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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:FS:LI

FROM: ASSOCIATE CHIEF COUNSEL
CC:PSI

SUBJECT:

This Field Service Advice responds to your memorandum dated September 6, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Agreement 1:
Agreement 2:
Bank P:
Bank Q:
Corp W
Corp X
Corp Y
Corp Z .
Date 1
Date 2
Date 3
Date 4
Date 5
Date 6
Date 7
Date 8
Lease 1
Lease 2
Lease 3
M
N
Partnership
Period 1
Period 2
Period 3
Period 4
Sub A
Sub B
Taxpayer
Year 1
Year 2
<u>a</u>
<u>b</u>
<u>c</u>
<u>d</u>
<u>e</u>
<u>f</u>
<u>g</u>
<u>h</u>
<u>i</u>
<u>k</u>
<u>m</u>
<u>n</u>
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<u>aa</u>
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<u>cc</u>
<u>dd</u>
<u>ee</u>
<u>ff</u>
<u>gg</u>
<u>hh</u>
<u>ii</u>
<u>kk</u>
<u>mm</u>
<u>nn</u>
<u>pp</u>
<u>qq</u>
<u>rr</u>

ISSUES

1. Whether a series of prearranged transactions entered into by Taxpayer, resulting in claimed rental deductions on Lease 1 and Lease 3 covering the same equipment for the same years, should be disallowed because they lacked economic substance and had no business purpose?

2. Whether the Service may allocate rental deductions claimed by Taxpayer to Partnership under the authority of § 482?

3. If the transaction is held to have economic substance and the transfer from Partnership to Sub B is held to qualify under § 351, may the Service challenge the rental deductions on the grounds that any payments of the rent obligation Sub B assumed from Partnership would be capital expenses of Sub B?

4. If the transfer of the Sub B stock to Partnership in exchange for certain property does not qualify as a valid § 351 transaction, are there any additional adjustments that should be made, and if not, should the issue be raised in the RAR if it could have an effect on another taxpayer?

5. Whether the Service can take the position that the accuracy related penalty provided by § 6662 applies to deficiencies that result from disallowing the rental deductions claimed by Taxpayer?

CONCLUSIONS

1. The deductions claimed by Taxpayer under Lease 1 (amortized prepaid rent) and Lease 3 (current rental payments), covering the same equipment for the same years, should be disallowed because they arise from a series of prearranged transactions that lack economic substance and nontax business purpose.

2. Section 482 potentially applies to Taxpayer and the other parties to this transaction. Because the participants appear to have acted in concert pursuant to a common plan to shift multiple rental deductions to Taxpayer, they should be treated as part of the same controlled group for purposes of applying § 482. Accordingly, § 482 may be applied to reallocate the rental deductions away from Taxpayer to prevent the evasion of taxes and to clearly reflect the income of the participants.

3. If the transaction is held to have economic substance and the transfer from Partnership to Sub B is held to qualify under § 351, the Service may challenge the rental deductions both on the grounds that any payments of the rent obligation Sub B assumed from Partnership were capital expenses of Sub B and on the grounds that such payments were not expenses ordinarily or customarily expended in a trade or business.

4. The transfer of the Sub B stock to Partnership in exchange for certain property does not qualify as a valid § 351 transaction. Though disallowing the § 351 transaction will have no effect on Taxpayer, the issue should be raised because of the potential impact it could have regarding Corp Z. We have no additional theories under which there would be adjustments with respect to Taxpayer if § 351 did not apply.

5. The accuracy related penalty under § 6662 applies to deficiencies that result from disallowing the rental deductions claimed by Taxpayer.

FACTS

For the periods at issue, Taxpayer filed a consolidated income tax return which included Sub A and Sub B as wholly-owned subsidiaries of Taxpayer. Taxpayer and Sub A are engaged in commercial trucking. Sub B's only function is or was to make lease payments.

Between Dates 1 and 3 there was a series of related transactions for the sale and leaseback of certain tractors and trailers, which Sub A acquired and placed in service in Years 1 and 2. See Notice 95-53, 1995-2 C.B. 334 (describing lease stripping transactions and stating the Service's intention to challenge the tax benefits arising from them). Current information indicates that Sub A paid $a for the tractors and trailers. (All dollar and percentage figures in this letter are approximations.) As of Date 1, Sub A had more than $b in liens on the equipment.

In Year 1 or 2, certain individuals contacted Taxpayer to propose the related sale/leaseback transactions. According to Taxpayer, the individuals either did not provide Taxpayer with promotional materials or Taxpayer did not retain them. Taxpayer claims that no law firm assisted the company in putting the deal together. The company asserts that a regional accounting firm provided the company with its only outside professional assistance. The accounting firm reviewed the lease agreements and advised Taxpayer as to proper financial statement presentation and GAAP accounting treatment for the leases. Taxpayer's accounting personnel analyzed the economic benefits and risks associated with the transactions for Taxpayer's senior management.

The related sale/leaseback transactions had several steps, including three sale/leasebacks of the same equipment and a purported § 351 transaction contributing certain sale/leaseback rights and obligations to Sub B. The parties to the transactions were the Partnership, Corp X, Corp Y, Taxpayer, Sub A, and Sub B. While the transactions had a number of convoluted steps, the net effect appears to have been an equipment sale/leaseback between Sub A and Corp Y.

Date 1 Transactions

a. Sub A / Partnership Transactions

Sub A and Partnership entered into a sale/leaseback transaction on Date 1 covering Sub A's tractors and trailers.

Sub A agreed to sell the tractors and trailers to Partnership for $c in cash ("Partnership Purchase Agreement"), which was financed with a loan from Corp Y for the entire amount. Partnership gave Corp Y a secured promissory note bearing d% interest and maturing in two months. Any prepayments of rent under a Date 1 lease of the equipment to Sub A ("Lease 1", discussed below) had to be applied to the note balance.

M, a limited partnership, held a e% interest in Partnership. N, a tax-exempt entity, held a f% interest in M. Thus, almost all of Partnership's income flowed through to a tax exempt entity.

On Date 1, Partnership agreed to lease the purchased equipment back to Sub A for an initial term plus renewal options (Lease 1). The initial term for the tractors was through Date 4, with a renewal term option through Date 5. The initial term for the trailers was through Date 6, with 2 renewal term options through Date 8. During the initial terms, Sub A was to pay $g per month for the tractors (h% of cost) and $i per month for the trailers (k% of cost). The rent for the renewal terms was fair rental value. If Sub A exercised the renewal options, it had the right to purchase any of the leased equipment for fair market value. All operating expenses for the equipment were borne by Sub A.

Though Lease 1 had no specific provision for rent prepayments, Partnership offered to allow Sub A to prepay the rent both for the tractors and the trailers for the initial terms of the lease. Sub A accepted the offer and paid Partnership $m 20 days after entering into the lease. As required by the Partnership promissory note to Corp Y, Partnership used the entire amount of the prepayment to pay part of the Corp Y debt, after which the balance on the note was $n.

b. Partnership / Corp X Transactions

Also on Date 1, Partnership entered into three related transactions with Corp X. First, Partnership agreed to sell the tractors and trailers to Corp X and to assign to Corp X all of its rights under Lease 1 ("Corp X Purchase Agreement"). The sale and assignment were subject to Sub A's rights under Lease 1 and Corp Y's secured interest in Lease 1 and the equipment.

The total purchase price was $c, payable through Corp X's execution of two promissory notes. One note was for $p at q% interest, payable in r monthly installments equaling the rent required by the Date 1 lease between Partnership and Corp X ("Lease 2") discussed below. The other Corp X note was for $s, payable without interest with a t-day term. Both notes required principal and interest prepayments if Corp X received prepaid rent under Lease 2 or cash from the sale of the collateral. The first note prohibited all other note prepayments.

Second, Corp X agreed to lease the same equipment back to Partnership (Lease 2). For purposes of this FSA, it is assumed that the terms of Lease 2 track a later amended and restated lease ("Lease 3", discussed below), entered into on Date 3, between Corp Y and Sub B. Thus, Lease 2 had a term of u months through

Date 5 for the tractors and r months through Date 8 for the trailers. The monthly rental was based on v% of the cost for the tractors and w% of the cost for the trailers.

Lease 2's term for the tractors expired one year after Lease 1's initial lease term. Lease 2's term for the trailers expired two years after Lease 1's initial lease term. If Sub A exercised all renewal terms contained in Lease 1, the terms under Lease 1 expired at the same time as those under Lease 2.

Lease 2 had a terminal rent adjustment clause which apparently was designed to satisfy the requirements of § 7701(h)(3). At the end of the respective lease terms for the tractors and the trailers, Partnership had the right to purchase all the vehicles at fair market value. If Partnership did not purchase the equipment, it was to be sold to third parties. If the sales price for the equipment exceeded x% of Corp X's cost for the tractors or z% of its cost for the trailers, Partnership was to receive the excess as a downward adjustment to its rental obligations. If the sales price for the equipment was less than x% of Corp X's cost for the tractors or z% of its cost for the trailers, Partnership was to pay the difference to Corp X as an upward adjustment to its rental obligations.

Third, Corp X assigned back to Partnership all of Corp X's rights as lessor under Lease 1, including the rights to accrued, but unpaid rent ("Lease 1 Assignment").

Finally, on Date 1, the parties entered into two agency agreements. Under Agreement 1, Bank P was appointed to act as agent for Sub A, Partnership, and Corp X in holding record title to the tractors and trailers. Under Agreement 2, Bank Q was appointed to act as agent and nominee for Corp X, Corp Y, Partnership, and Sub A in holding security interests in the tractors and trailers. Thus, the parties were able to enter into multiple sales and to transfer security interests without changing the identity of the recorded owner or the secured party on the certificates of title to the equipment.

Date 2 Transactions

a. Sub B Stock Subscription

On Date 2, in a transaction designed to qualify under § 351, Partnership acquired aa shares of preferred stock in Sub B (senior to Sub B common stock as to dividends and liquidation preferences). These shares had no voting rights and were redeemable at the option of the holder any time on or after Date 7. In exchange, Partnership assigned to Sub B certain rights and Sub B assumed certain obligations.

As part of the purported § 351 transaction, Taxpayer transferred $bb to Sub B in exchange for cc additional Sub B common shares. The sole purpose of this appears to have been to meet the control requirements of § 351(a).

b. Assignment and Assumption Agreement

In the purported § 351 transaction, Partnership contributed to Sub B rights obtained and obligations assumed in various transactions described above ("Assignment and Assumption Agreement"). The assignment of rights and the assumption of obligations include:

(a) Partnership's residual rights to the equipment under Lease 1;
(b) Partnership's right to receive the rent under Lease 1 during the renewal terms;
(c) Sub B's assumption of Partnership's remaining $n principal obligation under the Corp Y promissory note (plus unpaid interest);
(d) Partnership's right to receive payments under the $c in promissory notes issued by Corp X;
(e) Partnership's right to use the equipment during Lease 2's term; and
(f) Sub B's assumption of Partnership's obligation to pay rent under Lease 2.
(g) Sub B's assumption of Partnership's liability for unpaid promoter fees and transaction expenses.

Partnership's Lease 1 rights had nominal value at best. Partnership already sold any residual rights to the equipment to Corp X. Further, Sub A had no reason to exercise the Lease 1 renewal options. The Lease 2 terms already covered the Lease 1 renewal periods. Further, Lease 1 permitted Sub A to acquire the equipment only at fair market value rather than at some discounted price. Thus, Sub B obtained little by acquiring Partnership's Lease 1 rights. At the same time, Sub B assumed liability for the principal balance and unpaid interest on Partnership's Corp Y note, plus liability for the Partnership's unpaid promoter fees and transaction expenses, totaling $dd in assumed liabilities.

The rights and obligations Sub B acquired with respect to the Corp X notes and Lease 2 do not appear to overcome the assumed liabilities. While Sub B acquired rights to $c in note payments from Corp X, the vast majority of these payments were to be absorbed by the Lease 2 rental obligation. Corp X gave two notes to Partnership, a $s note due in t days, and a $p note due in installments. The installment note payments are equal to, and payable at the same time as, the Lease 2 rental payments. Thus, the obligations Sub B assumed in the purported § 351 transaction exceeded the rights it obtained by $ee ($dd in obligations less the $s Corp X note payment).

The only possible way to overcome this deficit was through the terminable rent adjustment clause in Lease 2 (if the residual value of the tractors and trailers at lease termination exceeded x% and z% of cost, respectively, Sub B could recoup some of the assumed liabilities. It is unclear whether Sub B realistically could have overcome this deficit based on the market in Year 2.

Date 3 Transactions

a. Corp X / Corp Y Transactions

On Date 3, Corp X agreed to sell the equipment to Corp Y and to assign all of its rights in the Lease 2 to Corp Y ("Corp Y Purchase Agreement") for $ff (representing the outstanding balances on the Corp X notes issued to Partnership). Sub B acquired these notes in the Date 2 purported § 351 transaction. As required by the Corp Y Purchase Agreement, the sale proceeds were used to pay off the Corp X notes on Date 3.

b. Sub B / Corp Y Transactions

At the same time, Sub B and Corp Y entered into a lease agreement intended to replace Lease 2 ("Lease 3"). Lease 3 contained substantially the same terms as Lease 2, with the only real changes being the substitution of Corp Y as lessor and Sub B as the lessee. Lease 3 had a lease term through Date 5 for the tractors and through Date 8 for the trailers, with monthly rental payments of $gg and $hh respectively. Lease 3 had a terminal rental adjustment clause identical to Lease 2. At the end of the respective lease terms for the tractors and trailers, Sub B had the right to purchase the vehicles at fair market value. If Sub B did not purchase the equipment, it was to be sold to third parties. If the sales price for the equipment exceeded x% of Corp Y's cost for the tractors or z% of its cost for the trailers, Sub B was to receive the excess as a downward adjustment to its rental obligations. If the sales price for the equipment was less than x% of Corp Y's cost for the tractors or z% of its cost for the trailers, Sub B was required to pay the difference to Corp Y as an upward adjustment to its lease rental obligations. Taxpayer guaranteed Sub B's performance under Lease 3.

As part of the same transaction, Sub A and Corp Y agreed that Lease 1 was subject and subordinate to Lease 3 ("Subordination Agreement"). The subordination was to have the same effect as if Lease 3 had been executed before Lease 1. All of Sub A's rights in the equipment were subordinated to those of Corp Y.

Sub A Return and Examination Positions

On Taxpayer's consolidated return, Sub A capitalized the $m in Lease 1 prepaid rent and amortized and deducted the cost over the initial Lease 1 terms. Sub A apparently exercised its renewal rights under Lease 1. During the Lease 1 renewal terms, Sub A continued to deduct on a current basis the Lease 1 rent paid. Sub B reported these amounts as income. The Lease 1 renewal term for tractors covered only the current examination cycle. The Lease 1 renewal term for trailers did not begin until a later examination cycle. Sub A's rental deductions under Lease 1 and Sub B's rental income under Lease 1 during the renewal periods cancel each other out on Taxpayer's consolidated return.

Sub B also paid and claimed a deduction for the Lease 3 rent paid to Corp Y during the current examination cycle. As a result, Taxpayer consolidated return claimed two rent deductions for the same equipment, one under Lease 1 and the other under Lease 3.

Exam is currently auditing the consolidated returns for Periods 1, 2, and 3. Exam issued a Form 5701 to Taxpayer proposing to disallow the Lease 1 prepaid lease amortization. The Form 5701 does not adjust either the Lease 1 renewal term rent deductions, or the Lease 3 rental deductions for amounts paid to Corp Y. Exam has not yet decided whether to assert penalties against Taxpayer and the other members of the consolidated group.

Taxpayer has three basic responses to the Form 5701. First, Taxpayer claims the transactions are not governed by proposed § 1.7701(l)-2. Taxpayer asserts that no significant element of the transactions was entered into or undertaken after October 13, 1995. (We agree that the proposed regulations would not apply to the subject transactions.) Second, Taxpayer asserts that Sub A's sole purpose for entering into the transactions was for economic gain. According to Taxpayer, its initial economic analysis indicated that Sub A would save $ii by entering into the transactions. Taxpayer has not supplied this initial analysis to the government. The projected savings were supposedly based upon "... interest rates and fair values of similar equipment existing immediately prior to the execution of the sale/leaseback." Third, Taxpayer contends that penalties are inappropriate because Sub A received information from the promoters or counsel for the promoters indicating that Notice 95-53 was invalid or inapplicable to the transactions.

To support its claim of a business purpose, Taxpayer points to rent adjustments for certain tractors under the terminal rental clause of Lease 3. In Period 3, Sub A exercised its purchase option and sold some tractors to Corp W at a gain of $kk. In Period 4, Sub A exercised the option for the remaining tractors and sold the equipment to Navistar at a gain of $mm. This represents a $nn reduction of its Lease 3 rent obligations. It is unclear whether Sub A reported these amounts as gains from the sale of equipment or as a reduction to rental deductions.

Taxpayer also supplied some figures claiming an additional $pp in potential gains from exercising its option on trailers. It is unclear how Sub A reached these figures, since the Lease 3 term for the trailers does not expire until Date 8.

To avoid the penalties, Taxpayer relies on a portion of a legal opinion that appears to come from the promoter or counsel for the promoter. The document is missing the first six pages and the signature page. It is unclear to whom the opinion is addressed or on what facts the opinion is based. The portion given to Exam analyzes and questions the validity of Notice 95-53. We do not know when Taxpayer received the document.

LAW AND ANALYSIS

Issue 1

A transaction entered into solely to reduce taxes and with 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), aff'd, 544 F.2d 1045 (9th Cir. 1976) ; 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); Nicole Rose Corp. v. Commissioner, 117 T.C. 27 (2001). If a transaction is treated as a sham, the form of the transaction is disregarded and the proper tax treatment of the parties to the transaction is determined.

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved by tax reduction. If a taxpayer seeks to claim tax benefits not intended by Congress, and 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, supra; ACM Partnership, supra.

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

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

The Service was successful in showing that a series of prearranged transactions involving the purchase and sale of debt instruments in an attempt to shift accelerated installment sale gain to a tax-neutral partner and manufacture a loss for another partner lacked economic substance. ACM Partnership, 157 F.3d at 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. According to the court, the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved primarily by tax reduction. The court held that the transaction lacked economic substance and, therefore, that the taxpayer was not entitled to the claimed deductions. Thus, 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, Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001); but cf, UPS of Am., Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001), rev'g T.C. Memo. 1999-268.

In UPS of Am., Inc. v. Commissioner, supra, the Eleventh Circuit reversed the Tax Court, finding that the restructuring by UPS of certain insurance premiums in the context of an ongoing, viable business had both real economic effects and a business purpose. According to the court, setting up a transaction with tax planning in mind is permissible as long as there is a bona fide, profit-seeking business purpose. Unlike the transactions in ACM Partnership, as well as those in the instant case, the UPS restructuring was part of its business.

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).

The series of sale/leasebacks and the purported § 351 transaction lack both economic substance and non-tax business purpose. Taxpayer claims either that it received no promotional materials from the promoter or that it did not retain the materials. Taxpayer also claims that no law firm assisted the company in putting the deal together, although an accounting firm apparently did provide some assistance with regard to the proper financial statement presentation and GAAP accounting treatment for the leases. Taxpayer represents that its accounting staff analyzed the economic benefits and risks associated with the transactions for its senior management.

Although Taxpayer has claimed that its sole purpose for entering into the transactions was for economic gain and that the company would save $ii by entering into the transactions, it has failed to supply the Service with a copy of the analysis. If the analysis showed that Taxpayer reasonably could have made a substantial nontax economic gain by entering into the transactions, it is likely that the information would have been provided.

To show business purpose, Taxpayer points to the Lease 3 terminal rental clause adjustments for tractors. In Period 3, Sub A exercised its purchase option and sold some tractors to Corp W at a gain of $kk. In period 4, Sub A exercised the option for the remaining tractors and sold the equipment to Corp W at a gain of $mm. These amounts represent a $nn reduction of Sub A's Lease 3 rent obligations (it is unclear how Sub A reported these amounts). Taxpayer is claiming also that it had additional potential gains of $pp from the future exercise of its option on the trailers.

The ability to sell the tractors and trailers at a profit, thereby reducing Taxpayer's rent obligations, does not show a business purpose for the transactions above. Taxpayer was the original owner of the equipment and presumably could have sold the equipment at a profit even if the sale/leasebacks and the § 351 transaction never took place. It is not even clear whether these potential rent deductions create any meaningful net profit after the costs associated with the transaction are taken into account (Taxpayer paid the promoter $qq to set up the transaction). There must be a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, 157 F.2d at 249. As discussed above, there must be a bona fide transaction with economic substance, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. Taxpayer has failed to show that there was any economic benefit for entering into the transaction that it would not have had without entering into the transaction.

The apparent purpose of the original sale/leaseback with Partnership and the almost simultaneous prepayment of the rent[1] was to accelerate the rental income to Partnership, which for the most part is a tax-exempt entity. The apparent purpose of the remaining sale/leasebacks and the § 351 transaction between Partnership and Sub B was to create the inflated basis stock[2] and to transfer the rental

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[1] Confirming that the monthly lease payments and the monthly payments on the notes in the original sale/leaseback between Taxpayer and Partnership were equal and created a circular flow of funds will help show a lack of business purpose. See Nicole Rose Corp. v. Commissioner, 117 T.C. 27 (2001). In addition, it appears that the prepayment of rent by Taxpayer was prearranged because it took place less than two weeks after the sale/leaseback. This fact, if it can be established, also will help show a lack of business purpose.

[2] The Sub B shares received by Partnership in the purported § 351 transaction became inflated basis stock. Partnership eventually transferred this stock to Corp Z, who eventually sold it to a third party. This sale purportedly created a $rr loss that was used by Corp Z to offset unrelated capital gains.

obligations and the cash to pay the obligations to Sub B so that Taxpayer would get a double rental deduction on its consolidated returns.[3]

The series of transactions, including the multiple sale/leasebacks of the same property and the purported § 351 transaction, is an economic sham. Therefore, the Service should disallow not only the deductions of the amortized prepaid rent under Lease 1, but also the current rental deductions under Lease 3.

Issue 2

a. Requirements under § 482

i. In general

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394, 400 (1972); Barford v. Commissioner, 194 F.3d 782, 786 (7th Cir. 1999); Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd, 358 F.2d 342 (6th Cir. 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 or more organizations, trades or businesses owned or controlled by the same interests. Section 482 imposes two requirements: (1) ownership or control must exist in some manner among the participants, and (2) the same interests must possess the control. None of the participants in the lease stripping transaction are directly or indirectly related to each other. Therefore, § 482 cannot be applied under a theory of common ownership. Section 482 can

[3] Showing that the entire transaction was prearranged (taking place, as it did, over approximately 5 weeks) will help establish a lack of business purpose.

only be applied if the participants in the lease strip are determined to be controlled by the same interests.

ii. Control

Control is defined by the regulations under § 482 to include any kind of control, regardless of whether such control is direct or indirect or legally enforceable[4]. Section 1.482-1(i)(4). The term includes control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. Id. Case law is in accord with 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), acq. in part, 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, it is not required that a taxpayer possess a majority stock ownership interest in a participant to establish control as defined under § 482. Both the regulations and case law provide the Service with the authority to determine the existence of control by considering the reality of the participant's relationships and examining whether the same interests effectively control the participants to the transaction involved, rather than basing the control determination solely on the taxpayer's percentage of ownership of voting stock or legal right to direct the participant's actions.

When control does not exist through majority ownership of voting stock or a

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[4] Section 1.482-1T applies for the part of the transaction allocable to the most recent year beginning before October 6, 1994. For years beginning after this date, the final regulations as cited in our FSA govern the definition of control. However, we interpret the acting in concert and common design or purpose application of control the same for both the temporary and final regulations. The cited jurisprudence is also supportive for concluding the existence of control for all years.

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

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

From the facts provided to us, it appears as though the participants acted in concert pursuant to a prearranged common plan to arbitrarily shift substantial rental deductions from Partnership and Corp Y to Taxpayer while shifting the associated rental income to tax exempt entities. The promoter brought all the parties together to engage in this lease stripping transaction, and the facts will likely show that each party played an integrated and predefined role pursuant to the preconceived plan developed by the promoter. Partnership and Corp X acted first as "purchasers" then as "lessors" of the property to provide Taxpayer with the means to take double rental deductions on the property upon its subsidiaries' re-leasing of the property; N was the tax neutral entity used to strip the rental income from the associated rental expense; the Taxpayer was the recipient of the stripped rental expense; and Corp Y provided the financing for the transaction.

Partnership played a significant role in effectuating this transaction. Sub A "sold" the property to Partnership which Partnership immediately leased back to Sub A. Partnership's purchase of the property was financed by a note from Corp Y which was substantially prepaid within a few weeks by Sub A. The remainder of the Corp Y note which was not prepaid by Sub A was transferred a few months later by Partnership to Sub B in the § 351 transaction. Partnership's entry into the second sale/leaseback with Corp X subsequently provided Sub B with the ability to claim a second rental deduction on the same equipment. The second sale/leaseback was an offsetting transaction to Partnership in that the rental payments to be made to Corp X under Partnership's re-leasing of the property was offset by Corp X's purchase obligations under its promissory notes. Partnership therefore bore no significant economic costs from participating in this transaction. Partnership's subsequent transfer of its Corp X lease to Sub B enabled Taxpayer to claim a second rental deduction on the same property which Sub A was also leasing. Partnership's participation in the lease strip enabled Taxpayer to receive a leasehold interest in the purported § 351 transaction stripped of its associated income, but not of its associated rental deductions and provided Taxpayer with the means to claim multiple rental deductions.

These facts lead us to conclude that the parties acted in concert with a common goal to: (1) separate rental income from the leases with the corresponding rental expenses and arbitrarily shift only the rental expenses to Taxpayer without any associated income inclusions; and (2) shift to Taxpayer artificially created double deductions on the same property. Accordingly, control is presumed to exist among the parties for the purposes of § 482 under the regulations and the applicable case law. Corp Y's benefit from participating in this transaction likely consisted in part of its right to receipt of the interest payable from Sub A on the $n outstanding balance of the Corp Y note. As to Partnership, it received stock from Sub B in the purported § 351 transaction which was redeemable at Partnership's option. The facts indicate that Partnership claimed an inflated basis in the Sub B stock which it subsequently transferred to another unrelated corporation to shelter capital gains income. More facts should be developed to determine what form of compensation or other benefit Corp X received from its participation in the transaction.

iii. Same interests

The regulations provide no guidance as to what the term "same interests" means under § 482. Case law has indicated that in using the term "the same interests," Congress intended to include more than the "same persons" or the "same individuals." See also B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972) (two independently owned corporations acting in concert together to make interest-free loans to a jointly owned corporation constituted the same interests within the meaning of section 482); South Texas Rice Warehouse Co. v.

Commissioner, 366 F.2d 890, 894-95 (5^{th} Cir. 1966). Cf. Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233-34 (1925); cf. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5^{th} 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). But see The Lake Erie and Pittsburg Railway Co. v. Commissioner, 5 T.C. 558 (1945), acq. 1945 C.B. 5, acq. withdrawn 1965-1 C.B. 5.

Case law indicates that the legal standard for determining whether “the same interests” control an entity is identical to the standard applied to determine whether control of an entity exists. Therefore, if different entities are found to have a common goal to shift income or deductions among each other, not only will control of the entities exist, but the entities will also constitute “the same interests” for the purpose of § 482. In the present case, the parties appear to have acted together pursuant to a common plan to shift deductions to Taxpayer while shifting income away from Taxpayer to a tax-exempt participant. Consequently, by acting collectively in this manner, Taxpayer constitutes “the same interests” with respect to the other participants in this transaction. Accordingly, under § 482, the Service may reallocate the rental income as well as the rental and loss deductions claimed by Taxpayer to clearly reflect income.

b. Application of § 482

There are two alternative bases to apply § 482 to this transaction: (1) to prevent the evasion of tax, and (2) to clearly reflect income.

i. Economic substance / tax evasion

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. See G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). 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. Section 1.482-1(d)(3)(ii)(B). The economic substance standard of the regulations overlaps with the economic substance and sham transaction doctrines developed in case law which allow the Service to disregard transactions lacking a business purpose and a potential for economic profit.[5] However, the § 482

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[5] 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 (4^{th} Cir. 1985)

regulations expand upon case law guidance by providing additional guidance. Specifically, the regulations provide the following:

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

Thus, § 482 provides an alternative approach to challenging a transaction for lack of economic substance by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of sham transactions. See G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987).

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

This transaction was contracted, in form, to resemble a series of leases. However, the terms of the transaction appear inconsistent with its true substance.

(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) (transaction devoid of economic substance cannot be the basis for a deductible loss).

Lack of economic substance may be demonstrated by Sub A's transfer of the equipment to Partnership and Partnership's subsequent re-transfer of the equipment to Corp X were structured to resemble sales while Corp Y's and Corp X's transfer of the notes was intended to represent the payment obligations under the purported sales. The transaction was also structured to include both Sub A's and Partnership / Sub B's leasing back of the equipment. Structuring the transaction as multiple sale/leasebacks with offsetting rental and note payment obligations on both sides of the transactions made possible Taxpayer's claiming of double rental deductions on the property without Partnership and Corp Y having to incur any economic cost. Sub B bore the economic burden of making payments on the $n note obligation transferred by Partnership in the purported § 351 transaction which was partially offset by Corp Y's assumption of Corp X's obligation under the $s note issued to Partnership. Thus, in substance, it appears that Taxpayer alone financed or "paid" for the ability to claim double rental deductions.

Section 482 permits the recasting of this transaction consistent with its economic substance. Recasting the transaction consistent with its economic substance would result in disregarding the leases between Partnership / Sub B and Sub A and the lease between Sub B and Corp Y so that Taxpayer never acquires through its subsidiaries the obligation to pay rent to Sub B and Corp Y as a result of the purported § 351 transfer. Treating the transaction consistently with its economic substance would prevent tax avoidance because Taxpayer would be prohibited from taking rental deductions for rent purportedly paid to Sub B and Corp Y which was not in substance, economically incurred.

Taxpayer claims that it had a valid business purpose for this transaction. Taxpayer's asserted business purpose was to achieve economic gain and that it expected to save $ii from entering into the transaction. However, Taxpayer has not provided any facts to support its claim that it expected to earn an economic profit. Taxpayer claimed that it earned gains from the sale of the equipment of $kk and $mm, and that it had potential future sale gains of $pp. It is unclear how these gains were reported. The facts indicate that Sub B incurred obligations from Partnership in the purported § 351 transaction totaling $dd. Even assuming that Taxpayer would in fact realize its future gains of $pp, which has not been factually established, it appears as though Taxpayer would incur a net loss (dd – s – kk – mm – pp) from its participation in the transaction. From the facts, it appears as though the purpose of the transaction was to strip rental income to a tax neutral entity, create inflated basis stock, and to create double rental deductions.

ii. Clear reflection of income

When a § 351 transfer is involved, the Commissioner may disregard the nonrecognition provisions of § 351 to make a § 482 allocation if necessary to clearly reflect income among controlled taxpayers. Section 1.482-1T(d)(1)(iii);

§ 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 disregarding of nonrecognition provisions if necessary to clearly reflect income.

In National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), 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 sold the stock approximately nine months later and claimed a loss deduction. Id. at 601. The Commissioner disregarded the nonrecognition transaction and treated the amount of the pre-contribution loss as sustained by the parent instead of the subsidiary under § 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 act. Id. According to the court, the section could still be applied to clearly reflect income, despite a conflict with the literal provisions of another section of the Code. Id.

Other cases in accord with National Securities Corp. uphold the Commissioner's use of § 482 to clearly reflect income when § 482 is in conflict with the provisions of another section of the Code. See Central Cuba Sugar Co., 198 F.2d at 215-16 (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) (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 at 686 (§ 482 will control when it conflicts with § 351); G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). But see Ruddick Corp. v. U.S., 643 F.2d 747, 226 Ct. Cl. 426 (1981), aff'd. without opinion, 732 F.2d 168 (Fed. Cir. 1984) (in the absence of tax avoidance motives, the Commissioner may not disregard § 351 transactions to apply § 482, even if doing so would be necessary to clearly reflect income).

In the instant case, Partnership's transfer of its leasehold interest to Sub B resulted in a distortion of income. Partnership's § 351 transfer enabled Taxpayer to acquire, in a tax-free transaction, the right to claim a second rental deduction on the equipment. A significant distortion of income resulted from the § 351 transfer because Taxpayer acquired the right to additional rental deductions which it did not economically incur. No rental deductions were economically incurred by Taxpayer resulting from the Lease 3 because Taxpayer never had any real, substantive obligation with respect to the rental payments owed to Corp Y in that the rental payments were offset by the note from Corp X.

Applying the analysis adopted in the National Securities Corp. line of cases, the Service may therefore disregard the § 351 transfer and allocate Taxpayer's rental deductions back to Partnership to clearly reflect income. A § 482 allocation may be made despite the fact that its application would result in a conflict with the provisions of § 351, which would treat the transferee corporation, Sub B, as the true owner of the leasehold interests and allow Taxpayer to claim the rental deductions.

Issue 3

ITA 200117039 addresses the tax consequences of a transaction in which an entity transfers a note receivable and an offsetting obligation to make rent payments to a taxpayer in exchange for the taxpayer's stock in a transaction that purports to qualify under § 351. That step, which is typical of lease stripping transactions, occurred in this case when Partnership transferred to Sub B the notes issued by Corp X and Partnership's obligation to make rental payments under Lease 2.

ITA 200117039 reasons that in these circumstances "under Holdcroft v. Commissioner, 153 F.2d 323 (8th Cir. 1946), the payment of the rent obligation will be a capital expenditure, not a deductible expense, with respect to the transferee corporation." Notice CC-2001-033a explains that:

> Although authorities such as Rev. Rul. 95-74, 1995-2 C.B. 36, permit a corporate transferee to claim deductions accruing upon payment of assumed liabilities, such authorities only apply if there is a transfer of a trade or business and, at the time of the section 351 exchange, the taxpayer had no plan to dispose of the stock received. In Notice 2001-17 transactions, there is no transfer of a trade or business and there is a plan to dispose of the stock immediately after the sale. Therefore, these transactions are not within the scope of Rev. Rul. 95-74. As a result, the taxpayers in these cases are subject to the rule set forth in Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), that the assumption of the liability is part of the cost of acquiring the transferred asset and so the payment of the liability does not give rise to a deductible expense for the transferee. In such a case, the

deduction upon payment by the transferee should accrue to the transferor, in which case there is no need to preserve the loss in the stock basis.

In this case, as was the situation in Notice 2001-17, there was no transfer of a trade or business to Sub B because the leasehold interest that Sub B received did not include a corresponding right to use the equipment that was the subject of the leasehold interest or to receive income from the equipment. This equipment was subject to the rights of others to use it for the term of Lease 2. As a result, based on the reasoning of Notice CC-2001-033a, payments of the rent obligations would be capital expenses of Sub B.

Section 162 allows a deduction for all the ordinary and necessary business expenses paid or incurred during the tax year in carrying on a trade or business. However, in this case, if it is determined that the liabilities were assumed by Sub B as a part of the cost of acquiring the assets, as in Holdcroft, then the payment of the liabilities does not qualify as ordinary and necessary business expenses under § 162. Under the rationale of Holdcroft, the expenses were not paid or incurred in carrying on a trade or business, but rather to acquire assets.

Further, it is questionable as to whether Sub B's payment of Partnership's rent and other incidental expenses transferred to Sub B are ordinary and necessary business expenses of Sub B. Section 162(a) requires that for expenses to be deductible they must be incurred in connection with a trade or business. Although the term trade or business is not defined by the Code or regulations, various litigated cases do offer some guidance. See Purvis v. Commissioner, 530 F. 2d 1332 (9th Cir. 1976) (one factor in whether a taxpayer had a trade or business as a securities trader was the "frequency, extent and regularity of the ... transactions.") If Sub B conducts no trade or business, its expenses are not be deductible under § 162(a).

Whether Sub B conducts a trade or business is a question of fact. We understand that Sub B conducts no trade or business activities at all. It is a shell corporation that merely holds the financial instruments received from Partnership in exchange for the preferred stock, plus the capital received from Taxpayer for common stock. Thus, if it is found as a fact that Sub B has no trade or business, its payments are not expenses ordinarily or customarily expended in a trade or business.

Issue 4

For the reasons discussed below, this does not appear to be a valid § 351 transaction. The issue is whether disallowing the § 351 transaction will have an effect on Taxpayer in the instant case, and if not, whether the issue should be raised because of the potential impact it could have with respect to another taxpayer, Corp Z.

a. Control

Section 351 provides nonrecognition treatment for transfers of property by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. Section 1.351-1(a)(1). 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. Id. 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.). 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." Section 1.351-1(a)(1)(ii).

At the time of the purported § 351 transaction, Taxpayer transferred $bb to Sub B in exchange for cc additional Sub B preferred shares. It appears that the control requirements of § 351 have probably been met because the ownership interest of all transferors participating in a single transaction are aggregated. Subject to certain limitations, to determine control, a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. A control group may consist of any combination of corporations, partnerships, estates, trusts, individuals or associations that transfer property to a corporation in related transfers and which, in the aggregate, control the transferee corporation immediately after the last transfer. Section 1.351-1(a).

b. Business purpose

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. 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.

As discussed above, the facts as currently developed do not suggest a plausible business purpose for the § 351 transaction. Assuming that § 351 does not apply, the transfers would be taxable exchanges under § 1001, and Partnership’s basis in the stock would be a cost basis determined under § 1012. Section 1.1032-1. The basis of the stock in the hands of Partnership would not be inflated. Therefore, when Corp Z sold the stock, it would not have the substantial loss to offset unrelated capital gains.

In exchange for the aa shares of Sub B stock, Sub B received or assumed the following: Partnership's residual rights to the equipment under Lease 1; Partnership's right to receive the Lease 1 rent during the renewal terms; Sub B's assumption of Partnership's remaining $n principal obligation under the Corp Y promissory note; Partnership's right to receive payments under the $c in promissory notes issued by Corp X;[6] Partnership's right to use the equipment during the Lease 2 term; and Sub B's assumption of Partnership's obligation to pay rent under Lease 2.

It does not appear that "busting" the § 351 transaction would have any impact on Taxpayer. Sub B would recognize no gain or loss on its transaction with Partnership even if the transaction did not qualify under § 351. Section 1032 provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Section 1.1032-1 emphasizes that the "no gain or loss" rule applies regardless of the nature of the transaction and the facts and circumstances involved by providing that the disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved.

Under § 1012, Sub B would take a cost basis in the property it received from Partnership. As Sub B gave stock for the property, its cost basis would be the value of the stock given up in the exchange. See FX Systems Corp. v. Commissioner, 79 T.C. 957, 963 (1982) and cases cited therein. Sub B's cost basis also would include the amount of lease obligations incurred or assumed by Sub B in acquiring the property, provided the lease obligations were not so contingent or indefinite that they were not susceptible to present valuation. See Rev. Rul. 55-675, 1955-2 C.B. 567.

Even if there are no adjustments attributable to "busting" the § 351 transaction, because the transaction as a whole lacks economic substance, including the § 351 transaction, the issue still should be raised in the instant case.[7]

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[6] After the Date 3 transaction between Corp X and Corp Y, Sub B received a $ff payoff of the note.

[7] If it is decided not to raise this as a separate issue, consideration could be given to raising the lack of a valid § 351 transaction as part of the overall lack of economic substance argument.

This would negate any possible argument in the Corp Z case that we are taking inconsistent positions by not attacking the § 351 transaction in this case while attacking the § 351 transaction in the Corp Z case.

Issue 5

Section 6662(a) imposes a penalty in an amount equal to 20% of the underpayment of tax attributable to one or more of the items listed in § 6662(b). These items include negligence, substantial understatements of income tax, and substantial valuation misstatements under chapter 1.

a. 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 § 6662(c); Martello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g on this issue, 43 T.C. 168 (1964); § 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[.]" Section 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 § 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 § 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.

We conclude that Taxpayer was negligent and that the accuracy-related penalty under § 6662(a) should be applied to the deficiencies resulting from the disallowance of the two sets of rental deductions. Taxpayer has offered no evidence that there was reasonable cause for its return positions or that it acted in good faith in asserting them. Many of the parties 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 similar to the one entered into by Taxpayer. Taxpayer received no promotional materials from the promoter (or did not retain the materials), nor did it receive legal counsel regarding the transactions. There is no evidence that Taxpayer thoroughly investigated the bona fide economic aspects of the lease stripping transactions or reasonably relied on professional advice that the losses were allowable. See Freytag v. Commissioner, 904 F.2d

1011, 1017 (5th Cir. 1990) aff'd, 501 U.S. 868 (1991); § 1.6664-4(c). See also Atkind v. Commissioner, T.C. Memo 1995-582 (taxpayer's reliance on the investment advice of the general partner and corporate counsel of a partnership, which was a tax sham designed to create spurious deductions, was not reasonable) and Marine v. Commissioner, 92 T.C. 958, 992-993 (1989), aff'd without opinion, 921 F.2d 280 (9th Cir. 1991) (reliance on representations by insiders, promoters, or offering materials is an inadequate defense to negligence).

b. Substantial Understatement

A substantial understatement of income tax exists for a tax year if the amount of understatement exceeds the greater of 10% of the tax required to be shown on the return or $5,000. Section 6662(d)(1)(A). Understatements generally are reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. Section 6662(d)(2)(B). However, those reductions do not apply to items of corporations attributable to tax shelters. Section 6662(d)(2)(C)(ii). The term "tax shelter" includes any plan or arrangement, a significant purpose of which is the avoidance or evasion of federal income tax. Section 6662(d)(2)(C)(iii).

We conclude that the series of transactions in which Taxpayer and its subsidiary claimed rental deductions on the same property was a tax shelter. Any understatement that results from the disallowance of the claimed deductions will, if substantial, be subject to the penalty provided by § 6662(a), unless Taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. As discussed above regarding negligence, the facts as currently developed do not satisfy even the lower reasonable basis standard that applies for purposes of determining negligence. See § 1.6662-4(d)(2).

We conclude, also, that any deficiencies that result from disallowing the rental deductions will, if substantial, be subject to the penalty provided by § 6662(a), even if the series of transactions in which Taxpayer created the two sets of rental deductions was not a tax shelter. If the transactions were not a tax shelter, the understatement will 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. Section § 6662(d)(2)(B). Neither of these exceptions apply. The substantial authority standard is higher than the reasonable basis standard. Section 1.6662-4(d)(2). As was discussed regarding negligence, the facts as currently developed do not support a conclusion that Taxpayer had even a reasonable basis for claiming the rental deductions. In addition, there is no indication that the relevant facts affecting the items' tax treatment were disclosed in Taxpayer's return or in attached statements.

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

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