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COORDINATED ISSUE
ALL INDUSTRIES
LOSSES REPORTED FROM INFLATED BASIS ASSETS FROM LEASE STRIPPING TRANSACTIONS
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ISSUE

Whether losses and deductions reported from assets with bases traceable to lease stripping transactions are allowed for federal income tax purposes?

CONCLUSION

The theories upon which the Service will challenge losses and deductions from assets with bases traceable to lease stripping transactions must be determined on a case-by- case basis depending on the specific facts and circumstances of each case. The Service will disallow such losses or deductions for one or more reasons including but not limited to the following Code sections and theories: the economic substance doctrine; Sections 358; 357; 351; 482; 269; and the Partnership Anti-abuse rule found in section 1.701-2(a)-(d) of the Income Tax Regulations. To assist in adequately developing the facts and to ensure that the appropriate theories are identified for pursuit in a particular case, examination personnel are encouraged to coordinate with the Leasing (Promotions) Technical Advisor and to seek the advice of Chief Counsel.

FACTS

A corporation owns depreciable equipment subject to pre-existing user leases. B partnership purchases the equipment from A in exchange for a note, and A immediately leases the equipment back. B has a majority partner, C, who is exempt from United States taxation. B sells the rents receivable from A to a bank for cash, thereby accelerating the income due under the lease. B allocates C's share of the accelerated income to C. B uses the cash received from the bank to repay its note to A. B then contributes the equipment to D corporation in exchange for D stock in a transaction that purports to qualify under Code section 351. D is a subsidiary of E. E is the parent of a consolidated group which includes D. D and E, through the consolidated group, take depreciation deductions for the depreciable equipment.

D takes the equipment subject to A's lease, and the residual value of the equipment at the end of the lease term is minimal. The Lease Stripping Coordinated Issue Paper, (July 21, 2000), addresses the abuse that results by allowing D to receive depreciation deductions from the equipment after the income from the equipment had already been accelerated ("stripped") to B and its majority partner C. See also Notice 95-53, 1995-2 C.B. 334.

After the lease stripping transaction described above, B holds preferred stock of D. Pursuant to Code section 358(a)(1), B takes the position that, under section 358(a)(1), its basis in the D preferred stock is equal to the basis of the property it contributed to D. B thereafter transfers the D corporation preferred stock to corporation F, a member of the G consolidated group, in exchange for F corporation preferred stock in a purported section 351 transaction. F claims it is entitled to a carryover basis in the preferred stock of D pursuant to Code section 362(a). F thereafter sells the D preferred stock to an unrelated party H for its value and claims a loss based on the carryover basis. F uses the built-in loss to offset income from other transactions. F's acquisition of the D stock from B and its sale of the preferred stock to H were arranged by P. B, F, H, and P are unrelated. This coordinated issue paper addresses the abuse that results from allowing F to deduct the loss that results from assets with bases traceable to lease stripping transactions such as the D preferred stock.

DISCUSSION

A. Primary Argument

LACK OF ECONOMIC SUBSTANCE

When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is without effect for federal income tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Yosha v. Commissioner, 861 F. 2d 494, 498-99 (7th Cir. 1988), aff'g sub nom. Glass v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership v. Commissioner, 157 F. 3d 231, 246-247 (3d Cir. 1998), aff'g in part and rev'g in part, T.C. Memo 1997-115, cert. denied, 526 U.S. 1017 (1999); United States v. Wexler, 31 F. 3d 117, 122, 124 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Goldstein v. Commissioner, 364 F. 2d 734, 740-741 (2d Cir. 1966), aff'g 44 T.C. 284 (1965), cert. denied, 385 U.S. 1005 (1967); Saba Partnership v. Commissioner, T.C. Memo. 1999-359, appeal docketed (D.C. Cir.).

The lack of economic substance hinges on all of the facts and circumstances surrounding the transaction. No single factor will be determinative. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). Whether a court will respect the taxpayer's characterization of the transaction depends on whether 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 ACM Partnership v. Commissioner, supra; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990), aff'g sub nom. Sturm v. Commissioner, T.C. Memo 1987-625; Compaq Computer Corp. v. Commissioner, 113

T.C. 214 (1999), appeal docketed (6th Cir); and Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), aff'd 254 F. 3d 1313 (11th Cir. 2001).

An evaluation of whether the lease stripping transaction lacked economic substance requires a review of separate, but interrelated inquiries: (1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an inquiry into the objective economic effect of the transaction. ACM Partnership, 157 F. 3d at 247-248; Casebeer, 909 F. 2d at 1363; and Kirchman v. Commissioner, 862 F. 2d 1486, 1490-1491 (11th Cir. 1989).

To satisfy the business purpose inquiry, the transaction must be "rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and …economic situation." Compaq Computer, supra, at 224, quoting ACM Partnership, T.C. Memo. 1997-115, 73 T.C.M. (CCH) 2189, 2217, affd. in relevant part, 157 F. 3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); See Kirchman, supra, at 1490-1491.

To satisfy the objective economic inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, 157 F. 3d at 248. Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960).[1] Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, 157 F. 3d at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-768 (1990); Saba Partnership v. Commissioner, T.C. Memo 1999-359, 78 T.C.M. (CCH) 684, 721-722. In conducting this economic review, it is appropriate to focus on the taxpayer's calculations at the outset of the transaction. ACM Partnership, 157 F. 3d at 257.

In ACM Partnership, the Tax 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. T.C. Memo. 1997-115. The Tax Court further stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. Id. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

[1] In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

The transactions outlined above, taken as a whole, have no business purpose independent of tax considerations. Because the lease stripping transactions in which B acquired the preferred stock lacked economic substance, B's basis in the preferred stock is limited to the value of the property B contributed in exchange for that stock. As a result, B would have no bases in the contributed assets for F to assume under Internal Revenue Code section 362.

Moreover, F had no business purpose for acquiring and selling the stock of D, and those transactions lacked economic substance. Consequently, F would have a cost basis in the preferred stock. As a result, F and the G consolidated group are not entitled to the loss generated from this transaction.

B. Secondary Arguments

The theories contained in the remainder of the paper assume that neither the lease stripping transactions nor F corporation's acquisition and sale of the D corporation preferred stock were transactions lacking economic substance. Although some of the facts that support the economic substance theory also support the following theories, the economic substance theory and the theories contained in the remainder of the paper are mutually exclusive. The following theories may also presume that other arguments, whether applied to an earlier portion of the transaction or to the same portion of the transaction are not under consideration. The arguments should thus be set up in the alternative.

Moreover, the following arguments necessarily respect certain portions of the transactions. Many of these arguments target the taxpayer by reallocating losses and deductions away from the taxpayer under audit to other parties to the transaction.

1. REDUCTION OF STOCK BASIS DUE TO ASSUMPTION OF TRANSFEROR'S OBLIGATIONS

a. Section 358(d)(1)

If, as taxpayers assert, the transfers in exchange for stock qualify as section 351 exchanges, (see section 351 discussion infra), then, under section 358(a)(1), the transferor's basis in the stock of the transferee corporation received in the exchange is, in the first place, equal to the transferor's basis in the property exchanged.[2] However, under section 358(a)(1)(A), such basis is reduced by, among other things, the amount of any money received by the transferor. Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of section 358, be treated as money received by the taxpayer on the exchange. Section 358(d)(1).

[2] Note that the terms of the stock received in the exchange should be closely scrutinized to determine if the stock is nonqualified preferred stock within the meaning of section 351(g).

In the first of the purported section 351 exchanges that comprise the subject transaction, D, the transferee corporation, receives property in exchange for stock and the assumption of B's liability to provide the property in accordance with the terms of the lease, but without the right to receive any income produced by the lease. A straightforward application of section 358(d)(1) requires that the basis of the stock received be reduced by the amount (measured by its value) of the assumed obligation.

Although taxpayers may take the position that the liability is one described in section 357(c)(3) (and thus excluded from section 358(d)(1) by operation of section 358(d)(2)), this liability is not within the scope of section 357(c)(3) because the related income has been stripped (as discussed more fully in the earlier CIP) and the satisfaction of the liability will give rise to neither basis nor a deduction to the transferee, D.

b. Section 357(b)(1)(B)

Even if section 358(d)(1) were not applicable, a comparable result is reached under section 357(b). Section 357(b)(1)(B) provides that if, taking into consideration the nature of the liability and the circumstances under which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to an assumption described in section 357(a) was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange.

In the subject transaction, the primary purpose for the assumption of the liability to satisfy the lease related obligations is to create an asset (the D stock) with a basis far in excess of its value, in order to sell that asset and thereby generate a substantial tax loss, with no bona fide economic loss suffered by any party to the transaction. This is not a bona fide business purpose. Thus, even if section 358(d)(1) were treated as not applying to the subject transactions, the assumption of the liability to satisfy the leasehold obligation is squarely within the scope of section 357(b)(1)(B) and the liability assumption is treated as a distribution of money to the transferor, B, on the exchange. Under section 358(a)(1)(A)(ii), B's basis in the transferee stock is thus reduced by the value of the leasehold obligations assumed by the corporate transferee, D.

c. Transactions on or after October 18, 1999: Section 358(h)

Section 358(h) provides rules to prevent the duplication of loss through the assumption of liabilities that would give rise to a deduction. Under section 358(h), if the basis of stock (determined without regard to section 358(h)) received by a transferor as part of a tax- free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduce the transferor's basis of the stock by reason of the assumption.[3] The term "liability" is broadly defined for purposes of section 358(h). Except as provided by the Secretary of the Treasury, section 358(h) does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets which the liability is associated are transferred to the corporation as part of the exchange. Section 358(h) was added to the Code by Section 309(a) of the Community Renewal Tax Relief Act of 2000, P.L. 106-554, and applies to liabilities assumed after October 18, 1999.

The facts of individual cases may warrant application of this provision; this issue should be coordinated with the National Office until regulations are promulgated.

Under section 358(h), B's basis in the preferred stock of D would be reduced by the amount of any liabilities that B contributed to D in the transaction that purported to qualify under section 351. That reduced basis would then carryover to corporation F in B's purported section 351 transaction with that corporation, reducing or eliminating the loss resulting from F's sale of the D corporation stock to H corporation.

2. SECTION 351

Each of the purported section 351 transfers must be closely scrutinized to determine that both the technical requirements and the business purpose requirements of section 351 are satisfied.

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.

For purposes of section 351, control is defined as ownership of at least 80 percent of the total combined voting power of all classes entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation. Sections 351(a) and 368(c). The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met. Generally, to determine control, a group of transferors may include all of the transferee stock owned directly (or, in the case of a transferor that is a member of a consolidated group, stock owned by any member of the transferor's group) by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. However, transfers by a transferor that previously owned transferee stock will not be considered in determining if the control requirement is satisfied if the value of the new stock issued to that transferor is relatively small compared to the value of the old stock owned by that transferor

[3] An example of a circumstance in which a transferee's assumption of a liability would not otherwise reduce the transferor's basis of the stock is if the payment of the liability by the transferee would give rise to a deduction. See discussion of section 309 of the Community Renewal Tax Relief Act of 2000 contained in H.Rept. 106-1033, P.L. 106-554 (Dec. 15, 2000).

and the primary purpose of the transfer by that transferor was to qualify other transferors for section 351 treatment. See Section 1.351-1(a)(1)(ii) and section 3.07 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570.

In addition to the technical requirements transferors must satisfy, the Courts have indicated there is a business purpose requirement in section 351. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in section 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). Generally, section 351 will apply to a transaction if the taxpayer has any valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331,1960-2 C.B. 189, 191. Whether a valid business purpose underlies a transaction whereby a taxpayer acquires ownership of an asset with an inflated basis traceable to a lease stripping transaction is a factual issue.

If the transfer fails to qualify as a section 351 exchange, it is a taxable exchange subject to section 1001. The transferors recognize gain or loss at the time of the exchange.[4] The transferee corporation does not recognize any gain or loss on the transaction. See section 1032.[5] However, both the transferor and the transferee, B and D in the first 351 transaction, then have a cost basis in the property received, in accordance with the provisions of section 1012 and the regulations thereunder, and there is no inflated basis stock. See Section 1.1012-1(a), which provides that such property will take a basis equal to the fair market value of the property exchanged.

It is important to note that this analysis is to be made with respect to each exchange that purports to qualify as a section 351 exchange, i.e., not only the first transfer (in which the inflated basis stock is created), but all successive transfers as well (in which the inflated basis, if permitted, would be replicated).

Whether or not the first section 351 transaction is challenged, the above argument applies also to the second 351 transaction. Thus, if the transfer of D preferred stock from B to F does not qualify under section 351, then it would be treated as a taxable exchange under section 1001.

3. SECTION 482

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[4] Note that, if the transferor and the transferee are members of the same consolidated group, recognition of any gain or loss will be deferred.

[5] 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 of such corporation.

Under section 482, the Service may allocate income or deductions between entities owned or controlled by the same interests in order to prevent the evasion of taxes or clearly to reflect income. Thus, in order for section 482 to apply to a transaction, the transaction must be between two or more taxpayers (as defined in section1.482-1(i)(3)) owned or controlled by the same interests. As there is no common ownership among the participants to the transaction, B, F, H, D, and P (other than B's ownership of D's preferred stock) the primary question under section 482 becomes whether any of the participants are controlled by the same interests. In determining what constitutes control by the same interests, the appropriate focus is with respect to controlled transactions and not overlapping ownership of the parties that control such transactions. A section 482 analysis of control does not focus rigidly on equity ownership although equity ownership may be sufficient to establish control. Rather it focuses on the ability of a person or an entity to direct the actions of another taxpayer. Section 1.482-1(a)[6] states:

> The purpose and scope of Section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. [emphasis added]

Controlled transactions or transfers are defined as any transaction or transfer between two or more members of the same group of controlled taxpayers. Section 1.482-1(i)(8). Controlled taxpayers are defined as any one of two or more taxpayers owned or controlled directly or indirectly by the same interests. Section 1.482-1(i)(5). For section 482 purposes, taxpayers are defined as any person, organization, trade or business, whether or not subject to any internal revenue tax. Section 1.482-1(i)(3). Control is defined as any kind of control, direct or indirect, whether legally exercisable or exercised, including control resulting from the action of two or more parties acting in concert or with a common goal or purpose. Section 1.482-1(i)(4). It is the reality of control that is decisive, not its form or mode of exercise. Id. For instance, the creation and use of a special purpose vehicle to facilitate the transfer of income and tax benefits among various parties at predetermined times may cause effective control to reside in the taxpayers who created or directed the creation of the vehicle and the carrying out of its intended purpose. See Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967).

In order for section 482 to apply, control may arise from overlapping ownership, but control in this manner is not an exclusive requirement. In addition to control that may be established by actual overlapping ownership, for purposes of section 482, control may be independently established under the "acting in concert" or "common goal or purpose" tests with respect to actions undertaken by unrelated parties with respect to a transaction or

[6] In this section 482 portion of the paper, we cite to the current section 1.482-1 regulations which are effective for taxable years beginning after October 6, 1994. In addition, the current regulations may be effective for earlier years if the taxpayer elects to apply all the provisions of the current regulations retroactively. See generally, 1.482-1(i). Please call the National Office for more specific guidance regarding tax years which precede the effective date of the current final regulations.

group of transactions. Section 1.482- 1(i)(4). See B. Forman v. Commissioner, 453 F.2d 1144 (2d Cir. 1972). A presumption of control may also arise independently of the “acting in concert” or “common goal or purpose” tests described above, if income or deductions have been arbitrarily shifted. Section 1.482-1(i)(4). See Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979). Under the facts here, the Service's burden of establishing the shifting of income and deductions may be met by the shifting of losses from B to F and the G consolidated group, parties that are subject to United States taxation.

Once control is established by demonstrating that the parties to the transactions were acting in concert or pursuant to a common goal or purpose, or that the parties arbitrarily shifted income or deductions, it must be determined whether the control was exercised by the same interests. Although the phrase "same interests" is not defined in the section 482 regulations, case law as well as the legislative history of section 482 provide guidance. The phrase "same interests" includes different persons with a common plan to shift income or deductions. Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-5 (5th Cir. 1966), aff'g 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967). Thus, central to the demonstration of "control" by the "same interests" is the establishment of a common design to shift income and deductions. See Hall v. Commissioner, 32 T.C. 390, 409-10 (1959), aff'd, 294 F.2d 82 (5th Cir. 1961).

Once an exercise of control by the same interests over a transaction or group of transactions is established, section 482 may be applied since the section 351 transaction was not engaged in for a nontax avoidance business purpose. Generally, the Service may apply section 482 to nonrecognition transactions where property was contributed for tax avoidance purposes. For example, section 482 may allocate income and deductions arising from an entity's disposition of built-in-loss property, which it acquired in a nonrecognition transaction, to the shareholder (or partner) that contributed it in the transaction, when the sole or primary purpose for the transfer was to avoid taxation. See sections 1.482-1(f)(1)(iii); Ruddick Corp. v. United States, 643 F.2d 747 (Ct. Cl. 1981); Eli Lilly and Co. v. Commissioner, 84 T.C. 996 (1985), aff’d in part, rev’d in part, 856 F.2d 855 (7th Cir. 1988). Under this application of section 482, the Service could allocate losses reported by F to B.

4. SECTION 269

Section 269(a) provides that, if–

(1) any person or persons acquire, directly or indirectly, control of a corporation (section 269(a)(1)), or

(2) any corporation acquires, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of the property, in the hands of the acquiring corporation, is

determined by reference to the basis in the hands of the transferor corporation (section 269(a)(2)),

and the principal purpose for which such acquisition was made is evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For the purposes of section 269, control means ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. Section 1.269-3(c)(1).

In the fact pattern presented here, there is no discernable purpose for any of the acquisitions apart from the creation of a high basis, low value asset to be disposed of in a transaction that will generate a substantial tax (but no economic) loss. Even if a particular taxpayer asserts a business purpose, we believe it would be far out-weighed by the purpose of avoiding federal income tax. Therefore, each acquisition should be carefully scrutinized to determine whether the additional requirements of either section 269(a)(1) or section 269(a)(2) are satisfied. Where the additional requirements of either section are satisfied, section 269 should be asserted to disallow any loss claimed from the sale of the stock.

5. Alternate Transaction: Transfer to Partnership

In one variation on the transaction described above, B contributes D preferred stock to a partnership J, instead of contributing the D stock to a corporation, and then B sells its partnership interest to K, a party that can utilize the built-in losses to offset other gain. In this situation, the anti-abuse regulation section 1.701-2 supports denying the losses reported by J from the sale of the D preferred stock.

If B contributes property in exchange for a partnership interest in J, under section 723, J partnership would take a carryover basis in the D preferred stock that exceeds its fair market value. Under these circumstances section 704(c) would apply. That section provides that where a partner contributes property to a partnership and the property has a fair market value that is different than the basis of the property to the partnership, then under regulations prescribed by the Secretary, gain or loss with respect to the property shall be shared among the partners so as to take into account the variation. In other words, losses from built-in loss property such as the D preferred stock must be allocated to the partner that contributed the property. Treasury Regulations issued under Code section 704(c) explain that its purpose is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Section 1.704-3.

Section 1.704-3(a)(7) provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Thus, under this fact pattern, J and B may attempt to rely on that provision to allocate the built-in loss from the preferred stock to K, a pre-existing partner of J, with sufficient basis to take the loss. This is accomplished by K's purchase of B's partnership interest in J before J sells the D preferred stock. After the sale, under section 1.704-3(a)(7), the loss inherent in the D preferred stock is allocated to K, who uses the loss to offset other gain.

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

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

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

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

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

PRS did not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remained at $100x. PRS sold the land to B for $60x, its fair market value. Thus, PRS recognized a $40x loss that was allocated equally between C and W, and they each reduced the bases in their partnership interests to $10x. Thus, upon liquidation of PRS (or their interests therein), each of C and W would recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. In section 1.701-2(d), Example 8, PRS was used with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707), the Commissioner can recast the transaction as appropriate under Section 1.701-2. <u>Compare</u>, Section 1.701-2(d), Example 9, in which the use of a partnership for which no election under section 754 had been made is consistent with the intent of subchapter K.
Here, <u>B</u>'s contribution of the <u>D</u> preferred stock to <u>F</u> partnership and the sale of <u>B</u>'s interest in <u>F</u> partnership to <u>K</u> were part of a plan to duplicate losses through the absence of a section 754 election. <u>B</u> contributed high basis, low fair market value <u>D</u> preferred stock to <u>F</u> partnership in exchange for an interest in <u>F</u>. <u>B</u> then sells its <u>F</u> partnership interest to <u>K</u> and presumably recognized a tax loss. Since <u>F</u> did not make an election under section 754, <u>F</u>'s adjusted basis in the <u>D</u> preferred stock remained high. Upon the sale of the <u>D</u> preferred stock, <u>F</u> partnership reports a loss, which is allocated to <u>K</u>. <u>K</u> uses the losses to offset other gains.

As in Example 8, the transactions here are subject to recharacterization under section 1.701-2, based on the following factors: First, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. If the transactions were respected for federal tax purposes, <u>K</u> would be allocated capital losses (resulting from transactions in which K did not sustain a corresponding economic loss) which K would use to offset capital gains. Accordingly, any purported business purpose for the transactions is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes.

Second, the present value of the partner's aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. If B and K had conducted the activities directly rather than through F partnership, B would have sold the D preferred stock directly to K rather than contributing the D preferred stock to F partnership. Upon the sale of the preferred stock to K, B would have recognized a tax loss. K would have taken a cost basis in the preferred stock equal to the fair market value of the preferred stock. Upon the subsequent sale of the preferred stock at fair market value, K would not have recognized a capital loss which it claimed through the partnership. Conducting the activities through F partnership allowed K to claim capital losses, which it used to offset capital gains. Because B and K conducted the activities through F partnership, K's aggregate federal tax liability was substantially less than it would have been if B and K had dealt directly.

Third, the present value of the partner's aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. As discussed above, the present value of K's federal tax liability was substantially less than would be the case if the transactions were integrated into a direct sale of B's D preferred stock to K. It was contemplated that B, whose F partnership interest was necessary to allocate the purported built-in loss in the preferred stock to K, would hold the interest for a transitory period, until the sale to K.

Accordingly, we conclude that the contribution by B of the D preferred stock to F partnership, and the subsequent sale of the F partnership interest to K were in substance a sale by B of the D preferred stock to K and a subsequent contribution by K of the D preferred stock to F partnership. The economic substance argument, discussed infra, leads to the same recast.

B. APPLICABILITY OF PENALTIES

Whether penalties apply to underpayments attributable to the disallowance of losses and deductions reported from assets with bases traceable to lease stripping transactions must be determined on a case-by-case basis depending on the specific facts and circumstances of each case. The application of a penalty must be based upon a comparison of the facts developed with the legal standard for the application of the penalty. Examination teams should accordingly ensure that the scope of their factual development encompasses those matters relevant to penalties. One important issue relevant to the potential assertion of the accuracy-related penalty attributable to a substantial understatement is whether the transaction constitutes a tax shelter as defined in section 6662(d)(2)(C)(iii). The transaction will constitute a tax shelter if a significant purpose of the transaction is the avoidance or evasion of federal income tax (if the transaction was entered into before August 6,1997, a "principal purpose" standard applies). If the transaction is a tax shelter, then, as explained below, the requirements of section 1.6664-4(e) should be carefully scrutinized to determine whether a corporate taxpayer had "reasonable cause" sufficient to avoid the accuracy-related penalty attributable to a substantial understatement. If the transaction is not a tax shelter, then sections 1.6664-4(a) through (d) apply in determining whether a corporate taxpayer had reasonable cause sufficient to avoid the accuracy-related penalty.

1. The Accuracy-Related Penalty

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement under chapter 1. Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40% in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). See DHL Corp. v. Commissioner, T.C. Memo. 1998-461, where the Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement penalty under section 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty provided by section 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under section 6663. Section 6662(b).

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See Section 6662(c) and Section 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g, 43 T.C. 168 (1964). Section 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. In Compaq v. Commissioner, 113 T.C. 214 (1999), the Service argued that Compaq was liable for the accuracy-related penalty because Compaq disregarded the economic substance of the transaction. The court agreed with the Service's position and asserted the accuracy-related penalty for negligence because Compaq "failed to investigate the details of the transaction, the entity it was investing in, the parties it was doing business with, or the cash-flow implications of the transaction." 113 T.C. at 227. If the facts establish that a taxpayer reported losses from a transaction that lacked economic substance or reported losses or deductions from assets with bases traceable to lease stripping transactions that would have seemed, to a reasonable and prudent person, to be "too good to be true," then the accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed losses or deductions.

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Section 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of notice or revenue ruling.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2), in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Section 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Section 1.6662-3(b)(2).

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

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. Section 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." Section 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20% penalty under section 6662(a) is increased to 40%. Section 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992). If the facts establish that the adjusted basis of an asset with a basis traceable to a lease stripping transaction is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the facts establish that the adjusted basis of an asset with a basis traceable to a lease stripping transaction is 400 percent or more of the correct amount, then a gross valuation misstatement exists.

2. The Fraud Penalty

Section 6663 imposes a penalty for fraud in an amount equal to 75 percent of the portion of the underpayment that is attributable to fraud. Fraud is established if it is shown that a taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983). Knowingly understating income by overstating basis can constitute evidence of fraud. Slaughter v. Commissioner, T.C. Memo. 1954-58 (holding that fraud existed with respect to return on which taxpayer had reported a loss by overstating basis of asset sold); Smith v. Commissioner, T.C. Memo. 1992-353 (holding that fraud existed with respect to return on which taxpayer had overstated basis of asset for depreciation and investment tax credit purposes), aff'd without published opinion, 993 F.2d 1539 (4th Cir. 1993). The existence of fraud is a question of fact to be resolved based on the entire record. Mensik v. Commissioner, 328 F.2d 147, 150 (7th Cir. 1964), cert. denied, 379 U.S. 827 (1964); Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), aff'd without published opinion, 578 F.2d 1383 (8th Cir. 1978). Fraud is never presumed and must be proven by clear and convincing evidence. Stone v. Commissioner, 56 T.C. 213, 220 (1971), acq. in result, 1972-2 C.B. 3.; Beaver v, Commissioner, 55 T.C. 85, 92 (1970). Fraud may, however, be proven by circumstantial evidence and, as a result, a taxpayer's entire course of conduct can be considered in determining whether fraud exists. Rowlee v. Commissioner, supra; see also Stone v. Commissioner, supra at 223-24.

Facts establishing that a taxpayer attempted to conceal or mislead, such as by deliberately mislabeling an item, incorrectly reporting the relevant facts, or reporting an item so as to reduce the likelihood that it would be identified for examination, can constitute evidence of fraud. Spies v. United States, 317 U.S. 492, 499 (1943). Similarly, implausible or inconsistent explanations of behavior are an indicia of fraud. Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980). If the factors discussed above are present, then the fraud penalty may be applicable.

3. The Reasonable Cause Exception

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

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

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. Section 1.6664-4(c)(1)(i). The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

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

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

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

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

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