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

MEMORANDUM FOR JODY S. TANCER
ASSOCIATE AREA COUNSEL (FINANCIAL SERVICES AND HEALTHCARE) CC:LM:FSH:BRK

Attention: Andrew J. Mandell

FROM: Jasper L. Cummings, Jr.
Associate Chief Counsel CC:CORP

SUBJECT: Lease Stripping Transaction

This Chief Counsel Advice responds to your memorandum dated April 6, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer	=
Partnership A	=
Partnership C	=
Limited Partnership B	=
Entity A	=
Entity B	=
Entity C	=
Entity Q	=
Entity R	=

Tax Exempt Entity Type A	=
Foreign Corporation T	=
Foreign Entity V	=
Corporation P	=
Corporation S	=
Corporation W	=
Corporation X	=
Corporation Y	=
Financial Institution A	=
Financial Institution B	=
Individual A	=
Individual B	=
Individual C	=
Individual D	=
Individual E	=
Individual F	=
Statement X	=
Executive Position A	=
Consultant	=
City A	=
City B	=
Country A	=
Country B	=
Country C	=
Article A	=
Article B	=

Paragraph A	=
A%	=
B%	=
C%	=
D%	=
E%	=
F%	=
G%	=
H%	=
J%	=
K%	=
L%	=
M%	=
N%	=
P%	=
#A	=
#B	=
#C	=
#D	=
#E	=
#F	=
Asset A	=
Asset B	=
Asset C	=
Asset A Business	=

$A	=
$B	=
$C	=
$D	=
$E	=
$F	=
$G	=
$H	=
$J	=
$K	=
$L	=
$M	=
$N	=
$P	=
$Q	=
$R	=
$S	=
$T	=
$U	=
$V	=
$W	=
$X	=
$Y	=
$Z	=
$AA	=
$BB	=

$CC	=
$DD	=
$EE	=
$FF	=
$GG	=
$HH	=
$JJ	=
$KK	=
Agreement A	=
Year A	=
Year B	=
Year C	=
Year D	=
Year E	=
Month A	=
Month B	=
Month C	=
Date A	=
Date B	=
Date C	=
Date D	=
Date E	=
Date F	=
Date G	=
Date H	=
Date J	=

ISSUES

You have requested written advice on a number of issues relating to a large loss taken by Taxpayer in Year C. You have indicated that this loss arose from a tax abusive transaction. As we informed you orally the facts have not been fully developed which are necessary to fully evaluate most of these issues. Nevertheless we will comment on each of the following issues as best we can.

Issue 1. Whether a series of prearranged transactions, culminating in a $BB capital loss on the sale of stock received by the taxpayer in a § 351 transaction, should be disallowed on the following grounds:

a. That the taxpayer failed to substantiate its entitlement to the capital loss.

b. That the series of transactions in which the taxpayer obtained and sold the assets lacked economic substance and whether the carryover basis in the stock received from Limited Partnership B was derived from lease stripping transactions that lacked economic substance.

c. That the capital loss may be allocated from Taxpayer to Limited Partnership B under the authority of I.R.C. § 482.

d. That I.R.C. § 351 does not apply to the exchanges so that Limited Partnership B would recognize gain or loss on the exchange and Taxpayer would take a basis in the stock equal to their fair market value.

e. That the basis in the inflated basis stock acquired in the original § 351 transaction, in the underlying lease strip, is overstated.

Issue 2. Whether the foreign shareholders of Taxpayer, a domestic corporation, may be held liable as transferees for Taxpayer's tax liability resulting from the corporation's long-term capital gain on the sale of the appreciated assets?

Issue 3. Whether the Service can take the position that the accuracy related penalty provided by § 6662 applies to deficiencies that result from adjustments to the capital losses reported by Taxpayer?

CONCLUSIONS

Issue 1 (With respect to a series of prearranged transactions, culminating in a $BB capital loss on the sale of stock received by Taxpayer in a § 351 transaction):

1 (a). The taxpayer failed to substantiate its entitlement to the capital loss.

1 (b). Further factual development is required both as to the taxpayer's subjective and objective motives for the transfers of the stock and as to the underlying lease strip transactions in order to assert that the transactions lacked economic substance and that the taxpayer cannot claim a carryover basis in the assets from those transactions.

1 (c). The capital loss may be allocated from Taxpayer to Limited Partnership B under the authority of I.R.C. § 482. From the facts provided, we conclude that § 482 is potentially applicable to Taxpayer and the other parties to this transaction to reallocate the loss from the sale of the Corporation P stock from Taxpayer to Limited Partnership B. Because the participants acted in concert pursuant to a common plan to shift deductions to Taxpayer, they are part of the same controlled group for purposes of applying § 482.

Section 482 may be applied under two alternative theories to prevent the evasion of taxes and clearly reflect the income of the participants.

> i) Under the first theory under § 482, the "economic substance/ tax evasion standards" of § 482, the Service would potentially disregard the purported § 351 transfer between Taxpayer, Partnership A, and Limited Partnership B due to a lack of economic substance so that Limited Partnership B is treated as never having transferred the Corporation P stock to Taxpayer. As a result, the loss that Taxpayer claimed on the sale of the stock to Corporation S will be disallowed and reallocated to Limited Partnership B. More facts will need to be developed to determine if this is a viable theory under which to reallocate the stock loss.
>
> ii) Under the second theory under § 482, the "clear reflection of income standard" of § 482, the Service would allocate Taxpayer's deduction for the built-in loss stock it received back to Limited Partnership B on the basis that § 482 may be applied to allocate deductions attributable to property received in a § 351 transfer from the transferee corporation back to the contributor to clearly reflect income. It is our understanding that the facts as currently developed suggest that this is a viable theory the Service may use to reallocate the stock loss back to Limited Partnership B.

1 (d). Section 351 does not apply to the exchanges so that Limited Partnership B would recognize gain or loss on the exchange and Taxpayer would take a basis in the stock equal to their fair market value.

1 (e). Depending on the facts that may be developed, the basis in the inflated basis stock acquired in the original § 351 transaction, in the underlying lease strip, is overstated.

Issue 2. The foreign shareholders of Taxpayer may be held liable as transferees for Taxpayer's tax liability as a result of the Taxpayer's long-term capital gain on the sale of the appreciated assets.

Issue 3. Depending on the facts that develop, there is support for the view that the accuracy-related penalty attributable to negligence potentially applies to the deficiency that results from the disallowance of the built-in losses from the inflated basis assets because Taxpayer appears to have disregarded the economic substance of the transactions from which the losses were claimed and has failed to offer evidence that there was reasonable cause for its return position for the losses or that it acted in good faith in claiming them.

FACTS

You have indicated that the facts, so far developed, are as follows:

(a) Background

Taxpayer (formerly Entity B) was incorporated in Month A Year A. In Month B Year A, Taxpayer purchased the Asset A in City B for $T.[1] The company financed another $U to renovate Asset A, which was completed in Month C Year B. Thereafter, Taxpayer entered into a contract with Entity A to operate the Asset A Business.[2]

From Month A Year A through Date E, Taxpayer was owned by Individual A (C%), Foreign Corporation T (C%), and Foreign Entity V(J%).

Individual A is a Country A citizen. He is the former Executive Position A of Entity B, which operates at least #A City A Asset A Business(es). Individual A is also believed to be involved in all facets of the operation of Entity A.

Foreign Corporation T is a Country A company. Foreign Entity V is a Country B/Country A joint venture. To date, Taxpayer has failed to adequately comply with the examiner's request for information in this case.

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[1] Taxpayer's Year C Schedule D, Statement X specifies Date J as the date when the corporation acquired the Asset A Business.

[2] According to Taxpayer's Year B and Year C Forms 1120, the corporation paid management fees in those years of $D and $P, respectively.

(b) Taxpayer's Year C Sale of the Asset A Business

On Date A, Taxpayer sold the Asset A Business and Asset C to Entity C for $KK. Although Taxpayer realized net capital gain on the transaction of $EE, it reported the sale on its Year C Form 1120 as separate transactions involving the physical assets and goodwill.

On its Year C Schedule D, Taxpayer reported gain on the sale of goodwill of $FF, computed as follows:

gross sales price	$GG
basis	($Q)
gain	$FF

The corporation also reported a loss in Year C on the sale of the physical assets of $C, computed as follows:

gross sales price	$HH
depreciation	($S)
basis	($JJ)
loss	($C)

According to Statement X, the $HH represents the sale price of Asset A, Asset B and Asset C. It is unknown how or on what basis Taxpayer allocated the sale price between goodwill and tangible property. According to the examiner, the corporation has not responded to her questions regarding the allocation.

(c) Resignation of Taxpayer's officers and directors

On Date D, all officers and directors of Taxpayer either resigned or were terminated. By letter dated Date E, Individual A also resigned as an officer and director of Taxpayer. By corporate resolution dated Date E, the resignations of all existing directors were accepted.

By that same resolution, Individual F was named as Taxpayer's sole director. By separate resolution, Individual F was also elected vice president, treasurer, and secretary; Individual E was elected president; and both Individual F and Individual

B[3] were given sole signature authority over the corporation's funds. The relationship, if any, between Individual A and the new officers of Taxpayer is unknown. Individual D was subsequently added as a director.

(d) The shareholders' sale of their Taxpayer stock

On Date E, Taxpayer's shareholders sold their entire stock interests in the corporation to Partnership A for $V.[4] Partnership A is a domestic partnership formed on Date B between Entity R (the general partner) and Entity Q (the limited partner). According to IRS records, the partnership has never filed a Form 1065.

From Date B to Date C, Partnership A's partners were Entity R (D%) and Entity Q (K%), a Country C corporation. As of Date C, Entity R's and Entity Q's partnership interests were reduced to A% and F%, respectively, with the introduction of two additional limited partners, Corporation W (N%) and Corporation X (E%). Thereafter, on Date E, Partnership A's partners were Corporation W (G%) and Corporation X (E%).

To finance the purchase of the Taxpayer stock, Partnership A borrowed $W from the Financial Institution A. This loan was guaranteed by Taxpayer, which also pledged as collateral its interest in funds on deposit at the Financial Institution B (pursuant to Agreement A) and its stock (pursuant to a stock pledge agreement). The examiner believes that the deposited funds represent the proceeds from the Month B Year C sale of the Asset A Business.

(e) The § 351 transaction

On Date E, Taxpayer entered into a transaction intended to qualify for nonrecognition treatment under § 351. In this transaction, Taxpayer received $N in cash from Partnership A, which received nothing in return. Taxpayer also contributed #C shares of Taxpayer stock to Limited Partnership B,[5] for which it (Taxpayer) received #D shares of Corporation P stock in return. Partnership A did not assume any of Taxpayer's liabilities.

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[3] Individual B, Consultant, prepared Partnership A's unfiled Year C Form 1065, as discussed in section (d) of the facts.

[4] To date, Taxpayer has not furnished the examiner with the purchase agreement.

[5] Limited Partnership B is a partnership whose M% limited partner is the tax-neutral Tax Exempt Entity Type A.

The Corporation P stock is allegedly valued at $G and has a basis in Limited Partnership B's hands of $CC. To date, Taxpayer has refused to provide any information regarding the Corporation P stock. Following the purported § 351 transaction, Partnership A owned L% of Taxpayer. The balance (B%) was owned by Limited Partnership B.

(f) Taxpayer's corporate distributions to Partnership A

On Date E, Taxpayer declared dividends payable to Partnership A totaling $Y. According to the corporate resolution, $R of this amount was required to be paid prior to the § 351 transaction. By separate resolution, Taxpayer was required to distribute an additional $X as a dividend after the § 351 transaction. Because Taxpayer did not have any earnings and profits as of Date H,[6] the distributions were treated as returns of capital. To date, the funds have not been traced. According to some of the documentation provided, these funds may have been used to pay off Partnership A's $W note and the required $E arrangement fee to the Financial Institution A. Following the § 351 transaction, Taxpayer held #D shares of Corporation P stock with a fair market value of $G and an alleged adjusted basis of $CC.

In addition to the above distributions, it also appears that Taxpayer made additional distributions to Partnership A of $L and $F in Year C. As reflected on Schedule L of Taxpayer's Year D Form 1120, its notes receivable went from $M to $H[7] in that year. This $L reduction was apparently later recharacterized as a Year C distribution. There was also an additional distribution in Year C of $F resulting in total distributions to Partnership A in that year of $AA. This figure does not, however, reconcile with the $Z appearing on Partnership A's unfiled Year C Form 1065, Schedule D.

(g) Taxpayer's sale of the Corporation P stock

On Date G, Taxpayer sold the #D shares of Corporation P stock it received in the § 351 transaction to Corporation S for $G[8] the alleged fair market value on Date E. Presently, the examiner is unaware of the identity of the principals of Corporation S.

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[6] The absence of earnings and profits is attributable to the capital loss discussed in section (g) of the facts.

[7] This figure includes the $G Corporation S note, discussed in section (g) of the facts, and a miscellaneous note for $A.

[8] In the purchase and sale agreement, the purchase price of the stock was listed at $J. The reason for the difference is unknown.

The purchase price was paid with a promissory note dated Date G in the face amount of $G.

On Schedule D of its Year C Form 1120, the corporation reported a long-term capital loss of $BB, computed as follows:

gross sales price	$G
basis	($CC)
loss	($BB)

Taxpayer used this loss to offset the gain realized on the Month B Year C sale of the Asset A Business. As noted above, Taxpayer's basis in the Corporation P stock received from the tax-neutral Limited Partnership B has not been substantiated to date.

(h) Subsequent Taxpayer returns

On its Year D Form 1120, Taxpayer reported only interest income of $B from the $H note receivable from Corporation S. According to the corporation's balance sheet, it had total assets for that year of $K, representing the face value of the note plus accrued interest of $B. It appears that Corporation S satisfied the $G note sometime in Year E, although actual payment has not been demonstrated. Taxpayer's Year E Form 1120 reflects that it had no income and cash of only $K.

(i) Relationships between the parties

According to the various transactional documents, the parties appear to be related. For example, Individual C signed a consent of shareholders as president of Corporation W (the general partner of Partnership A) and is also the "signing authority" for Partnership C (the general partner for Limited Partnership B).

Additionally, Individual D is involved with three entities. Individual D is a director of Taxpayer, evidenced by Individual D's signature on the Date F consent of stockholders. Individual D also signed the stock subscription on behalf of Limited Partnership B (with title omitted) and the purchase agreement on behalf of Corporation S (title also omitted).

Finally, as noted above, Individual B prepared Partnership A's unfiled Year C Form 1065. Individual B is also the vice president of Corporation Y (Entity R's general partner) and a signatory for Taxpayer.

(j) Taxpayer's lack of cooperation

To date, Taxpayer has provided only selected transactional documents. Additionally, Taxpayer has yet to respond to the examiner's questions regarding the circumstances and/or business purpose for the § 351 transaction. Furthermore, it is unknown whether the foreign shareholders have any other property interests in the United States. Consequently, the examiner intends to issue third-party summonses to further develop the facts in this case.

LAW AND ANALYSIS

Issue 1 (Whether a series of prearranged transactions, culminating in a capital loss on the sale of stock received by Taxpayer in a § 351 transaction, should be disallowed on the following grounds):

1(a). That Taxpayer failed to substantiate its entitlement to the capital loss.

As set forth above, although the Corporation P stock is valued at $G and had an alleged basis in Limited Partnership B's hands of $CC, to date Taxpayer has refused to provide any information regarding the Corporation P stock.

It has long been recognized that when taxpayers claim bases carried over from other parties, they are required to prove the carryover bases. Stock Yards National Bank v. Commissioner, 153 F.2d 708, 710-12 (8th Cir. 1946); Boyle Ice Co. v. Commissioner, 33 B.T.A. 420, 425 (1935); James Manufacturing Co. v. Commissioner, 17 B.T.A. 205, 211-12 (1929). The books of the party from whom the basis is carried over do not prove the basis of the assets reflected on them. Fairmont Aluminum Co. v. Commissioner, 7 T.C.M. (CCH) 783, 787 (1948), aff'd, 180 F.2d 832 (4th Cir. 1950) (reasoning that the balance sheet of the predecessor corporation, without more, cannot logically be viewed as proof of basis). A taxpayer is not entitled to basis it cannot substantiate. Stock Yards National Bank v. Commissioner, 6 T.C.M. (CCH) 478, 482 (1947) (citing Burnet v. Houston, 283 U.S. 223 (1931), aff'd, 169 F.2d 39 (8th Cir. 1948)). Therefore, the claimed loss should not be allowed without Taxpayer providing evidence of its claimed $CC basis.

If Taxpayer does provide you with substantiation of this loss then you may wish to seek our advice again on how this affects Taxpayer's entitlement to the loss.

1(b). Economic Substance: Lease strips and Inflated Basis Transactions

A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. 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). To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved by tax reduction. If a taxpayer seeks to claim tax benefits that Congress did not intend by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance applies. 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 Public Service Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership, supra.

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

The Service was successful recently 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, 157 F.3d 231. 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 primarily 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 Rev. Rul. 99-14, 1999-13 I.R.B. 3 (because lease-in/lease-out transactions have no economic substance, a U.S. taxpayer may not take deductions for rent or interest paid or incurred in connection with a transaction). See also, Compaq Computer Corp. v. Commissioner, 113 T.C. 214 (1999); Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), aff'd, (11th Cir. Jun. 28, 2001).

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

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.

Taxpayer has not provided any information regarding its business purpose for getting and disposing of the Corporation P stock, resulting in a $BB capital loss, in the same taxable year in which it had an approximate unrelated $DD gain. Taxpayer should be made to demonstrate not only its reasons for entering into these transactions, but also that it performed due diligence in its pursuit of that business purpose. [9]

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[9] As you note, if the taxpayer had a valid business purpose for this transaction, it is likely that an explanation would have already been provided. We understand that the credibility of any possible explanations for the investment in and sale of the stock will be investigated further by you through discovery and other means.

The inflated basis stock was received by Taxpayer in a purported 351 transaction on Date E in exchange for #C shares of its own stock.[10] Taxpayer sold the stock on Date G for $G which resulted in the $BB loss.[11] There must be a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.[12] Yosha v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership v. Commissioner, 157 F.2d at 249. No evidence has been presented by Taxpayer as to how it expected to make a profit from the ownership of the stock. Pending further factual development, the transfers of the stock may lack economic substance.

In order to make the argument that the basis should be reduced because it stemmed from a lease stripping transaction further development of the facts surrounding that lease strip itself is required. In particular, it must be shown that the transaction giving rise to the inflated basis property, was one in which income was inappropriately separated from related deductions in a prearranged manner.

If Taxpayer provides additional information that bears on the objective economic substance and non tax business purpose of these transactions, you may wish to again seek our advice on this issue.

1(c). The Service may allocate the capital loss claimed by Taxpayer to Limited Partnership B under the authority granted by I.R.C. § 482.

It is our opinion that a valid § 351 transaction did not occur in this case. If a bona fide § 351 transaction did not take place, Taxpayer will not be entitled to take a carryover basis in the Corporation P stock of $CC. Instead, Taxpayer will be obligated to take a fair market value basis in the stock of $G. The following § 482 analysis will only have consequence in this case if the § 351 transaction is ultimately found to be valid. If the transaction is ultimately determined to meet the requirements of § 351, § 482 can be applied to allocate the capital loss attributable to the Corporation P stock back to its contributor, Limited Partnership B.

I. Discussion of § 482's Requirements

A. § 482-Generally

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394, 400 (1972); Barford v. Commissioner,

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[10] You state that you do not know the value of the #C shares of Taxpayer stock.

[11] The alleged basis in the stock was $CC.

[12] You state that you do not know all of the transaction costs involved in the transaction.

194 F.3d 782, 786 (7th Cir. 1999); Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd., 358 F.2d 342 (6th Cir. 1966), cert. denied, 385 U.S. 899 (1966). Cf. H.R. Rep. No. 2, 70th Cong., 1st Sess., 16-17. Section 482 provides in relevant part:

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

For the reallocation rule of § 482 to apply to a transaction, the transaction must involve at least two entities owned or controlled by the same interests. Section 482 imposes two additional requirements regarding the entities: (1) ownership or control must exist in some manner among the participants, and (2) the same interests must possess the control. Regarding the first requirement, because Partnership A and Limited Partnership B were unrelated to Taxpayer, the mutual ownership provision of § 482 will not apply. Therefore, Taxpayer and Limited Partnership B must be found to be controlled by the same interests if we are to apply § 482 to the transaction that took place between them.

B. Legal Standard for Determining Control under § 482

1. *Definition of control*

a. *Court decisions*

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

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

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

Current final regulations which govern the years covered by this case provide that when control does not exist through a taxpayer's majority ownership of a participant's voting stock or a legally enforceable agreement delegating the power to direct an entity's actions, alternatively control results from the actions of two or more taxpayers acting in concert or with a common goal or purpose. Treas. Reg. §1.482-1(i)(4). See also DHL Corp., T.C. Memo 1998-461 at 100 (When the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled.) By its terms, the regulation does not require taxpayers to be related to each other by overlapping ownership to effect § 482 control by "acting in concert."

Alternatively, a presumption of control arises under the regulations if income and deductions have been arbitrarily shifted. Id. Case law is in accord with the regulation's presumption of control through the arbitrary shifting of income or deductions. See Dallas Ceramic Co. v. U.S., 598 F.2d 1382, 1389 (5th Cir. 1979) (holding that the government correctly argued that proof of a shifting of income between two corporations establishes a presumption of common control under Treas. Reg. §1.482-1(a)(3) (1968)-predecessor to current § 482 regulations); Hall v. Commissioner, 294 F.2d 82, 85 (5th Cir. 1961) (finding presumption of control under § 29.45-1 of Regulation 111-predecessor to current § 482 regulations). However, by its terms, the existence of control by acting in concert or with a common goal or purpose may be found separately under the regulations whether or not a presumption of control is found through an arbitrary shifting.

2. *Existence of control among Taxpayer, Partnership A, and Limited Partnership B*

Under Treas. Reg. 1.482-1(i)(4) and the relevant case law, none of the participants to this transaction are required to own interests in each other, majority or otherwise, for the requisite control to exist under § 482. Instead, the Service may consider whether effective control existed among the parties, even in the absence of a legal or contractual right to direct the actions of the entities.

a. *Common officers*

In determining the existence of control among Taxpayer, Partnership A, and Limited Partnership B, the fact that the entities shared some common directors and officers must be taken into account. Individual C, the president of the general partner of Partnership A, was also the signing authority for the general partner of Limited Partnership B. On Date D, all of the officers and directors of Partnership A either resigned or were terminated. Individual F was elected the sole director, vice president, treasurer, and secretary of Taxpayer. Individual F signed the stock subscription agreement with Limited Partnership B as well as the purchase agreement with Corporation S on behalf of Taxpayer. Individual D, one of the #A directors of Taxpayer, signed the stock subscription agreement on behalf of Limited Partnership B and the purchase agreement on behalf of Corporation S. More facts must be developed to determine the extent of the above-mentioned officers and directors' authority over their respective entities. When making the control determination, it is the reality of how control was actually exercised among the parties that must be considered for purposes of § 482. For instance, if Individual D had the unilateral authority to bind Taxpayer, Limited Partnership B, and Corporation S to the Corporation P stock transfer and sale or if he effectively controlled the operation of the entities despite the existence of other directors or officers, this would be indicative that the three entities were under common control. Similarly, Individual D could have been acting in conjunction with Individual F to control the business decisions of the entities. Individual F's involvement in other lease stripping transactions is also relevant in that the resignations of Taxpayer's board and officers and his subsequent assumption of the roles of director, vice president, treasurer and secretary may have occurred solely to make use of his knowledge and experience to effectuate the shifting of the Corporation P stock basis to Taxpayer.

b. *The existence of control through the parties' acting in concert and with a common goal or purpose*

The Corporation P stock contributed by Limited Partnership B in the § 351 transaction had a substantial built-in loss of -$BB (the difference between its purported fair market value of $G and its purported basis of $CC). By contributing the Corporation P stock to Taxpayer on Date E, only approximately #A months subsequent to the date Taxpayer sold its Asset A Business at a substantial capital gain, Limited Partnership B acted in concert with Taxpayer to shift the potential capital loss deduction inherent in the stock from it to Taxpayer. Partnership A's ownership of L% of Taxpayer's stock was the result of an attempt to make the high basis Corporation P stock transfer by Limited Partnership B to Taxpayer appear to be a valid § 351 transaction.[13] Thus, Partnership A acted in concert with Taxpayer and Limited Partnership B to ensure that Taxpayer would be permitted to claim the benefits of a nonrecognition transfer, including taking a carryover basis in the Corporation P stock.

It also appears as though a common goal may have existed among the parties to shift the loss deduction inherent in the Corporation P stock to Taxpayer. Partnership A's participation in this transaction allowed it to receive prearranged distributions of $R and $W as well as distributions in the amounts of $L and $F. These distributions were treated as returns of capital to Partnership A due to Taxpayer's lack of earnings and profits for the Year C taxable year. Although Partnership A may have used the $W distribution to pay off its note to the Financial Institution A, Partnership A would have received the remaining distributions as tax-free returns of capital. Therefore, Partnership A benefitted from aiding Taxpayer in achieving the goal of shifting the loss deduction. It is not clear from the facts what benefit Limited Partnership B received from its participation in the transaction. This fact must be developed to provide support for the position that the parties had a common goal to shift the loss deduction to Taxpayer, since Limited Partnership B would have had no reason to aid Taxpayer in achieving this goal through the stock transfer if it received nothing of value in return. Additionally, the Service should develop facts relating to whether the partners of Limited Partnership B had the ability to use the capital loss deduction shifted to Taxpayer. If the partners could not have claimed the loss on their returns had it been passed through to them, the Service's argument that Limited Partnership B had a common interest with Taxpayer in shifting the deduction to Taxpayer will be stronger because the transfer of a loss deduction to a U.S. taxpayer would have been worth more to them.

c. *The presumption of control among the parties*

In making the § 482 control determination, the Service may apply the presumption of control provided for in Treas. Reg. 1.482-1(i)(4) and in the applicable case law. The regulations do not require the Service to also establish that the parties acted in concert or with a common goal or purpose for the presumption to be applicable. The Service must only establish that income or deductions have been arbitrarily shifted between the parties for the presumption of control to arise.

From the facts provided to us, and in addition to the acting in concert control theory discussed above, it appears as though a loss deduction has also been arbitrarily shifted from Limited Partnership B to Taxpayer to allow it to offset the majority of the long-term capital gain attributable to the Asset A Business sale. No plausible

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[13] As previously discussed, it is our primary position that the transaction whereby the high basis low fair market value Corporation P stock was transferred to Taxpayer was not a valid § 351 transaction.

reason has been offered as to why Taxpayer would accept stock with such a low value in exchange for its own stock, especially when considered in light of the fact that Taxpayer had recently received gross income from the Asset A Business sale in the amount of $KK. The lack of a credible non-tax reason as to why Taxpayer would want the Corporation P stock makes the shifting of the deduction attributable to the stock appear to have occurred in an arbitrary manner.

Because an arbitrary shifting of the built-in loss inherent in the Corporation P stock appears to have occurred between Taxpayer, Limited Partnership B, and Partnership A, control is presumed to exist among the entities for the purposes of § 482 pursuant to Treas. Reg. 1.482-1(i)(4) and the applicable case law. As stated though, it is sufficient under the final regulation to show independently that the parties acted in concert or with a common goal or purpose without having to argue a rebuttable presumption of control was created through an arbitrary shifting.

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

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

The regulations do not define what the term "the same interests" means under § 482. Case law indicates that in using the term "the same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979) (holding that different persons with a common goal or purpose for arbitrarily shifting income can constitute "the same interests" for purposes of § 482). See also B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972) (reversing Tax Court's holding that two independently owned corporations acting in concert together to make interest-free loans to a jointly owned corporation did not constitute the same interests within the meaning of § 482); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), cert. denied, 386 U.S. 1016 (1967). Cf. Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233-34 (1925). But see The Lake Erie and Pittsburg Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq. 1945 C.B. 5, acq. withdrawn 1965-1 C.B. 5.

Case law indicates that the legal standard for determining whether "the same interests" control an entity is identical to the standard applied to determine whether control of an entity exists. Under this approach, if different entities are found to have a common goal to shift income or deductions among each other, not only will control of the entities exist, but the entities will also constitute "the same interests" for the purpose of § 482. As previously discussed, facts show the apparent existence of a common plan among Taxpayer, Partnership A and Limited Partnership B to shift deductions to Taxpayer in the Year C year. Consequently, we conclude that Taxpayer, Partnership A and Limited Partnership B constitute "the same interests" under § 482 and thus establish the necessary control group for purposes of this section. In making such an allocation, if Taxpayer is able to substantiate the requirements for a § 351 transaction, then independent grounds exist under § 482 to reallocate the loss deduction claimed by Taxpayer to prevent the evasion of taxes or to clearly reflect income.

II. Application of § 482 to this Transaction

Generally, there are two alternative bases to apply § 482 to a transaction: (1) prevention of the evasion of tax, and (2) the clear reflection of income.

A. Economic Substance/Tax Evasion Standards of § 482

The application of § 482 has been upheld where the challenged transaction was arranged without a valid business purpose and solely in order to avoid taxes. Eli Lilly and Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988). When analyzing potential tax avoidance aspects of a transaction, the Commissioner will respect the transaction's contractual terms if consistent with the true economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B). The economic substance standard of the regulations overlaps with the economic substance and sham transaction doctrines developed in case law which allow the Service to consider the economic realities of a transaction and disregard transactions lacking a business purpose and entered into solely for tax avoidance motives.[14] However, the § 482 regulations expand upon case law and provide the following specific guidance:

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

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

> such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. §1.482-1(d)(3)(ii)(B).

Thus, § 482 provides an alternative approach. It provides additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and terms adopted and does not restrict the Service's authority to make allocations in instances of "colorable" or "sham" transactions. We note that in the context of this 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 § 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. See Treas. Reg. 1.482-1(d)(3)(ii)(B). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This treatment may result in a denial of deductions arising from the transaction at issue. See e.g. B. Forman, 453 F.2d at 1160-61.

Applying the regulation's economic substance standard to this transaction, the facts show an indicia of a lack of economic substance. The Corporation P stock had a purported value of only $G. Taxpayer sold the stock only #B months after receiving it in the § 351 transfer. The facts appear to show that the purpose of the § 351 transaction was to trigger the loss in the high basis, low value stock, as evidenced by the quick sale. The large carryover basis of the stock compared to its low purported fair market value ensured the generation of a substantial loss deduction to offset the gain from Taxpayer's Asset A Business sale upon Taxpayer's sale of the stock. No facts have been provided concerning Taxpayer's business purpose for entering into the § 351 transaction. However, considering that the stock had a minimal fair market value in relation to its basis, it also appears unlikely that Taxpayer could have generated even any economic profit from stock which was essentially worthless. See Sheldon v. Commissioner, 94 T.C. 738 (1990). Given the stock's low value, the Corporation P stock would have had to increase in value over #F times its received value of $G for Taxpayer to simply break even with the purported $CC million basis (P% growth in value was required). By disposing of the stock only a few months after its receipt, Taxpayer did not even attempt to realize a profit from the stock by affording the stock enough time to appreciate in value, nor does the possibility of a future profit over a long-term seem even feasible under realistic business considerations. Even under extraordinary industry expectations, no projection or due diligence of any anticipated profit has been shown. See Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 223 (1999) (The Tax Court found significant that neither the taxpayer nor any other representative conducted an analysis of the risks associated with trading transactions in concluding that the transactions lacked economic substance and were entered into solely for the attendant tax benefits) .

Despite the indicia of a lack of economic substance which are present in this case, further facts must be developed to determine if under all reasonable expectations, this is a valid approach under which to make a § 482 allocation.

Further, this transaction appears to be a back-end part of a lease stripping transaction as described in part (a) of Notice 95-53, 1995-2 C.B. 334, in which the Service indicated that lease stripping transactions effected through a transferred basis transaction would result in the exercise of the Service's authority to reallocate gross income, deductions, credits, or allowances between the participants in the transaction. If the facts, once fully developed, indicate that the contribution and sale of the stock appear to be part of a prearranged transaction to avoid taxation of the gain from the Asset A Business sale which took place during the Year C taxable year, the transaction should be recharacterized pursuant to Treas. Reg. 1.482-1(d)(3)(ii)(B) in conformity with its true economic reality. Recharacterization of the transaction in this case would result in the Commissioner's disregarding Limited Partnership B's transfer of its high basis, low value Corporation P stock, which would consequently result in the reallocation of the capital loss claimed by Taxpayer on the sale of the stock back to Limited Partnership B. Such a reallocation made pursuant to the Commissioner's authority under the economic substance/tax evasion standards of § 482 would serve to prevent Taxpayer from evading substantial taxes on an unrelated capital gain.

B. Clear Reflection of Income Standard of § 482-

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

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

Other cases are in accord with National Securities Corp. that § 482 may be applied to clearly reflect income despite apparent conflict with the provisions of another section of the Code. See Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 215-16 (2nd Cir. 1952), cert. denied, 344 U.S. 874 (1952) (Commissioner properly applied § 482 to reallocate deductions associated with property acquired in a reorganization to transferee to clearly reflect income); Dolese v. Commissioner, 811 F. 2d 543, 546 (10th Cir. 1987) (Commissioner has broad discretion under § 482 to correct distortion of income occurring through the strict application of other provisions of the Code and may invoke § 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction); Aiken Drive-In Theater Corp. v. U.S., 281 F.2d 7, 9-11(4th Cir. 1960); Foster v. Commissioner, 756 F.2d 1430, 1433 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986) (Commissioner may invoke § 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction). See also Rooney v. U.S., 305 F.2d 681, 686 (9th Cir. 1962) (Section 482 will control when it conflicts with § 351.); Eli Lilly, 84 T.C. at 1116-1118 (Section 482 may be applied in circumstances involving § 351 transactions if necessary to clearly reflect income or prevent the avoidance of tax.); G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987).

In the instant case, we conclude that Taxpayer primarily engaged in the § 351 transaction to further tax avoidance motives and that the subsequent disposition of the Corporation P stock Taxpayer acquired in the 351 transfer resulted in a distortion of income. By disposing of the high basis, low value Corporation P stock received in the § 351 transfer at a substantial loss, Taxpayer was able to shelter significant capital gains income for the cost of eight shares of its stock. Given the short period of time Taxpayer held the stock and that the stock was likely sold prior to the close of the Year C taxable year to trigger the substantial loss inherent in the stock, it is apparent that the pre-contribution loss attributable to the stock properly belongs to Limited Partnership B. Accordingly, under the analysis adopted in National Securities Corp. and its progeny, the Service may disregard the § 351 transfer and allocate the losses Taxpayer claimed on the sale of the Corporation P stock back to the transferor entity, Limited Partnership B, to clearly reflect income. A § 482 allocation may be made despite the fact that its application would result in a conflict with the literal provisions of § 351, which would treat the transferee corporation, Taxpayer, as the true owner of the Corporation P stock and allow it to claim the loss. As set forth in National Securities Corp., this conflict is inevitable and is not sufficient reason to prevent the application of § 482 to the instant transaction.

III. Potential Application of Treas. Reg. §1.897-6T(c)(2)

As mentioned previously and discussed below, our primary argument is that the requirements of § 351 were not met. We note that if Taxpayer is ultimately determined to have met the requirements of § 351, Treas. Reg. §1.897-6T(c)(2) may potentially apply to this transaction. Under §1.897-6T(c)(2), if a foreign person transfers property that is not a U.S. real property interest to a domestic corporation in a nonrecognition exchange which has an adjusted basis in excess of its fair market value on the date of transfer, which will not be used in or held for use in a trade or business of the domestic corporation, and which is sold at a loss within two years of the transfer by the domestic corporation, the domestic corporation may not use the loss to offset the gain recognized from the sale of a U.S. real property interest. The facts indicate that the regulation may potentially be applicable to this transaction. The adjusted basis of the Corporation P stock exceeded its fair market value on the date of its transfer to Taxpayer. No facts have been provided indicating that Taxpayer ever had the intention to hold the stock for use in its trade or business. Additionally, Taxpayer sold the Corporation P stock within #B months of its transfer. It is not clear whether a foreign person transferred the stock to Taxpayer. Further facts should be developed to determine whether Limited Partnership B is a foreign partnership. However, regardless of whether Treas. Reg. §1.897-6T(c)(2) is applicable, § 482 may still be applied to reallocate the stock loss back to Limited Partnership B.

1(d). The Service may challenge the capital loss reported by Taxpayer on the ground that I.R.C. § 351 does not apply to the property exchanges so that Limited Partnership B would recognize gain or loss on the exchange and Taxpayer would take a basis in the stock equal to fair market value.

Based on the facts as currently developed, it is our position that the transaction in which Limited Partnership B contributed Corporation P stock to Taxpayer in exchange for its stock did not satisfy the requirements of § 351.

A. Control Requirement

Section 351 provides nonrecognition treatment for transfers of property "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 (as defined in § 368(c)) of the corporation" to which the property was transferred. See § 351.

Transferors who contribute property to a corporation at different times may be considered part of a single control group if their rights "have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Treas. Reg. § 1.351-1(a)(1). For example, two transferors were treated as a group where their transfers of property were made 28 days apart pursuant to a non-binding mutual understanding. See Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940).

An existing shareholder will not be considered part of a transferor group if the property it transfers "is of relatively small value in comparison to the value of the stock and securities already owned" by the transferor and "if the primary purpose of the transfer is to qualify under [§ 351] the exchanges of property by other persons transferring property." Treas. Reg. § 1.351-1(a)(1)(ii).

It is generally contemplated that where a transferor in a § 351 transaction transfers property to a controlled corporation, the transferee corporation must exchange its stock for the property contributed. There is an exception whereby stock of the transferee corporation would not have to be received by the transferor as part of the exchange. Additional stock of the transferee subsidiary corporation does not have to be given to the transferor as part of a § 351 transaction in a situation, for example, where a parent corporation owned all of the stock of a subsidiary corporation and the parent corporation transferred property in the § 351 transaction to that subsidiary corporation. This is because the transferor in the § 351 transaction would be a 100% owner of the subsidiary both before and after the § 351 transaction. For the transferee to issue additional stock to the transferor under such circumstances would be meaningless. See Rev. Rul. 64-155, 1964-1 C.B. 138, (exchange of stock in a § 351 transfer is not necessary where the transferor's receipt of additional stock would not change the level of ownership interest in the wholly owned transferee subsidiary). See also, Lessinger v. Commissioner, 85 T.C. 824, 836 (1985), rev'd on other grounds, 872 F. 2d 519 (2d Cir. 1989) (The Tax Court held that the requirements of § 351 were met in a transfer to a wholly owned subsidiary even though no additional stock was issued).

Prior to the purported § 351 transaction in the facts before us, Partnership A owned all of the stock of Taxpayer. In the purported 351 transaction Taxpayer (as transferee): 1) received $N in cash from Partnership A; and 2) received #D shares of Corporation P stock from Limited Partnership B and contributed #C shares of its stock to Limited Partnership B. Partnership A also received a $X distribution from Taxpayer as part of the transaction that dwarfed the $N transferred in form from Partnership A to Taxpayer. Partnership A got no actual stock back for its transfer in form of $N to Taxpayer. Following the purported § 351 transaction, Partnership A owned L% of Taxpayer and Limited Partnership B owned the remaining B%.

Partnership A Received No Taxpayer Stock-

Where Limited Partnership B is a Taxpayer shareholder as a result of the purported § 351 transaction, there can be no meaningless gesture with respect to Partnership A not having received Taxpayer stock back in exchange for Partnership A's purported contribution of $N. In other words, with Limited Partnership B as a shareholder after the purported § 351 transaction, Partnership A was required in the § 351 transaction to have received Taxpayer stock back in exchange for its purported transfer of $N to Taxpayer. Therefore, the transaction appears to fail the control requirement of § 351(a). Because Partnership A owns such a large part of Taxpayer stock, as part of the 351 transaction, Partnership A needs to be a qualified transferor.[15] Here, there was no qualified transfer of property for stock by Partnership A. The facts of this case reflect that this purported § 351 transaction was not a transaction for which failure for Partnership A to receive stock in Taxpayer, the transferee corporation, could be a meaningless gesture. Failure on the part of Partnership A to receive Taxpayer's stock means that Partnership A is not a qualified transferor under § 351.

Required Transfer of Property Under § 351

Partnership A transferred $N to Taxpayer. It was contemplated, as part of the purported § 351 transaction, that Partnership A would receive significantly more in cash ($X) from Taxpayer than the $N. The $X dividend from Taxpayer to Partnership A was over #E times greater than the original transfer from Partnership A to Taxpayer. Therefore, there was no net transfer of property by Partnership A to Taxpayer. Since Partnership A did not transfer property to Taxpayer, Partnership A was not a transferor in this transaction. Therefore, the transaction does not meet § 351's control requirement.

Failure to Qualify Under § 351

Since the only transferor, for purposes of § 351, was Limited Partnership B and Limited Partnership B did not have actual control, the transaction fails the § 351 control test and results in giving Taxpayer a fair market value basis in the Corporation P stock it got from Limited Partnership B so that Taxpayer will not have a large loss on the sale of that stock.

B. Business Purpose Requirement

Courts have held that a transaction meeting the statutory elements of § 351 does not qualify for nonrecognition if it lacks a non-tax business purpose. Caruth v.

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[15] Limited Partnership B was only a B% shareholder after the purported § 351 transaction.

United States, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), aff'd on other issues, 865 F.2d 644 (5th Cir. 1989); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983).

In Caruth, the taxpayer transferred stock in a closely held corporation to his wholly owned corporation four days before the closely held corporation declared a large dividend. The government argued that the dividend should be recognized by the taxpayer because his transfer of the closely held stock to his wholly owned corporation had no business purpose. The taxpayer argued that § 351 did not require a business purpose. The Court's opinion traced the development of § 351 and concluded that the provision is tied very closely to the corporate reorganization provisions. On that basis, the court reasoned that the principles applicable to reorganizations were equally valid for transfers of property to a controlled corporation under § 351.

In Kluener v. Commissioner, T.C. Memo. 1996-519, aff'd, 154 F.3d 630 (6th Cir. 1998) the taxpayer sold his thoroughbred horses to raise funds to meet loan obligations. He first transferred the horses to his wholly owned corporation, which then sold the horses at auction. The corporation reported the sale of the horses on its tax return but offset the gain with a loss carryover. Rather than use the proceeds for its own purposes, the corporation held the funds in a separate account for several months and then distributed the entire amount to the taxpayer, who used part of the funds to pay loans and loaned part back to the corporation. The Tax Court held that, in substance, the taxpayer sold the horses using the corporation as a conduit. On appeal, the Sixth Circuit affirmed. In discussing § 351, the Court summarized the application of the business purpose requirement by noting that a shareholder's transfer of property to his closely held corporation is not taxed "if the transfer occurred for a valid, non-tax business purpose" but that the Code will tax a shareholder who transfers property solely to avoid taxes.

The Court in Kluener identified the standards used to determine whether there is a business purpose for a transfer. These factors include:

> Whether the transfer fulfilled its stated purpose; the extent to which the transferor, rather than the transferee, benefitted from the transfer; the extent to which the transferee needed the property; the length of time between the transfer and subsequent events; the number of such transfers; the taxpayer's expertise in tax matters; and the transactions' form. Courts also examine any explicit indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a prearranged plan.

154 F.2d at 635.

You have indicated that the facts as currently developed do not suggest a plausible business purpose for the transactions. You state that the taxpayer has not, as of yet, even attempted to argue that it had a valid business purpose.

If § 351 does not apply to the transactions, the transfers would be taxable exchanges under § 1001. Taxpayer's basis in the Corporation P stock would be determined under § 1012.

If the Taxpayer does provide a purported business purpose for this transaction you should attempt to get as many details as possible and address any defects in that explanation. After this occurs you may wish to seek our further advice on that matter at that time.

1(e). <u>Whether the basis in the inflated basis stock acquired in the original § 351 transaction (in the underlying lease stip) is overstated.</u>

Depending on the facts that may be developed with regard to the lease strip transactions, additional arguments might be made that the application of § 358(d)(1) will reduce the basis by the amount of any liability (usually the obligation to pay rent) that is assumed in the underlying 351 transaction that created the inflated basis.[16] The assumption of the liability would be within the scope of § 357, and under §§ 357(a), 358(a)(1)(A)(ii), and 358(d)(1), the basis of the stock received must be reduced by the amount of the liability assumed. The Service should reject any argument that the obligation to pay rent 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).

Additional arguments should be considered. Even if the assumption of the lease obligations would otherwise be within the scope of §§ 357(c)(3) and 358(d)(2), you should consider whether the assumption should be treated as a distribution of money under § 357(b) and therefore should reduce the stock basis under § 358(a). In general, § 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 either] a purpose to avoid Federal income tax on the exchange, or .... if not such 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.”

§ 357(b)(1)

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[16]These transactions occurred before October 19, 1999 and therefore § 358(h) would not be applicable.

This will require consideration of whether the facts show that Taxpayer assumed the indebtedness without a proper business purpose. Once you have determined these facts, you may wish to seek additional field service advice.

In addition, you should consider whether an argument can be made that the transaction does not provide a bona fide loss under § 165. This will also require a consideration of whether the facts show an economic loss. See Notice 99-59, 1999-2 C.B. 761. Once you have determined these facts, you may wish to seek additional field service advice on that issue.

2. <u>The foreign shareholders of Taxpayer, a domestic corporation, may be held liable as transferees for Taxpayer's tax liability resulting from the corporation's long term capital gain on the sale of the appreciated assets.</u>

Although Taxpayer is a domestic corporation, the original shareholders consist of a Country A nonresident alien, a Country A company, and a Country B/Country A joint venture. On Date E, Taxpayer's shareholders sold their entire interests to Partnership A. Partnership A's partners ultimately were Corporation W and Corporation X.[17]

If it is possible to hold the original shareholders liable as transferees, then the $V transfer to the shareholders in exchange for their stock could be characterized in two ways. On the one hand, it could be characterized as a redemption distribution (and hence a transfer to the original shareholders) since the payments had their source in Taxpayer (because they were derived from an obligation taken on and satisfied by Taxpayer).[18] <u>See</u>, <u>Custom Chrome v. Commissioner</u>, 217 F.3d 1117 (9th Cir. 2000).

Alternatively, the transfer could be characterized as a liquidation (i.e. a <u>de</u> <u>facto</u> liquidation) distribution (and hence a transfer) by Taxpayer to its original shareholders, since Taxpayer did not have the ability to satisfy its liabilities after it paid the dividends to Partnership A, which Partnership A apparently used to pay off the loan to the Financial Institution A. <u>See</u>, Treas. Reg. § 1.332-2(c); <u>Redina v. Commissioner</u>, T.C. Memo. 1996-392.

More specifically, if the shareholders and not Taxpayer are to be held liable for the tax, it must be determined whether transferee liability can be asserted.

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[17]The examiner believes that Partnership A is either the promoter of this transaction or an entity created by the promoter.

[18]Partnership A borrowed the money to purchase the stock from the Financial Institution A. On Date E, Taxpayer declared dividends payable to Partnership A totaling $Y. According to #A corporate resolutions, $R was required to be paid prior to the 351 transaction and $X was required to be paid after the 351 transaction. Although the funds have not yet been traced, it is likely that the funds were used to pay off Partnership A's $W note and the $E arrangement fee to the Financial Institution A.

Transferee Liability

Section 6901 of the Internal Revenue Code provides a procedure through which the Service may collect from a transferee of assets unpaid taxes owed by the transferor of the assets if a basis exists under applicable federal or state law for holding the transferee liable. Bresson v. Commissioner, 111 T.C. 172 (1998), aff'd, 213 F.3d 1173 (9th Cir. 2000). A transferee's liability may be established either at law or in equity. Estate of Stein v. Commissioner, 37 T.C. 945 (1962). Section 6901 of the Code does not create the liability of a transferee, but is a secondary method for enforcement of the existing liability of the transferor. Mysse v. Commissioner, 57 T.C. 680 (1972). Although I.R.C. § 6901 provides a method by which to collect the tax, federal or state law determines the existence and extent of the liability of a transferee. Gumm v. Commissioner, 93 T.C. 475, 479 (1989).

In the case of a shareholder under the facts before us, transferee liability can arise in equity under state law in the form of Uniform Fraudulent Transfer Act (UFTA), as adopted by the District of Columbia in 1996. Furthermore, transferee liability can arise under the Federal Debt Collection Procedure Act (FDCPA). Because we can assert liability under the DCUFTA or the FDCPA, we need not address whether transferee liability arises under the equitable trust fund theory or whether transferee liability at law can be asserted.

DCUFTA and FDCPA

State law has traditionally governed transferee liability in both equity and law. See Commissioner v. Stern, 357 U.S. 39, 45 (1958), the Court held "that, until Congress speaks to the contrary, the existence and extent of [transferee] liability should be determined by state law." However, transferee liability can be based either on the federal or state statutes such as the Uniform Fraudulent Transfer Act (UFTA) or the Federal Debt Collection Procedure Act (FDCPA). In the instant case, both the UFTA, as enacted by the District of Columbia in 1996 (hereafter DCUFTA),[19] and the FDCPA, govern the transaction.

DCUFTA

In particular, D.C. Code § 28-3104(a) provides that a transfer made, or obligation incurred, by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation: (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor (1) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (2) intended to incur, or believed or reasonably should have

[19] D.C. Code §§ 28-3101 to 28-3111 (1996).

believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.

The DCUFTA defines a creditor as anyone having a claim. D.C. Code § 28-3101(4). A claim is defined as a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. D.C. Code § 28-3101(3).

Under the DCUFTA, a transaction may be voided whether it involves constructive or actual fraud. In the case of constructive fraud, the transfer is fraudulent without regard to actual intent if the conveyance is made without fair consideration and the debtor is either insolvent at the time or is rendered insolvent by the transfer. A transfer made by a debtor is fraudulent whether the creditor's claim arose before or after the transfer was made if the debtor made the transfer without receiving a reasonably equivalent value in exchange for the transfer.

In the case of actual fraud, there is no need to show that the conveyance was made for inadequate consideration. However, unlike constructive fraud, the IRS would be required to show actual intent by the transferor to defraud, delay, or hinder creditors. This is normally achieved through circumstantial evidence known as the "badges of fraud," which are listed in D.C. Code § 28-3104(b). As in the case of constructive fraud, the transfer need not be made before the creditor's claim arises.

FDCPA

The Federal Debt Collection Procedure Act (FDCPA), is an additional law at the federal level for which the Service can use to provide for transferee liability.[20]

The FDCPA describes five potential grounds (in § 3304) for setting aside transfers that are fraudulent as to debts owed the United States, including tax debts.[21]

Three of these FDCPA provisions for setting aside transfers fraudulent as to the United States involve variants of "constructive fraud," subsections 3304(a)(1),

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[20]The FDCPA, 28 U.S.C. §§ 3001, et seq., was enacted in 1990 and basically parallels the provisions of the UFTA. 28 U.S.C. § 3003(b) provides that "This chapter shall not be construed to curtail or limit the right of the United States under any other Federal law or any State law . . . to collect taxes or to collect any other amount collectible in the same manner as a tax."

[21] See 28 U.S.C. § 3002(3)(B) (defining "debt" as including an amount owing to the United States on account of a "tax"). See also In re Bonham, 224 B.R. 435 (Bankr. D. Al 1998); and United States v. Sawaf, 74 F.3d. 119 (6th Cir. 1996).

3304(b)(1)(B)(i), and 3304(b)(1)(B)(ii). A fourth FDCPA provision addresses "actual fraud," subsection 3304(b)(1)(A).[22] A fifth FDCPA provision, subsection 3304(a)(2), involves transfers to insiders of the transferor for even bona fide antecedent debts if the insider had reasonable cause to believe the transferor was insolvent.

In addition to the DCUFTA fraudulent transfer provisions described above, the Service can consider alternative reliance on any of the five FDCPA provisions as potential grounds in this case for imposing personal transferee liability (under I.R.C. § 6901) or for filing a federal district court action to set aside a fraudulent transfer with respect to the transfers to the Taxpayer shareholders. See Bresson v. Commissioner, 111 T.C. 172, 185 n.8 (1998), aff'd, 213 F.3d 1173 (9th Cir. 2000).

Subsection 3304(b)(2) describes eleven, non-exclusive factors (badges of fraud) to be considered in determining the Transferor's "actual intent" to hinder, delay, or defraud a creditor for purposes of the FDCPA, including that (1) the transfer was to an insider; (2) the transfer was of substantially all the debtor's assets; (3) the value of the consideration received by the debtor was not reasonably equivalent; (4) the debtor was insolvent or became insolvent shortly after the transfer was made; and/or (5) the transfer occurred shortly before or shortly after a substantial debt was incurred.

The five potential FDCPA grounds, described in 28 U.S.C. § 3304, that are available to the Service for setting aside a transfer that is fraudulent as to a tax debt owed the United States are as follows:

> **§ 3304. Transfer fraudulent as to a debt to the United States**
> **(a) Debt arising before transfer.** – Except as provided in § 3307, a transfer made or obligation incurred by a debtor is fraudulent as to a debt to the United States which arises before the transfer is made or the obligation is incurred if –
>
> > **(1)(A)** the debtor makes the transfer or incurs the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation; and
> > **(B)** the debtor is insolvent at that time or the debtor becomes insolvent as a result of the transfer or obligation; or
> > **(2)(A)** the transfer was made to an insider for an antecedent debt, the debtor was insolvent at the time; and
> > **(B)** the insider had reasonable cause to believe that the debtor was insolvent.

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[22] According to United States v. Maryans, 73 AFTR2d 2064 (N.D. Ind. 1994), a transfer made with intent to defraud a creditor under 28 U.S.C. § 3304(b) is fraudulent as to a debt to the United States regardless of when such debt arose in relation to the transfer. See also United States v. Barrier Industries, Inc., 991 F. Supp. 678, 681 (S.D.N.Y. 1998).

(b) Transfers without regard to date of judgment. – (1) Except as provided in § 3307, a transfer made or obligation incurred by a debtor is fraudulent as to a debt to the United States, whether such debt arises before or after the transfer is made or the obligation is incurred, if the debtor makes the transfer or incurs the obligation –

(A) with actual intent to hinder, delay, or defraud a creditor; or

(B) without receiving a reasonably equivalent value in exchange for the transfer or obligation if the debtor –

(i) was engaged or about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

In the instant case, we understand that your office intends to recast the transaction as a redemption or, alternatively, as a liquidation. The facts submitted disclose that the transfer to the shareholders rendered Taxpayer insolvent. A transfer to a shareholder, whether in the context of a redemption or liquidation, is considered to be in exchange for an inadequate consideration because the stock of a shareholder is simply a certificate representing the assets of the corporation. Based on the facts submitted, the transaction, as recast in this case, is a constructive fraud on the creditors under the DCUFTA or the FDCPA.

You question whether the DCUFTA or FDCPA will apply here since there is no indication that the amount paid the shareholders for the stock by Partnership A was not reasonable. As indicated above, a recharacterized transaction is considered to be the actual transaction for all purposes of the Code since the form of the recasted transaction reflects the true nature of the transaction. In light of your recharacterization of the transaction, the shareholders will be treated as having received their consideration from Taxpayer, rather than Partnership A. As a consequence, the distribution to the shareholders will be considered either as a redemption or as a liquidating dividend. In either case, the distribution will be deemed to lack adequate consideration.

Furthermore, it has been questioned whether the Service can impose transferee liability where a transfer is made during (as opposed to after) the taxable year of the transferor. The question arises because it might be argued that the tax liability of the transferor did not accrue until a tax was due at the end of the year. However, it is our position that DCUFTA and FDCPA both provide that transferee liability can be established by demonstrating that the transfer occurred either during or after the period for which the tax liability of the transferor accrued.

Since the shareholder transferees are liable under both DCUFTA and FDCPA, we need not address whether they are liable under the trust fund doctrine or transferee liability at law.

Guidance as to Collection From Foreign Shareholders

It is a well established principle of common law that no country has an obligation to further the governmental interests of a foreign sovereign by assisting in the collection of taxes owed the latter. Known as the “revenue rule”, the doctrine is traced to an opinion by Lord Mansfield in Holman v. Johnson, 98 Eng. Rep. 1120 (K.B. 1775). Although courts have sometimes questioned the soundness of the revenue rule, it has long been accepted and prevails both in international and United States practice. See Restatement (Third) of Foreign Relations § 483 and note1 (1987); see also Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964).

The revenue rule is overcome in modern times by bilateral tax treaties that provide for mutual assistance in collection. In most of the tax treaties signed by the United States, the collection assistance provision is generally directed only against persons who improperly claim the treaty benefits. But the U.S. tax treaties with Canada, Denmark, France, Netherlands, and Sweden each has more comprehensive provisions for collection[23]. Each of these countries and the United States have, by a separate bilateral tax treaty, mutually agreed to assist each other in collecting the taxes owed the treaty partner, subject to certain conditions. In the only domestic case on the subject, Miller v. United States, 955 F. Supp. 795 (N.D. Ohio 1996), the U.S. District Court upheld an IRS treaty collection request to the Dutch government, which resulted in the seizure of taxpayer’s assets held in a bank safe deposit box in Baarn, the Netherlands.

In the present case, assuming that the original shareholders of Taxpayer are liable as transferees, any collection of taxes from them would depend on the provisions of the tax treaties the United States has with the respective countries, where the transferees or their assets are located. Individual A is a Country A citizen, Foreign Corporation T is a Country A corporation, and Foreign Entity V is a Country B/Country A joint venture. Article A of the U.S.-Country A Income Tax treaty provides for mutual assistance in collection of income taxes. But Paragraph A of this Article states that assistance shall not be accorded with respect to “citizens, companies, and other entities of the Contracting State to which application is made ...”. The Country A tax authorities would therefore refrain from assisting the Service in collecting taxes owed by Individual A, Foreign Corporation T , and Foreign Entity V. The Country B authorities would be equally disinclined to assist in collection with respect to taxes owed by Foreign Entity V because of a nearly identical provision in Article B of the U.S.-Country B Income Tax treaty.

[23] Convention with Respect to Taxes on Income and on Capital, Sep. 26, 1980, U.S.-Can., TIAS 11087; Income Tax Convention, May 6, 1948, U.S.-Den., TIAS 1854; Convention for the Avoidance of Double Taxation, Aug. 31, 1994, U.S.-Fr., KAV 3989; Convention for the Avoidance of Double Taxation, Dec. 18, 1992, U.S.-Nether., KAV 3507; Convention for the Avoidance of Double Taxation, Sep. 1, 1994, U.S.-Swe., KAV 3979;

In these instances, the bar against providing assistance in collection applies only with respect to the citizens and residents of each requested state. We interpret this to mean that neither requested state is prohibited from assisting in collection of U.S. taxes from out of property or assets of noncitizens and nonresidents located within its boundaries. We can, therefore, request the U.S. competent authority to see if her counterpart in Country B would assist in collection of taxes owed by Individual A and Foreign Corporation T. Likewise, we may also ask the U.S. competent authority to request her counterparts in both Country A and the Country B to assist in collecting from assets owned by the noncitizen or nonresident component of the joint venture Foreign Entity V, and located in each country.

In the event collection efforts using the Country B and Country A treaties are unsuccessful, there is another avenue worth exploring. The Service may initiate a suit for appointment of a receiver as authorized by § 7403(d)[24]. Such an action needs to be coordinated with the Office of Procedure and Administration (Collection, Bankruptcy and Summons). For appointment of a receiver, the Service need only make a *prima facie* showing that a substantial tax liability probably exists, and that collection of the tax may be jeopardized if a receiver is not appointed. United States v. O'Connor, 291 F.2d 520 (2d Cir. 1961). If a U.S. District Court could assert personal jurisdiction over any of the former shareholders of Taxpayer based on their physical presence in the United States, it can order the appointment of a receiver and repatriation of assets to the United States. United States v. Ross, 196 F. Supp. 243 (S.D. N.Y. 1961), aff'd, 302 F.2d 821 (2d Cir. 1962); see also United States v. Clough, 33 A.F.T.R. 2d 74-650 (N.D. Calif. 1974).

It would not be appropriate or practicable under any other theories or remedies to hold the foreign shareholders liable as transferees of domestic stock in Taxpayer or on its subsequent disposition.

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

Code section 6662(a) imposes a penalty in an amount equal to 20 percent of the underpayment of tax attributable to one or more of the items set forth in Code section 6662(b). The items set forth in Code section 6662(b) include, as is relevant here, negligence, substantial understatements of income tax, and substantial valuation misstatements under chapter 1. Also, section 6662(a) imposes a penalty equal to 40 percent of the underpayment of tax attributable to a gross valuation misstatement as defined in section 6662(h).

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[24] For detailed discussions on these subjects, see Litigation Guideline Memorandum entitled Appointment of Receivers for Foreign Assets, INTL-3, and the related LGM *Writs of Ne Exeat Republica,* INTL-2/GL-7.

Negligence - “Negligence” includes a failure to make a reasonable attempt to comply with provisions of the internal revenue laws or failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See I.R.C. § 6662(c); Martello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g on this issue, 43 T.C. 168 (1964); Treas. Reg. § 1.6662-3(b)(1). A return position that has a reasonable basis is not attributable to negligence, but negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item "which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances[.]" Treas. Reg. § 1.6662-3(b)(1). The accuracy-related penalty does not apply with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion of an underpayment and that the taxpayer acted in good faith with respect to such portion. See I.R.C. § 6664(c)(1). The determination of whether the taxpayer acted with reasonable cause and in good faith depends upon the pertinent facts and circumstances. See Treas. Reg. § 1.6664-4(b)(1). The most important factor is the extent of the taxpayer’s effort to assess the proper tax liability for the year. See Id. The negligence penalty can be applied to deficiencies resulting from the application of the economic substance doctrine. Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 226-27 (1999).

Here, the facts developed seem to support the view that the accuracy-related penalty attributable to negligence applies to the deficiency that results from the disallowance of the built-in losses from the inflated basis assets because Taxpayer appears to have disregarded the economic substance of the transactions from which the losses were claimed and has failed to offer evidence that there was reasonable cause for its return position for the losses or that it acted in good faith in claiming them. Many of the "players" involved in the transactions were individuals with a history of involvement in lease stripping transactions, and either knew or should have known that the Service had issued Notice 95-53 stating that it intended to challenge lease stripping transactions such as those from which the inflated bases of the stock were derived. There is no evidence that they thoroughly investigated the bona fide economic aspects of the lease stripping transactions or reasonably relied on professional advice that the losses are allowable. See Freytag v. Commissioner, 904 F.2d 1011, 1017 (5th Cir. 1990); Treas. Reg. § 1.6664-4(c). We accordingly conclude that the facts as currently developed may well support the conclusion that Taxpayer was negligent and that the penalty provided by Code section 6662(a) should therefore be considered.

Substantial Valuation Misstatement - A 20 percent accuracy related penalty is imposed on the portion of any underpayment caused by a substantial valuation misstatement. The penalty is increased to 40 percent in the case of a gross valuation misstatement. A substantial valuation misstatement exists if the adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such adjusted basis. I.R.C. § 6662(e)(1)(A). A gross valuation misstatement occurs where the value or adjusted basis of any property claimed on any return is 400% or more of the amount determined to be the correct valuation or adjusted basis. § 6662(h). The circumstances in which a valuation misstatement exists include the circumstance when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992). Here, if the Service prevails on its challenge to the basis reported by Taxpayer in the stock it received in the purported section 351 transaction, we believe the penalty provided by Code section 6662(a) would apply on the grounds that a substantial valuation misstatement would exist. If the basis Taxpayer claimed was 400 percent or more of the amount determined to be the correct basis, we believe the penalty would be 40 percent of the underpayment. See I.R.C. § 6662(h).

Substantial Understatement of Income Tax - A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in case of a corporation, other than an S corporation or personal holding company (as defined in § 542). I.R.C. § 6662(d)(1)(A). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. § 6662(d)(2)(B). However, those reductions do not apply to items of corporations attributable to tax shelters. I.R.C. § 6662(d)(2)(C)(ii). Tax shelter means, as is relevant here, any plan or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax. I.R.C. § 6662(d)(2)(C)(iii). However, for transactions entered into on or before August 5, 1997, a principal purpose, rather than a significant purpose, test applies in determining whether a tax shelter is present.

We believe that the facts currently developed support the position that the series of transactions in which Taxpayer acquired and sold the inflated basis stock to recognize the built-in losses was potentially a tax shelter. The facts suggest that the purpose of the transactions was to generate losses to offset gains from the sale of the Asset A Business by Taxpayer and do not suggest a business purpose for the transactions. In these circumstances, we believe that any understatement that resulted from the disallowance of the loss claimed from the preferred stock, if substantial, may well be subject to the penalty provided by Code section 6662(a) due to a substantial understatement unless the taxpayer meets the reasonable cause exception to § 6664(c).

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

The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in Treas. Reg. § 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Treas. Reg. § 1.6664-4(e)(2)(i)(B)(2). In addition, the requirements of Treas. Reg. § 1.6664-4(c) must also be met with respect to the opinion of the tax advisor. In particular, the opinion must be based on all the pertinent facts and circumstances and the taxpayer’s purposes (and their relative weight) for entering into the transaction and structuring it in a particular manner. Also, the advice cannot be based on unreasonable factual or legal assumptions and must not unreasonably rely on the representations or statements of the taxpayer or any other person. Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met.

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

You have indicated that the facts as currently developed do not satisfy the reasonable basis standard that applies for purposes of determining negligence. Therefore, the more stringent substantial authority standard would also not be satisfied. See Treas. Reg. §§ 1.6662-4(d)(2) and 1.6662-3(b)(3). Also, assuming the underpayment is due to negligence (i.e., a failure to make a reasonable attempt to comply with the tax laws or to exercise ordinary and reasonable care in the preparation of the return), then the reasonable cause exception of section 6664(c) would not apply. The most important factor in determining whether the taxpayer acted with reasonable cause and in good faith is “the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability.” Treas. Reg. § 1.6664-4(b)(1). A finding of negligence would be consistent with a conclusion that the taxpayer made only minimal efforts to assess the proper tax liability.

Moreover, we believe that any understatement that resulted from the disallowance of the loss claimed from the inflated basis assets may well, if substantial, be subject to the substantial understatement penalty provided by Code section 6662(a) even if the series of transactions in which Taxpayer acquired and sold the inflated basis assets to recognize the built-in losses was not a tax shelter. If the transactions were not a tax shelter, the understatement would be reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. § 6662(d)(2)(B). Neither of those exceptions appears to apply. The substantial authority standard is higher than the reasonable basis standard. Treas. Reg. § 1.6662-4(d)(2). You have indicated that the facts as currently developed do not support a conclusion that Taxpayer had even a reasonable basis for claiming the inflated basis. In addition, you have indicated that the relevant facts affecting the items' tax treatment were not disclosed in the return, of Taxpayer or in attached statements.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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

Please call if you have any further questions.

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