to frustrate the intent of § 482); Appeal of Rishell Phonograph Co., 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 § 482 can be applied, but 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 interest is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met. See Hall v. Commissioner, supra, 32 T.C. at 409-10 (An arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of § 482 -- whether or not ownership exists.).

D. Control by the Same Interests in the Transaction

Based on the facts as presented, we believe the parties to the transactions likely acted pursuant to a common plan to shift the unrealized loss on the preferred stock from Company A to the Tiered Group. The facts show that the large unrealized loss was the principal reason P1 acquired the preferred stock, although P1 and the Tiered Group also assured themselves that the preferred stock would yield them an economic gain on their investment on a pretax basis.

First, we note that P1 did not purchase the stock with cash, as a normal investment, rather they issued the First Partnership Interest in order to take a carry over basis in the stock under § 721. The First Partnership Interest was also issued to a partner that economically needed to exercise a Put Option to sell the interest to the issuer's related party in order to repay financing it obtained to service preexisting debt. Therefore, P1 issued the First Partnership Interest to a party it knew would not be able to remain an investor due to its obligations to the issuer's affiliate. In this regard it is noteworthy that Company A's investment in P1 differed in the following significant ways from the normal investment in P1, which leads to the inference that Company A was only permitted to invest in P1 in order for P1 to acquire the preferred stock with its carryover basis.

1. The subscription agreement for Company A waived P1's usual requirements for a partner to invest a minimum of $n8 and for an investor to be a U.S. person. The normal investors in P1 were . In contrast, Company A's financial statements, which were provided to P1, reflect that Company A's total assets and the value of the preferred stock contributed were significantly less than $n8. Similarly, according to a letter written by a representative of the Tiered Group to Company A, Company A's three principals would only be allowed to invest in Month 1 of Year 5 or Year 6, in PRS, one of the investment vehicles which , a minimum of $n7 each, up to a combined maximum of $n8. [4]
2. Lender lent Company A funds to repay loans which were encumbering the preferred stock. Generally, the Tiered Group did not provide loans to its investors.
3. GP sold Put Options to Company A so that Company A could sell the First Partnership Interest at the higher of its net asset value, or the net asset value when it originally invested. No Put Options were ever granted to other investors.
4. Company A would not have had funds available to repay its loan to Lender without exercising its Put Options.

In addition, we note that Company A's acquisition of the preferred stock, and its contribution of the preferred stock for the First Partnership Interest, indicates that it

---

[4] The facts do not state the net worth of the investors in Company A, however, two of the investors appear to be . The third owner of Company A was the wife of Company A's outside counsel.

was acting in concert, or with a common goal or purpose, together with the Tiered Group to shift its loss on the preferred stock to GP. Had Company A's motive been to acquire a partnership interest, Company A would merely have contributed the lease and Treasury securities to the partnership for the First Partnership Interest without going through the interim step of acquiring preferred stock. However, since preferred stock was necessary to P1 in order to allow Company A to enter the partnership group, Company A's actions indicate that they were acting in concert with the partnership group since they did not need to acquire preferred stock to establish their tax basis.

Lastly, we note that in order for the partners of GP to enjoy the tax benefit derived from P1 or its lower tier partnership, P2, selling the preferred stock at a huge loss, GP had to acquire Company A's First Partnership Interest, since the loss is allocated to the contributor Company A or the transferee of its interest. Section 704(c). Accordingly, Company A was apparently "encouraged" to sell the First Partnership Interest through issuance of the Put Options, and allowed to reinvest in P1, should it so desire. Furthermore, since the First Partnership Interest secured Lender's loan to Company A, and Company A apparently did not have any other funds to repay the loan, it was safe to assume that Company A would be forced to sell the First Partnership interest to GP.

Therefore, based on the above considerations, we believe it is clear that the parties to the transaction, Company A and the Tiered Group, acted in a manner to shift the loss from Company A, which being owned by foreign persons could not use the loss in the United States, to GP, which could benefit from the loss.

E. Section 482's Application to the Transaction

Assuming the Secretary has proven that the parties are controlled by the same interests, he "may distribute, apportion, or allocate . . . deductions . . . 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 clearly to reflect the income of any such organizations, trades or businesses." Section 482. Generally, the Commissioner's determinations under § 482 must be sustained absent an abuse of discretion. G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 358 (1988). The taxpayer must meet a heavier than normal burden of proof and demonstrate that Commissioner's determinations are arbitrary, capricious, or unreasonable in order for the courts to set aside the Commissioner's determinations. Id.

Pursuant to his authority to make allocations under § 482, if necessary to prevent the avoidance of tax or to clearly reflect income, the Commissioner may allocate to the transferor with respect to a nonrecognition transaction, the built in loss from a sale of property which had previously been transferred in a nonrecognition transaction. § 1.482-1(f)(1)(iii)(A). Courts have sustained the Commissioner's reallocation of gain or loss on taxable dispositions to the transferor with respect to the previous nontaxable transfer of the property under §§ 351 or 311 (as then in effect), when the sole or primary purpose of the transfer was to avoid taxation, e.g., when the transferee was better able to use the loss, absorb the capital gain, or use the deduction for charitable contributions. Ruddick Corp. v. United States, 3 Cl. Ct. 61, 83-2 U.S.T.C. P 9480 (1983), on remand from 643 F.2d 168 (Ct. Cl. 1981), aff'd, 732 F.2d 168 (Fed. Cir. 1984) (Commissioner's reallocation of capital gain to the subsidiary -transferor was sustained when a wholly owned subsidiary distributed appreciated stock to its parent in a tax free distribution under § 311 as then in effect so that the parent could offset the capital gain from the disposition of the stock with its net operating loss); Northwestern National Bank v. United States, 556 F.2d 889 (8th Cir. 1977) (Commissioner's reallocation of charitable contribution deduction to the wholly owned subsidiary was sustained when the subsidiary distributed the appreciated stock to the parent corporation, and the parent contributed the stock to a charitable organization, so that the parent corporation could make use of the charitable deduction); National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943) (sustaining Commissioner's reallocation of capital loss to the parent corporation when the parent corporation contributed built in loss stock to its wholly owned subsidiary in a transaction tax free under the predecessor of current § 351, so that ten months later upon sale of the stock, the subsidiary can make use of the capital loss deduction); Southern Bancorp. v. Commissioner, 67 T.C. 1022, 1027 (1977). In this regard it is particularly noteworthy that in Southern Bancorp. v. Commissioner, the Commissioner's allocation of gain to the distributing bank subsidiary was sustained notwithstanding that the court noted that the dividend had a business purpose, since the primary purpose for the dividend was tax avoidance. In Southern Bancorporation a bank under § 581, distributed appreciated U.S. Treasury notes as a dividend to its nonbank parent, and a few days later the parent sold the notes and realized capital gain. Had the subsidiary sold the Treasury notes, it would have realized ordinary gain. Although the court recognized that "admittedly the payment of a dividend . . . had a business purpose . . . to provide [the parent corporation] with the funds necessary to carry on its business", 67 T.C. at 1027, the court, sustained the Commissioner's reallocation, since the subsidiary's primary business purpose for distributing the Treasury notes as a dividend in kind was tax avoidance. Id. See also, Ruddick Corp. v. United States, 643 F.2d 747 (Ct. Cl. 1981) at 751-52 (stating that the tax evasion prong of § 482 was applied when a significant element of tax avoidance existed, and conversely that § 482 should not be applied in nonrecognition transactions in which no tax avoidance was present); but see Eli Lilly and Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988), at 1117, 1119 (stating the tax evasion prong of § 482 as situations when the sole purpose of the nonrecognition transfer was for tax avoidance); G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 365 (1987) (same).

In the present case, the Tiered Group may argue that it acquired the preferred stock for a business purpose, i.e., as good investments. The facts show that P2's return on the preferred stock was respectable, rather than merely a nominal gain, and arguably may be a reasonable investment for the Tiered Group irrelevant of the tax advantages. Although the preferred stock only paid a dividend of between p1% and p2% annually depending on then extant interest rates, plus a possibility of a small gain on the sale or redemption of the preferred stock, Taxpayer may argue that the investment in the preferred stock contained very little risk, since the issuers of the preferred stock were subsidiaries of healthy corporations. We have not seen the issuing documents in reference to the preferred stock, and therefore do not know whether the parent corporations guaranteed payment of the dividend, or redemption of the stock. Accordingly, we cannot evaluate the inherent risk in the investment.[5]

Based on the cases and principles cited, Taxpayer's loss on the sale of the preferred stock may be allocated to Company A since the primary purpose for the transfer was tax avoidance, i.e., for GP and its partners to benefit from the loss on disposition of the preferred stock, rather than Company A and its foreign partners, who are persons not subject to U.S. taxation.

Issue 7

---

[5] Notwithstanding that the investment may be a relatively low risk, low return investment, we argue that § 482 may be invoked (assuming that the control element is met) since Taxpayer's primary purpose in acquiring the stock was to realize the built in capital loss inherent in the stock. We primarily base our position on Southern Bancorp. v. Commissioner, 67 T.C. 1022 (1977) in which the court sustained the Commissioner's allocation notwithstanding that a business purpose existed, since the primary purpose for the transaction was the tax avoidance purpose. Yet, cases state that § 482 may only be applied in the face of nonrecognition provisions when the sole purpose of the transaction was tax avoidance, or when there is a separation of revenue and expense, which did not occur in this case. See, e.g., Eli Lilly and Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988), at 1117, 1119; G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 365 (1987). Both Eli Lilly and Co. and G.D. Searle are distinguishable from our situation in that both Eli Lilly and Co. and G.D. Searle involve situations when taxpayers' investments in Puerto Rico were encouraged by Congress, and the particular assets which were transferred in § 351 transactions were not disposed of. In addition, the courts stated that substantial nontax business purposes existed for the transfers. Nevertheless, the cases state that the tax evasion prong of § 482, which we apply in this case, was applied only when the taxpayer's sole purpose for the transaction was tax avoidance. Accordingly, it is possible that the court will not sustain the application of § 482 in this situation.

A partnership proceeding is the appropriate forum for challenging the partnerships' inside basis in the preferred stock, the partners' outside bases in their interests in the partnerships under audit, and reallocation of the partnership losses under § 482.

Internal Revenue Code § 6221 mandates that partnership items shall be determined at the partnership level. When partnership items flow from one partnership through an intermediate partnership to the ultimate taxpayer, the partnership items must be determined in a TEFRA proceeding for the partnership generating the loss, income or credit rather than in a proceeding for the intermediate partnership. See Sente Investment Club v. Commissioner, 95 T.C. 243 (1990).

Section 6231(a)(3) defines a partnership item as any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent that regulations prescribed by the Secretary provide that such item is more appropriately determined at the partnership level than at the partner level.

Partnership items include the partnership aggregate and each partner's share items of income, gain or loss, and liabilities. § 301.6231(a)(3)-1(a). They also include the amount and character of a contribution to the partnership including the basis to the partnership of contributed property (including necessary preliminary determinations such as the partner's basis in the contributed property). § 301.6231(a)(3)-1(a)(4)(i) and -1(c)(2).

Finally, partnership items include the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc. § 301.6231(a)(3)-l(b).

A partner's basis in his partnership interest is an affected item rather than a partnership item. Dial USA v. Commissioner, 95 T.C. 1 (1990). Thus, it cannot be determined in a partnership proceeding. Id. Nevertheless, a partner's basis in his partnership interest is usually comprised exclusively of partnership items including a partner's contributions to and distributions from the partnership (including changes in the partner's share of liabilities), and a partner's share of income and losses. Sections 722 and 705. All of these partnership item components of a partner's basis in his partnership interest can only be redetermined in a partnership proceeding. Thus, to the extent that a legal or factual determination which affects basis is a partnership item, that issue must be determined in the partnership proceeding. See University Heights at Hamilton Corp. v. Commissioner, 97 T.C. 278 (1991); Gemini Twin Fund III v. Commissioner, T.C. Memo. 1991-315. All issues determined will be res judicata[6] for purposes of any subsequent partner level proceeding concerning the final determination of a partner's outside basis in his partnership interest. Dial USA v. Commissioner, supra at 6. To the extent that issues relating to basis are not partnership items, they should be included in an affected item statutory notice of deficiency following completion of the relevant partnership proceeding. See § 301.6231(a)(3)-l(c)(3)(iv)(purchase price from an existing partner is not a partnership item).

A. Partnerships' Basis in Preferred Stock

Based on the above, the Service may redetermine the loss on the sale of the preferred stock in the FPAA issued to P2. As part of this determination, the FPAA should redetermine the partnership's basis in the preferred stock, including necessary preliminary determinations such as Company A's and P1's basis in the contributed property. § 301.6231(a)(3)-1(a)(4)(i) and -1(c)(2). The preliminary determinations of Company A's basis in the preferred stock could include determinations of sham, § 351 computation issues, the applicability of § 351, and the theory that, in substance, Company A first sold the preferred stock to GP which then contributed the preferred stock to P1.

These same issues should also be determined in the FPAA issued to P1 for protective purposes as well as to determine any direct consequences of a basis adjustment to P1 aside from the loss flowing from P2.

B. Allocation Issue

The Service may also reallocate the partnership losses as appropriate under § 482. Since the reallocation would ultimately be between two partners in P1, this allocation issue should be raised in the FPAA issued to P1. Arguably, the P2 FPAA can also make this allocation. Under § 6223(c)(3), Company A and GP can both be treated as direct partners in P2 if information concerning their indirect interest in P2 is furnished to the Service. Under § 301.6223(c)-1T(f) the Service can use information otherwise in its possession for this "furnishing" purpose. In addition, if P2 losses are in fact allocated to Company A, this would make it a "partner" in P2 for purposes of the P2 TEFRA proceeding under § 6231(a)(2)(B) (the term "partner" includes any person whose income tax liability is determined by taking partnership

[6] To the extent that no partnership proceeding precedes a partner level proceeding, the parties will be bound by the reporting of the partnership items components of basis as these items are reflected on the partnership return and the partnership books and records. See Estate of Quick v. Commissioner, 110 T.C. 172 (1998); Doe v.Commissioner, 97-1 U.S.T.C. ¶ 50,460 (10th Cir. 1997).

items into account). See also § 6231(a)(6) (computational adjustment may be made against indirect partners). Thus, this allocation issue should also be included in the FPAA to P2 for protective purposes. In addition, both Company A and GP should be sent copies of the P2's FPAA as if they were direct partners in P2. Section 6223(c)(3).

The Court may determine, however, that it does not have jurisdiction over this allocation issue in either of the TEFRA proceedings. In Hang v. Commissioner, 95 T.C. 74 (1990), the Court considered whether it had jurisdiction over a determination that William Hang was the beneficial owner of the stock of a TEFRA Subchapter S corporation. The shareholders of record were William's two minor children. The Court found that the issue of beneficial ownership of the stock was more appropriately determined at the individual level, and that it did not have jurisdiction over that issue in a TEFRA corporate level proceeding. We disagree with the Hang decision. In any event the period for assessment has expired for GP, so that an independent notice may not currently be issued to it. Nevertheless, the allocation issue may be considered to be an "affected item" that may be assessed within the period for assessing the partnership items of P1 or P2. See § 6229(a) setting forth the period for assessing both partnership items and affected items. A notice asserting affected items may not be issued until completion of the partnership proceedings for P1 or P2. See GAF Corp. v. Commissioner, 114 T.C. 533 (2000). Thus, if necessary, this issue may be revisited following the completion of the TEFRA proceedings.

In summary, all of the above adjustments must be included in the FPAA issued to P2. All of the same issues should be determined in the FPAA issued to P1. Company A and GP should be sent copies of both sets of FPAAs.

Issue 8

The Service is not precluded from challenging these basis amounts if the partner who contributed preferred stock in the year under examination acquired such stock in a year for which the applicable period of limitations has or may have expired.

Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Commissioner v. Sunnen, 333 U.S. 591, 598, 92 L. Ed. 898, 68 S. Ct. 715 (1948). Thus, absent the application of doctrines such as res judicata, valuation in a prior year is not binding on any prospective litigation for the current year in issue. Id. Furthermore, nothing in the TEFRA provisions indicates that the Service is bound by reporting in an earlier year in a judicial proceeding for a subsequent year. Cf. § 6231(e)(1) (partner level judicial proceedings do not bar proceedings under TEFRA). Thus, the Service is not bound by reporting for prior tax years absent a TEFRA judicial proceeding for the prior years.

Issue 9

It is appropriate to raise specified penalties as part of the TEFRA partnership proceedings for Year 4.

We have reviewed the portion of your request concerning the applicability of § 6662 to the adjustments of partnership losses reported from the disposition of preferred stock derived from the above lease stripping transactions. In addition to the arguments noted below in support of the request's conclusion that assertion of the § 6662 penalty is appropriate.

Individual G, an attorney and CPA, was the Director of Taxes for GP and the Tiered Group. In Month 2 of Year 3, Individual G learned of the preferred stock from Promoter. Individual G claims to have relied on tax opinions rendered by Q and R. However, Individual G knew that the Service had issued a notice stating that it intended to challenge lease stripping transactions such as those from which the preferred stock was derived. Further, Individual G knew that Q had served as counsel on the underlying lease stripping transactions. Moreover, P2 has declined to disclose the tax opinions it received from Q and R.

We agree that, based on the current facts, assertion of the § 6662 accuracy-related penalty is appropriate in this matter.

Further, we agree that facts exist to support the assertion of § 6662 penalty based on the negligence, disregard of rules and regulations, substantial understatement, or substantial valuation misstatement components of § 6662.

Regarding the negligence component, your request notes P2 is subject to the accuracy-related penalty for negligence because, among other things, P2' tax advisor failed to throughly investigate the bona fide of the economic aspects of the lease stripping transactions. As additional support for assertion of the § 6662 penalty, it should be noted that P2 failed to show that it relied on the advice of a competent, independent, tax professional. Freytag v. Commissioner, 904 F.2d 1011 (5th Cir. 1990). See also Atkind v. Commissioner, T.C. Memo 1995-582 (taxpayer's reliance on the investment advice of the general partner and corporate counsel of a partnership, which was a tax sham designed to create spurious deductions, was not reasonable) and Marine v. Commissioner, 92 T.C. 958, 992-993 (1989), aff'd without published opinion, 921 F.2d 280 (9th Cir. 1991) (reliance on representations by insiders, promoters, or offering materials is an inadequate defense to negligence). Additionally, it should be noted that P2 has not established that the overstated preferred stock basis was incorrectly claimed as a result of advice provided by a competent, independent, tax professional. See Cordes Finance Corp. v. Commissioner, T.C. Memo. 1997-162 (taxpayer's contention of reasonable cause rejected because there was no evidence that errors on the taxpayer's returns resulted from advice given by taxpayer's CPA).

A gross valuation misstatement exists if the adjusted basis (or fair market value) of property claimed on a return is 400 percent or more of the amount determined to be the correct amount. Further, if the claimed valuation is 400 percent or more of the correct value, the § 6662 penalty rate is 40 percent rather than 20 percent. Section 6662(h). If it can be established that the transaction is a sham and should not be respected for tax purposes, the correct basis of the preferred stock will likely be zero or a nominal amount, and the 40 percent penalty rate will be applicable. See Gilman v. Commissioner, T.C. Memo. 1989-684, aff'd, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992) (correct adjusted basis was zero and higher overvaluation rate applied where the underlying transaction lacked economic substance).

It should be noted that in determining the total amount of penalties imposed, where at least two penalty rates may apply or where there is an adjustment with respect to which no penalty has been imposed, the ordering rules of § 1.6664-3 should be followed.

Please call if you have any further questions.

ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS AND SPECIAL INDUSTRIES

By: ________________________
Matthew Lay
Assistant to the Branch Chief, Branch 1
Office of the Associate Chief Counsel
Passthroughs and Special Industries