APPEALS

COORDINATED ISSUE PROGRAM

APPEALS SETTLEMENT GUIDELINES

INDUSTRY: Leasing Promotions

ISSUE: Lease Stripping Transactions

COORDINATOR: James W. Lanphear

TELEPHONE: (716) 551-5330 Ext. 23
FACSIMILE: (716) 551-5257

UIL NO: 9300.03-00

FACTUAL / LEGAL ISSUE: Factual

APPROVED:

Thomas C. Lillie

for **DIRECTOR, APPEALS TECHNICAL GUIDANCE** — MAY 2 1 2003 **DATE**

Beverly A. Baker

DIRECTOR, APPEALS TECHNICAL SERVICES — MAY 2 1 2003 **DATE**

Effective Date: MAY 2 1 2003

SETTLEMENT POSITION
LEASE STRIPPING TRANSACTIONS
UIL 9300.03-00

STATEMENT OF THE ISSUE

Whether multiple-participant transactions, where one participant realizes rental income and other income from a contract and another participant reports deductions related to that income in a lease stripping transaction, must be respected for federal income tax purposes?

EXAMINATION DIVISION POSITION

The theories upon which the Service might successfully challenge lease stripping transactions must be determined on a case-by-case basis depending on the specific facts and circumstances of each case.

In Notice 95-53, 1995-2 C.B. 334, the Service discusses "lease strips" and the tax consequences of these transactions. In addition to the code sections and theories discussed herein, the Service announced that it may apply the following Internal Revenue Code sections and theories to lease strips: Sections 269, 382, 482, 701, or 704, and the regulations thereunder and the assignment of income theory. Other theories applicable to lease strips include the Partnership Anti-abuse rules found in Treas. Reg. 1.701-2(a)-(d).

On July 21, 2000 the Examination Industry Specialization Program Coordinated Issue Paper on Lease Stripping Transactions was approved. Therein the following theories are discussed:

1. Sham/Lack of Economic Substance Theories
    a. Sham the Entire Transaction
    b. Sham the Partnership/Partners
    c. Step Transaction
2. Section 351 not applicable – Lack of Business Purpose
3. Benefits and Burdens of Ownership—Sale v. Financing
4. Section 482 Reallocation
5. Section 446(b) -- Clear Reflection of Income
6. Proposed Treas. Reg. § 1.7701(l)-2

The Appeals settlement guidelines will deal strictly with the issues raised in the Examination Coordinated Issue Paper, which the Service continues to argue. The Service has set forth a number of theories for addressing "lease strips" in Notice 95-53 which are not being addressed herein. The Service's omission of the theories from the position paper should not prejudice Examination's ability to assert other theories nor Appeals consideration of alternative theories raised by the Examiner. As with the issues raised herein, Appeals Officers, Appeals Team Case Leaders and Appeals Team Managers should consult with the Appeals ISP Coordinator, Leasing Promotions, with respect to such alternative positions.

BACKGROUND

Lease stripping transactions are multi-participant transactions intended to allow one participant to realize rental income or other income from property or service contracts and

to allow another participant to report deductions related to that income (i.e., rental expenses or depreciation). It is this bifurcation of the income from the related expenses that the Service believes does not accurately reflect the true economic or tax consequences of these transactions.

It should be noted that, while there is a wide variety of transaction structures, lease stripping transactions generally share many of the following components[1], which are designed to direct lease income or other income to one participant and related deductions to another:

- Sale-leasebacks of the same asset within a relatively short period of time;
- Use of a significant amount of non-recourse financing;
- Notes structured so that the payments roughly equal the rent receivable;
- A partnership that includes a tax neutral entity as a limited partner with a substantial profit interest;
- A step designed to strip the future rents related to the lease asset such as the assignment of the right to receive the future rents;
- Reporting of most of the income from the assignment of future rents by the tax neutral entity which is not subject to US tax or by a US taxpayer with expiring net operating losses or capital losses;
- After the asset is stripped of its future income, either the underlying asset or the partnership interest held by the tax neutral entity is contributed to a subsidiary of a US taxpaying entity in order to create lease/rent deductions or depreciation deductions for the US taxpaying entity;
- Results in a disproportionate amount of tax benefits compared to the potential economic benefits of the lease investment.

Lease stripping transactions are not "cookie cutter" type deals. Rather, they are complex transactions that are tailored to the needs of the parties.

Discussion

Lease stripping transactions share many of the common characteristics discussed in the Treasury's White Paper on Tax Shelters[2] including the following:

- Minimal economic effect – often participants are insulated from risk (and reward) through hedging, defeasement or circular cash flow;
- Inconsistent financial accounting and tax accounting treatment;
- Presence of tax-indifferent (neutral) participant and/or accommodation party who is paid a fee to participate (e.g. foreign offshore entities and individuals);
- Marketing and promotional material which emphasizes the tax benefits;
- High transaction costs;
- Contingent fees based on tax benefits, or refundable fees if the tax benefits are not realized;
- Confidentiality;

---

1 Although none of these components is dispositive, it is the combination of the components combined with a tax avoidance motive that creates an abusive lease strip.

2 Department of Treasury, "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals," aka "Treasury White Paper on Corporate Tax Shelters," July 1999

- Complex multiple steps, unnecessary steps or novel investments;
- Tax arbitrage.

While tax shelters, including lease strips, exhibit many of these characteristics, it is not necessary that an activity display every characteristic in order to be regarded as an abusive transaction.

Treasury continues to seek legislative changes to foster compliance and enforcement. Recently, Treasury and the Service published final regulations relating to the disclosure of reportable transactions under Treas. Reg. § 1.6011-4, the registration of confidential corporate tax shelters under Treas. Reg. § 301.6111-2, and the list maintenance requirements under Treas. Reg. § 301.6112-1. At this time, the Service has listed 25 transactions that have been identified as tax avoidance transactions. Inclusive in that list are lease stripping transactions as set forth in Notice 95-53, 1995-2 C.B. 334.

The ability of the Service to disallow the tax attributes associated with lease stripping transactions is dependent on the facts and circumstances of each case. To help understand how the transactions work, the Examination Coordinated Issue Paper (CIP) gives one such example of a lease stripping transaction. Note that other variations exist and are subject to review under the theories discussed herein.

Example

A, a corporation, owns depreciable equipment subject to pre-existing user leases. A and B, which is a thinly capitalized partnership, engage in a sale-leaseback of the equipment. B issues a note to A for the equipment. The payments due under the terms of B's note approximate the rental payments due under the lease. A retains the option to buy the equipment back at the end of the lease term, and also retains all risks associated with the leased equipment. The true residual value of the equipment at the end of the lease term is minimal.

B has a majority 98 percent partner, C, who is exempt from United States taxation. B subsequently sells the rent receivables from A to a bank for cash, thereby accelerating the income due under the lease. (*This is the lease stripping transaction that causes the income to be recognized by the tax neutral entity and thereby escape U.S. taxation*). B allocates to C, the tax neutral partner, C's respective share of the accelerated income. B uses the cash to pay off its note to A [3]

D, a corporation, is a subsidiary of E. E is the parent of a consolidated group which includes D. B contributes the equipment to D in exchange for preferred D stock in a purported I.R.C. section 351 transaction. [4] At the same time, E transfers property to D in

[3] If B does not pay off the note to A, or if B transfers property, rights, or obligations other than the equipment to D, the section 351 analysis contained in this paper may not be relied upon to determine the gain or loss recognition and basis consequences of the underlying transactions.

[4] Other lease strips involve contributions of the partnership interest by the tax-neutral partner to a corporation in a purported section 351 transaction. Also, B could engage in a second sale-leaseback and thereafter transfer certain property and rental obligations to a corporation. In that situation, the corporation subsequently takes a deduction for rental payments. Such a transaction involves further basis calculations not addressed by this

exchange for additional D common stock.[5] The amount of the property E transfers to D is sufficient for E to count as a transferor in the purported section 351 transaction. D claims depreciation deductions for the depreciable equipment; the deductions are used by the E consolidated group. (*Since the income has already been stripped off to the tax-neutral entity, the US taxpayer inherits the benefits of the tax deduction without the burden of the taxable income associated with the equipment*).

This example is referenced throughout the Examination Industry Specialization Program (ISP) coordinated issue paper (CIP).

TAXPAYER'S POSITION

Taxpayers assert that the leasing investments were entered into for bona fide business reasons with the requisite intent of making a profit. They assert that the transactions entered into by the tax–neutral parties, prior to their investment in the activity, are of no consequence to their case and only those transactions that occurred subsequent to their investment are relevant.

Taxpayers will usually acknowledge that they considered the substantial tax benefits in evaluating the investment, but argue that it was the projected re-leasing income and/or residual values that persuaded the company to invest. Taxpayers contend that while the projected residual values may never have materialized, this is a moot point since the appraisals exhibited sufficient profit potential.

Taxpayers disagree with each of the issues raised herein.

DISCUSSION

Depending upon the facts and circumstances of the case, the Service may raise any one of or combination of issues. The resolution of lease stripping cases is highly dependent upon the facts and circumstances. The following is a discussion on the legal theories advanced by the Service in response to lease stripping activities.

1. SHAM/LACK OF ECONOMIC SUBSTANCE THEORIES

a. Disregarding the Transaction or Series of Transactions

For federal income tax purposes, when the structure of a transaction is not reflective of its substance and economic realities, judicial doctrines may be invoked to recast transactions in accordance with their substance.

When a transaction is treated as a sham in 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 a sham and is without effect for federal income tax purposes. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Rice's Toyota World Inc.

---

paper.

5 Unless otherwise stated, it is assumed that the section 351 control test is satisfied in these transactions. However, for purposes of analyzing the potential litigating hazards inherent in any case, whether a given transaction satisfies the control requirement of section 351 must always be determined.

v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985) aff'g in part 81 T.C. 184 (1983); Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (2001), aff'd 254 F.3d 1313 (2d Cir. 2002).

The sham transaction approach hinges on all of the facts and circumstances surrounding *all* of the transactions involved in a lease stripping transaction. No single factor will be determinative. 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 Frank Lyon Co. v. United States, supra; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); and Rice's Toyota World, Inc. v. Commissioner, supra.

Admittedly, taxpayers are generally free to structure their transactions in a manner that results in the least amount of tax provided there is economic substance apart from the tax benefits and a business purpose for the transaction. As stated in the landmark Supreme Court decision of Gregory v. Helvering, "the legal right of the taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing the statute intended". Gregory v. Helvering, 293 U.S. 465 (1935). See also Knetsch v. United States, 364 U.S. 361 (1960).

As set forth in Gregory, one must look beyond the form of the transaction to determine whether it has the economic substance that its form represents, because regardless of its form, a transaction that is devoid of economic substance must be disregarded for tax purposes and cannot be the basis for a deductible loss. See Kirchman v. Commissioner, 862 F.2d 1486, 1490 (11th Cir. 1989); Lerman v. Commissioner, 939 F.2d at 45 (3rd Cir. 1991); accord United States v. Wexler, 31 F.3d 117, 122 (3rd Cir. (1994); cert. denied, 513 U.S. 1190 (1995).

The courts have emphasized that the existence of tax benefits accruing to its investors does not necessarily deprive a transaction of economic substance. Estate of Thomas v. Commissioner, 84 T.C. 412 (1985); Mukerji v. Commissioner, 87 T.C. 936 (1986) and Frank Lyon Co. v. United States, supra. The Supreme Court in Frank Lyon Co. stated "we cannot ignore the reality that the tax laws affect the shape of nearly every *business transaction.* However, the doctrine of economic substance becomes applicable where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings." See also Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988).

As so aptly pointed out by the 4th Circuit in Hines, after a certain point, the transaction ceases to have any economic substance and becomes no more than a sale of tax profits. Therein the court found that the evidence "clearly indicates that the investment scheme.... reached the point where tax tail began to wag the dog." Hines "did not purchase or lease a computer, but rather, paid a fee. . . in exchange for tax benefits." Hines v. Commissioner, 912 F.2d 736,741, citing Rice's Toyota World, Inc., 752 F2d at 95.

The courts look at the sequence of the transactions as a whole to determine if there is a significant or merely nominal change with incidental effect on the taxpayer. In applying these principles, transactions must be viewed "as a whole, and each step, from the commencement…to the consummation…is relevant." Court Holding Co. v. United States, 324 U.S. 331, 334, 65 S. Ct. 707, 708 (1945). Where the transactions are intentionally and cleverly structured to have the appearance of bona fide transactions, but are without substance within the meaning of established case precedence, they will be considered

shams. Sheldon v. Commissioner, 94 T.C. 738 (1990). When a transaction is treated as a sham, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction.

Contrary to the taxpayers' assertions that the transactions that occurred prior to their investment should be ignored when evaluating the taxpayer's activities, the courts have consistently held that it is the totality of the transaction that must be considered. See ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), aff'g in relevant part T.C. Memo. 1997-115. For example, in lease stripping cases, one cannot ignore the sale and leaseback under offsetting terms, the lack of a bona fide residual, or the stripping of the income to a tax-indifferent participant.

Whether a taxpayer's transaction had sufficient economic substance to be respected for tax purposes turns on both the "*subjective business motivation*" behind them and the "*objective economic substance of the transactions.*" Rice's Toyota World, Inc. v. Commissioner, supra, and ACM Partnership, supra, and Casebeer v. Commissioner, supra. The Tax Court and other circuits have not always strictly applied this two-prong test. Rather, a unitary rule has emerged which blends the two inquiries. This was articulated in James, wherein the court observed that the better approach holds that the consideration of business purpose and economic substance are simply more precise factors to consider in determining whether the transaction had any practical economic effects other than the creation of income tax losses. James v. Commissioner, 899 F.2d 560, 563 (10th Cir) aff'g, 87 T.C. 905 (1986); see also Lerman v. Commissioner, 939 F.2d at 45 (3rd Cir. 1991) and Gilman v. Commissioner, 933 F.2d 143, 147-148 (2d Cir. 1991), aff'g T.C. Memo 1990-205.

A court may conclude that where there is no potential for a pre-tax profit, there is no reason to look to the business purpose prong. In one such case the court considered whether the taxpayer should have known that the transaction could not generate a non-tax profit and stated "we refuse to allow a sophisticated businessman who has not taken adequate steps to form a reasoned assessment of an investment to rely on his failure to take such steps and on his resulting ignorance. . . To do so would encourage 'tax shelter charlatans,' and discourage taxpayers from independently evaluating transactions and making informed business judgments, thereby putting a premium on gullibility." Carlson v. Commissioner, 53 T.C.M. 1176, 119 (1987); see also James v. Commissioner, supra, and Cherin v. Commissioner, 89 T.C. 986, 993 (1987).

Additionally, the existence of some profit potential does not legitimize the entire transaction. In Sheldon, supra, the Court held that a transaction resulting in gain that was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions" had no economic substance. The Court, citing Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir. 1966), affg. 44 T.C. 284 (1965), stated that "the principle of Goldstein would not, as petitioners suggest, permit deductions merely because the taxpayer had or experienced de minimus gain."

In ACM, supra, the Tax Court noted that there was a potential for profit in the transaction (without considering the tax benefits), but stated that the potential for profit was small in comparison to the fees paid to the promoter. In Hines, a computer leasing activity, the 4th Circuit concluded that the taxpayer's profit potential was minimal and the transaction a sham, citing as additional evidence of the tax motivation the front-loading of interest payments and the offsetting obligations to pay rent and debt servicing. Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990).

In contrast, the courts have found that a transaction has economic substance and will be

recognized for tax purposes if the transaction offers a reasonable opportunity for profit exclusive of tax benefits. Gefen v. Commissioner, 87 T.C. 1741, 1490 (1986); and Thomas Est. v. Commissioner, 84 T.C. 412, 437 (1985). Where the facts indicate that the taxpayer entered into the transaction for a valid business purpose independent of tax benefits and said investment provides a reasonable opportunity for profit independent of tax benefits, the transaction will be considered to have economic profit. Salina Partnership LP v. Commissioner, T.C. Memo 2000-352.

As stated in Rice's Toyota World, Inc., supra, the economic substance test requires an analysis of the transaction as a prudent businessman would to ascertain whether it had any economic substance apart from its beneficial tax consequences. The question then becomes whether there was a realistic hope for profit. Dunlap v. Commissioner, 74 T.C. 1377 (1980), rev'd and rem'd on other issues , 670 F.2d 785 (8th Cir. 1982).

In Levy v. Commissioner, 91 T.C. 838, 856 (1988), a computer sale-leaseback transaction, the court observed that the following factors were particularly significant in determining whether a computer leasing transaction possessed economic substance: presence or absence of arm's length price negotiations, the reasonableness of the income and the residual value projections, the structure of the financing, the degree of adherence to contractual terms, and the relationship between the sales price and fair market value of the property acquired.

Keep in mind that when evaluating whether the potential for profit exists, the courts will not be constrained to the estimates in the promotional materials or appraisals furnished to induce an investment. Larsen V. Commissioner, 89 T.C. 1229 (1988), aff'd in part and rev'd in part; Gilman v. Commissioner, supra, and Shriver v. Commissioner, T.C. Memo. 1987-627 , aff'd. 899 F.2d 724 (8th Cir. 1990). The courts will look to the data that was available at the time the taxpayer entered into the transaction to ascertain whether the projections were, in fact, reasonable.

Recently, the Service has been successful in challenging lease stripping transactions under the sham/economic substance theories. In Andantech v. Commissioner, T.C. Memo 2002-97, (appeal pending in D.C. Circuit), the Tax Court disallowed deductions from petitioner's involvement in a lease stripping transaction. Petitioner acquired an interest in a partnership in a purported section 351 transaction, claimed a carry-over basis, and took depreciation deductions passed through from the partnership. The partnership held depreciable property whose income had been stripped to a tax neutral entity prior to the purported section 351 transaction. The Tax Court based its holding upon the following theories: 1) The partnership was a sham; 2) the participation of the initial partners was disregarded under the step transaction doctrine; and 3) the sale-leaseback lacked economic substance.

In addition, the Tax Court addressed alternative theories for disallowing the deductions. The Tax Court posited that, assuming the transaction did not lack economic substance, petitioners would still not be entitled to the depreciation because there was no true sale and the seller financing did not constitute bona fide debt.

In Nicole Rose Corp. v, Commissioner, 117 T.C. 328 (2001), aff'd 254 F.3d 1313 (2d Cir. 2002),the Tax Court found that petitioner's acquisition of certain stripped lease interests to shelter gain in an intermediary transaction lacked economic substance. Petitioner stepped into the transaction by purchasing the shares of a corporation and

merging that corporation into petitioner. Petitioner then sold assets it had acquired in the merger, generating an approximately $11 million gain. Pursuant to a series of prearranged transactions including several section 351 transactions, petitioner acquired the purported interests and obligations relating to certain leases. The majority of the income relating to these interests had been stripped off and placed into a trust fund. Upon petitioner's subsequent transfer of these interests, petitioner claimed, inter alia, an ordinary business expense deduction of approximately $21 million.

In holding that the transactions lacked economic substance the court noted that "no credible business purpose and . . . no viable economic substance existed" for petitioner's transfer of the lease interests. Further the court noted that the prearranged transactions leading up to petitioner's acquisition of the purported interests created a circular flow of funds. In imposing the accuracy related penalty, the Court held that the participation of highly paid professionals did not provide petitioner any protection, excuse, justification, or immunity.

The Service's arguments against lease strips were further bolstered by the Court of Appeals for the Second Circuit's affirmance in Nicole Rose v. Commissioner, 254 F.3d 1313 (2d Cir. 2002) (per curiam) aff'g 117 T.C. 328 (2001). The Second Circuit found that the relevant inquiry was "whether the transaction that generated the claimed deductions – the lease transfer – had economic substance." In upholding the Tax Court's determination that the lease transfer did not have economic substance, the Second Circuit found that because the funds were controlled by, and were for the benefit of, a third participant, and because the equipment sublease was immediately leased back, the taxpayer did not have a "significant interest" in the fund or the equipment. Nor did the taxpayer attempt to obtain information on the value of the assets transferred. Accordingly, the Second Circuit upheld the Tax Court's determination that the transaction lacked economic substance.

See also, ACM Partnership v. Commissioner, supra; Winn-Dixie Stores, Inc. and Subsidiaries v. Commissioner, 254 F.3d 1313 (3rd Cir. 2001), aff'g. 113 T.C. 254 (1999); American Electric Power Inc. v. United States, F. Supp. 2d 762 (D. Ohio 2001); and IRS v. C.M. Holdings, Inc. (In re C.M. Holdings, Inc., et. al.), 86 AFTR2d Par. 2000-5397 (D. Del. 2000), aff'd, 301 F.3d 96 (3rd Cir. 2002). In each of these cases the Courts looked behind the form of the transaction, to its true substance, essentially looking "behind the scenes." It is this inquiry that is fundamental in the evaluation of lease stripping cases. Although the Service has been fairly successful in tax shelter litigation, there have been several cases in which we have been unsuccessful. See, e.g., United Parcel Service of America v. Commissioner, 254 F.3d 1014, 1019 (11th Cir. 2001); Compaq v. Commissioner, 277 F.3d 1014(5th Cir. 2001), and IES Industries, and Subsidiaries v. U.S., 253 F.3d 350 (8th Cir. 2001). Those cases did not involve lease stripping transactions, however, and were decided before the Service's wins in Andantech v. Commissioner, supra, and Nicole Rose Corp. v. Commissioner, supra.

Lease stripping transactions are distinguishable from the offshore reinsurance structure in UPS and the ADR foreign tax credit issue in IES and Compaq. They do, however, share many of the characteristics exhibited in the section 453 transactions including high transaction costs, use of tax-indifferent participants, structured over a short period of time, limited risk, complex multiple steps, and structured to take advantage of Code provisions in a manner unintended by Congress.

In the section 453 installment sales promotions, corporate taxpayers were parties to multiparticipant transactions that were designed to afford one participant (tax-indifferent) to recognize income upfront, whereas the other (US taxpayer) recognized the

deductions/losses in subsequent years. The taxpayers took advantage of the section 453 basis allocation provisions to accelerate income into the initial year when a tax-indifferent participant was present. Once the tax-indifferent participant exited the deal, the US taxpayer benefited by the built-in losses. ACM Partnership v. Commissioner, supra.

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. This 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.

The Third Circuit affirmed the Tax Court's decision and reversed in part with respect to the actual economic losses sustained on the LIBOR notes that it determined were separable and economically substantive, citing United States v. Wexler, supra, at 127.

It is the Service's position that the bifurcation of income from the deductions in a lease stripping transaction exemplifies a situation where the taxpayer is taking advantage of a loss that is not economically inherent in the transaction, but rather, one which is created artificially by injecting a tax indifferent participant into the deal. The Service believes that the taxpayer's acquisition of a loss position in a lease stripping transaction is devoid of economic substance and should be disregarded for federal income tax purposes. The foregoing case law, including ACM, supports such a position.

b. Sham the Partnership/Partners

Sham principles may also be applied to the partnership and the partners. Accordingly, many of the principles and cases cited in section (a) are equally applicable with respect to disregarding the partnership/partners.

In order for a partnership to exist for federal income tax purposes, the parties must, in good faith and with a business purpose, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise. The entity's status under state law is not determinative for federal income tax purposes. Commissioner v. Tower, 327 U.S. 280, 287 (1946); Luna v. Commissioner, 42 T.C. 1067, 1077 (1964). The existence of a valid partnership depends on all of the facts, including the agreement of the parties, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts shedding light on the parties' true intent. The analysis of these facts shows whether the parties in good faith and action, with a business purpose, intended to join together for the present conduct of an undertaking or enterprise. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g T.C. Memo 1998-305.
In ASA Investerings, the Tax Court first disregarded several parties as mere agents in determining whether the parties had formed a valid partnership. T.C. Memo 1998-305, see also Commissioner v. Bollinger, 485 U.S. 340 (1988). In reaching its conclusion that the remaining parties did not intend to join together in the present conduct of an enterprise, the court found that the parties had divergent business goals.

The Tax Court's opinion was affirmed by the Court of Appeals for the District of Columbia, ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000). Although the Appellate Court wrote that parties with different business goals are not precluded from having the intent required to form a partnership, the court affirmed the Tax Court's holding that the arrangement between the parties was not a valid partnership, in part because "[a] partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership." Id. at 515. The Appellate Court rejected the taxpayer's argument that the test for whether a partnership is valid differs from the test for whether a transaction's form should be respected, writing that "whether the 'sham' be in the entity or the transaction . . . the absence of a nontax business purpose is fatal." Id. at 512.

As in ASA Investerings, the taxpayer may assert that Moline Properties, Inc. v. Commissioner, 319, U.S. 436 (1943), stands for the proposition that as long as the purpose is the equivalent of business activity or is followed by the carrying on of business by the *corporation* [the same is true for a partnership], the separate entity must be respected for tax purposes. The Tax Court has applied Moline Properties to partnership cases. See Bertoli v. Commissioner, 103 T.C. 501, 511-12 (1994). In responding to this argument in ASA Investerings, the Court acknowledged that if engaging in business activity were sufficient to validate a partnership, then ASA Investerings would qualify. After all, ASA Investerings was infused with a substantial amount of capital and invested in short-terms private placement notes and international (LIBOR) notes as well as other short-term notes over a period of two years. However, the court understood the "business activity" in Moline Properties to exclude activity whose sole purpose is tax avoidance.

In an earlier case, National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944), the court also considered Moline Properties. Therein, Judge Learned Hand concluded that the retention and sale of securities, after the date when the corporate holding had served its non-tax goals, could not be considered for tax purposes. He held that retention of the corporation merely for the purpose of tax minimization was insufficient to rise to the level of business activity in the ordinary meaning of the phrase.

In Boca Investerings Partnership, et al, v. United States, 167 F Supp. 2nd 298 (D.D.C. 2001), the District Court concluded that Boca and the partners satisfied the four basic attributes of a partnership; they intended to organize as a partnership; all partners contributed substantial capital; all partners participated and jointly controlled Boca; and all jointly shared in the income, gain, losses and expenses. As such, it found that a valid partnership was created. The Circuit Court for the District of Columbia reversed the district court as being inconsistent with ASA Investerings; and held that no nontax reason existed for forming a partnership. Boca Investerings Partnership v. United States, 314 F.3d 625 (D.C. Cir. 2003) rev'g 167 F. Supp. 2nd 298 (D.D.C. 2001).

In the factual example provided in the Examination Coordinated Issue Paper (CIP), the Service asserts that the participation of B and its partners in the lease stripping transactions, taken as a whole, had no business purpose independent of tax considerations and should be disregarded. Once one ignores B, all that is left is a basic sale-leaseback transaction between D and A. Alternatively, the participation of B should be disregarded because B acted on behalf of E as an accommodation party or mere broker and its activities were designed solely to create deductions for the E consolidated group. Under this alternative theory, the E consolidated group may still be able to claim deductions; however, the group would recognize the accelerated income arising from the sale of the rent stream to the bank. See Andantech, supra.

c. Step Transaction

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Andantech, supra. See also Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). Because the Tax Court has applied the step transaction doctrine even where it had not found a sham transaction, this doctrine should be considered in addition to the economic substance argument discussed above. See Packard v. Commissioner, 85 T.C. 397 (1985).

In characterizing the appropriate tax treatment of the end result, the doctrine combines steps; however, it does not create new steps, or recharacterize the actual transactions into hypothetical ones. Greene v. United States, 13 F.3d 577, 583 (2nd Cir. 1994); Esmark v. Commissioner, 90 T.C. 171, 195-200 (1988), aff'd per curiam, 886 F.2d 1318 (7th Cir. 1989).

Some lease stripping transactions may lend themselves to being collapsed. If so, the question is whether the transitory steps added anything of substance or were nothing more than intermediate devices used to enable the subsidiary corporation to acquire the lease property stripped of its future income, leaving the remaining rental expense and depreciation deductions to be used to offset other income. See Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184-185 (1942).

Courts have developed three tests to determine when separate steps should be integrated. The most limited is the "binding commitment" test. If, when the first transaction was entered into, there was a binding commitment to undertake the later transaction, the transactions are aggregated. Commissioner v. Gordon, 391 U.S. 83 (1968); Penrod, 88 T.C. at 1429. If, however, there was a moment in the series of transactions during which the parties were not under a binding obligation, the steps cannot be integrated using the binding commitment test, regardless of the parties' intent.
Under the "end result" test, if a series of formally separate steps are prearranged parts of a single transaction intended from the outset to achieve the final result, the transactions are combined. Penrod, 88 T.C. at 1429. This test relies on the parties' intent at the time of the transactions, which can be derived from the actions surrounding the transactions. For example, a short time interval suggests the intervening transactions were transitory and tax-motivated. A short time interval, however, is not dispositive.

A third test is the "interdependence" test, which considers whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without completing the series of transactions. Greene, 13 F.3d at 584; Penrod, 88 T.C. at 1430. One way to show interdependence is to show that certain steps would not have been taken in the absence of the other steps. Steps generally have independent significance if they were undertaken for valid business reasons.

In this transaction, the nature of B and C's involvement may support the conclusion that steps involving B and C should be eliminated from the transaction. In this event, D could be required to recognize the accelerated income arising from the purported sale of the rent stream to the bank. Therefore, through the consolidated return, E would recognize the income, and thereby match the income with the deductions.

The analysis of the transaction above suggests that partnership B is nothing more than an accommodation party or broker for D in D's transaction with A and/or the bank. In this role, B is a service provider whom D compensates with D preferred stock. This explains D's issuance of its preferred stock to B as compensation for services. Because B receives the

D preferred stock in exchange for services, section 351 does not apply to the exchange and B takes a cost basis in the D preferred stock. See Treas. Reg. § 1.351-1(a)(1)(i) and section 1012. The cost of the preferred stock is the fair market value of B's services, and presuming an arms-length transaction, the fair market value of B's services equals the fair market value of the preferred stock received in exchange thereof. See Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

Assuming B is recharacterized as a broker, D is deemed to purchase the property from A and to lease it back to A. D is treated as selling the lease receivables from A to the Bank for cash. Therefore, D (rather than B) recognizes the accelerated income from the sale of the lease obligation (i.e. even though B in fact received the cash payment from the Bank, it is effectively reallocated to D). D then uses the cash to satisfy the purchase price note. This explains A's receipt of payment for the property and D's ownership of the property.

2. **SECTION 3516**

These transactions must be examined to determine whether **all** of the structural requirements of section 351 and the corresponding regulations have been satisfied. These transactions must also be examined to determine whether the business purpose doctrine has been satisfied. For example, typically in such transactions, where the section 351 exchange is with a member of the consolidated group, the control requirement is satisfied by virtue of the common parent or other group member also making a contribution to the transferee. It is important to confirm that the common parent or other group member, in fact, contributed property to the transferee, and that the amount contributed equaled or exceeded 10 percent of the fair market value of the stock and securities already owned by the common parent or other group member (if not–arguably–the aggregate of the stock and securities in the transferee already owned by all of the group members). With respect to this latter point, see Treas. Reg. § 1.621-1(a)(1)(ii) and section 3.07 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570, as well as Treas. Reg. § 1.1502-34 (providing for aggregation of stock ownership with a consolidated group).

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 by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. But see Treas. Reg. § 1.351-1(a)(1)(ii) and section 3.07 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570, which negate transfers by a transferor that previously owned transferee stock if the value of the new stock issued to that transferor is relatively small compared to the value of the old stock owned by that transferor and the primary purpose of the transfer by that transferor was to qualify other transferors for section 351 treatment.

---

6 The arguments contained in this portion of the paper assume that the existence of B could not be ignored under a sham transaction theory. The sham transaction theory and the section 351 alternative arguments are mutually exclusive.

In Kamborian v. Commissioner, 56 T.C. 847, 864 (1971), aff'd, Estate of Kamborian v. Commissioner, 469 F.2d 219, 221 (5th Cir. 1972) the Tax Court agreed that a nominal contribution by a shareholder for the primary purpose of qualifying the exchange of other shareholders will not be included in determining whether the transferors are in control immediately after the transactions. On appeal, the circuit court required some economic connection between the transfers for them to be considered part of the same transaction for purposes of the control requirements.

Section 358(a)(1), in relevant part, provides that in an exchange to which section 351 applies and in which the transferor receives only transferee stock, the basis of property permitted to be received (i.e., the stock of the transferee corporation received by the transferor) under such section without the recognition of gain or loss shall be the same as that of the property exchanged.

Section 362(a), in relevant part, provides that in a section 351 transaction, in which the transferor receives only transferee stock, the (transferee) corporation's basis in the property acquired in the transaction will be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

In addition to the statutory requisites, 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 requisite in section 351transfers is contained in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989).

In Caruth v. United States, the court explained that section 351 is tied very closely to the reorganization provisions and, hence, reasoned that doctrines applicable there are equally valid for capital contributions. Therein, the court dispelled any misconception that somehow if the Code provision fails to explicitly require a business purpose, then one is not required. Citing Gregory v. Helvering as the origin of the business purpose doctrine, the court reiterated that under said doctrine:

> A transaction is not to be given effect for tax purposes unless it serves a legitimate business purpose other than tax avoidance. Thus, Gregory established the general principle that, in order to fit within a particular provision of the tax code, a transaction must satisfy not only the language of the statute, but also must have a purpose that lies within the spirit of the statute.

In Caruth, the court went on to explore the legislative history behind sections 351 and 368, concluding that the transfer of property to a controlled corporation must, under section 351, have a business purpose. Otherwise, it would permit the section 351 exemption to be used as a device for evading taxes.

Determining whether a bona fide non-tax business purpose motivated, at least in part, the section 351 transaction requires intensive factual development of the motives and intent of the parties, as gleaned through their written communications, contracts and agreements, and their expertise on tax matters in general, as well as their conduct throughout the transaction. The Service and the various courts have distilled several factors that aid in determining whether a valid non-tax business purpose is present in a purported section 351 transaction. These factors are:

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

See Kluener v. Commissioner, T.C. Memo 1996-519, aff'd, 154 F.3d 630 (6th Cir. 1998).

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.

If the transfer does not qualify under section 351, then it will be treated as a taxable exchange under section 1001. [7] D would still recognize no gain or loss on the transaction under section 1032;[8] however, D would determine its basis in the property it receives under section 1012. Under Treas. Reg. § 1.1012-1(a), D takes a basis in the equipment equal to the fair market value of the stock D distributes in the exchange. The fair market value of the preferred stock D distributes in the exchange is typically less than B's basis in the equipment. Consequently, D, and through the consolidated return E, would not be able to take depreciation deductions in the claimed amounts. Depreciation deductions would instead be calculated based on D's section 1012 basis in the equipment. As a taxable exchange under section 1001, B would recognize gain or loss on the exchange and determine its basis in the D preferred stock it receives under section 1012.

If, after considering all of the issues addressed in this paper, the purported section 351 transfer is respected as such and D is allowed depreciation deductions with respect to the equipment it received from B, some or all of the depreciation deductions may be subject to the separate return limitation year ("SRLY") limitation on built-in losses or built-in deductions. The threshold amount required for a built-in loss or built-in deduction to be subject to the SRLY limitation, the mechanisms for determining whether a built-in loss or built-in deduction exists, and the amount of the SRLY limitation vary depending on several factors. The factors include the date of the transfer, the tax year of the depreciation deduction, the difference between the fair market value and the adjusted basis of the assets transferred from B to D, and certain elections made by the E consolidated group. See, generally, Treas. Reg. §1.1502-15 (particularly paragraph (b)(2)(ii)), §1.1502-15A (particularly paragraph (a)(2)), and §1.1502-15T(b)(2)(i)). For years to which Treas. Reg. § 1.1502-15A applies, the organizational status of the transferor also is a relevant factor.

3. BENEFITS AND BURDENS OF OWNERSHIP/ SALE V. FINANCING

[7] If the transaction is a sale under section 1001, B may be able to recognize a loss at the time of the sale.

[8] 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.

Whether a transaction represents a sale for federal income tax purposes depends on the economic substance of the underlying transaction. Levy v. Commissioner, 91 T.C. 838, 859-62 (1988). The issue is whether the buyer of the equipment acquired the benefits and burdens of ownership. Andantech, supra. This is a question of fact as evidenced by the written agreements read in light of the attendant facts and circumstances.

In determining whether a sale of the equipment should be respected, the relevant factors are: (1) the investor's equity interest in the property as a percent of the purchase price; (2) renewal or purchase options at the end of the lease term based on fair market value of the equipment; (3) whether the useful life of the property exceeded the lease term; (4) whether the projected residual value of the equipment plus the cash-flow generated by the rental of the equipment allowed the investors to recoup at least their initial cash investments; (5) whether at some point a turnaround was reached whereby depreciation and interest deductions were less than income received from the lease; (6) whether the net tax savings for the investors was less than their initial cash investment; (7) whether there was the potential for realizing a profit or loss on the sale or release of the equipment; (8) whether the documentation was consistent with the substance of the transactions; and (9) whether the parties acted in a manner consistent with the purported sale. Levy, 91 T.C. at 860; see also Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1238 (1981).

In addition, some of the factors enumerated in Grodt & McKay Realty, Inc. v. Commissioner, supra, are either less relevant or must be considered in a different light because the transaction under consideration in that case did not include a leaseback of the subject property. For a discussion of the relevance of the different factors found in Grodt & McKay see Torres v. Commissioner, 88 T.C. 702, 721 (1987).

A transaction may be a financing arrangement if repayment of the debt is relatively certain, and the putative buyer has little risk. Mapco, Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977).

The CIP states that, assuming the factors above indicate that the transaction between A and B was a financing and not a sale, then the partnership, B, would not be the owner of the equipment, and thus could not transfer the equipment along with depreciation or other related deductions to D for the benefit of the E consolidated group.

SETTLEMENT GUIDELINES

Each lease stripping case is unique and hence, the issues raised may differ. Many of the arguments and points addressed herein, in particular in section 1a, equally apply to alternative issues. For this reason it is recommended that the reader review the contents of each of the various theories.

The various legal doctrines discussed herein stem from a long history of judicial review. The settlement of these issues will be driven by the application of these legal principals to the specific facts and circumstances of each case. As such, it is the strength of the facts and circumstances, as considered in light of the judicial doctrines, that will determine the appropriate settlement range.

1. a. Sham/Lack of Economic Substance

Based upon the facts and circumstances exhibited to date, there is strong support for the Service's position that lease stripping transactions are abuses that Congress had not

intended. When coupled with evidence establishing that the taxpayer's projected residual values are inflated and hence, not supportive of finding the requisite profit potential, the Service is posed with limited hazards in litigation.

The courts have rendered favorable decisions on lease stripping transactions. In Andantech v. Commissioner, supra, the Tax Court disallowed deductions from petitioner's involvement in a lease stripping transaction. Petitioner acquired an interest in a partnership in a purported section 351 transaction, claimed a carry-over basis, and took depreciation deductions passed through from the partnership. The partnership held depreciable property whose income had been stripped to a tax neutral entity prior to the purported section 351 transaction. The Tax Court based its holding upon the following theories: 1) The partnership was a sham; 2) the participation of the initial partners was disregarded under the step transaction doctrine; and 3) the sale-leaseback lacked economic substance.

In addition, the Tax Court addressed alternative theories for disallowing the deductions. The Tax Court posited that, assuming the transaction did not lack economic substance, petitioners would still not be entitled to the depreciation because there was no true sale and the seller financing did not constitute bona fide debt.

In Nicole Rose Corp, supra, the Tax Court found that petitioner's acquisition of certain stripped lease interests to shelter gain in an intermediary transaction lacked economic substance. Petitioner stepped into the transaction by purchasing the shares of a corporation and merging that corporation into petitioner. Petitioner then sold assets it had acquired in the merger, generating an approximately $11 million gain. Pursuant to a series of prearranged transactions including several section 351 transactions, petitioner acquired the purported interests and obligations relating to certain leases. The majority of the income relating to these interests had been stripped off and placed into a trust fund. Upon petitioner's subsequent transfer of these interests, petitioner claimed, inter alia, an ordinary business expense deduction of approximately $21 million.

In holding that the transactions lacked economic substance, the court noted that "no credible business purpose and . . . no viable economic substance existed" for petitioner's transfer of the lease interests. Further, the court noted that the prearranged transactions leading up to petitioner's acquisition of the purported interests created a circular flow of funds. In imposing the accuracy related penalty, the Court held that the participation of highly paid professionals did not provide petitioner any protection, excuse, justification, or immunity.

In Nicole Rose v. Commissioner, 254 F.3d 1313, (2d Cir. 2002) (per curiam) aff'g 117 T.C. 328 (2001), the Second Circuit found that the relevant inquiry was "whether the transaction that generated the claimed deductions – the lease transfer – had economic substance." In upholding the Tax Court's determination that the lease transfer did not have economic substance, the Second Circuit found that because the funds were controlled by, and were for the benefit of, a third participant, and because the equipment sublease was immediately leased back, the taxpayer did not have a "significant interest" in the fund or the equipment. Nor did the taxpayer attempt to obtain information on the value of the assets transferred. Accordingly, the Second Circuit upheld the Tax Court's determination that the transaction lacked economic substance.

Although this is one of the Service's strongest theories, there may be instances where the Appeals Officer finds that the alternative position is the stronger. If that occurs, it is recommended that the case settlement reflect the merits of the alternative argument.

In evaluating the merits of a particular lease stripping transaction, it is important to understand the flow of the transactions and monies, including those that occurred both prior to the taxpayer's investment and subsequent to the tax years at issue. Recent court decisions provide support that the courts will look beyond the form of the transactions, including steps that were entered into prior to the taxpayer's investment, to ascertain the true intent (substance) of the transactions. In this regard, the more facts that can be developed that show the relationships between the parties and the prearrangements between them, the more likely the victory for the Service.

In formulating a lease stripping case settlement, it is important to consider all of the facts and circumstances. The burden is upon the taxpayer to provide the answers. Some of the questions that should be answered include the following. What is the motivation behind the transaction? Would the taxpayer have invested in the transaction if it were not for the tax benefits? What was actually being purchased, a tax-product or an investment with a tax by-product? Could the taxpayer have acquired the same lease position without the tax-indifferent parties? Do the tax-indifferent parties add anything of substance to the transaction other than absorbing taxable income? Were the residual values reasonable in light of the information available at the time the taxpayer entered the investment? What steps did the taxpayer take to investigate the activity and were those steps different from those taken with respect to non-tax motivated transactions engaged in by the company? Were there any side agreements?

The factual development of the case is crucial in formulating a settlement. Driving facts will include: whether the transactions could reasonably be expected to be tax neutral over the life expectancy; whether there was an artificial bifurcation of the gain leg from the loss leg; whether income was artificially accelerated to a tax neutral participant; timing of the tax neutral participants' exit from the transaction; US taxpayer's lack of risk of economic loss and inability to earn an economic profit (without tax benefits), insignificant profit in comparison to risk-free investments; emphasis upon the tax benefits in comparison to economic gains, lack of independent inquiry into the profit potential (i.e. appraisals, financial forecasts, etc.), circular cash flow, etc.

Taxpayers will assert that their motivation for entering the transaction was to earn a profit from re-leasing the property at the end of the initial user lease and disposition of the property (residuals). Often they assert that they were looking to diversify their investments by expanding into the leasing business. To support the position that they exercised due diligence in evaluating the activity they will most likely supply an appraisal by a nationally recognized appraisal company. This may or may not be accompanied by an opinion or review by another appraisal firm or leading consulting firm. There may very well be an opinion by a well-recognized accounting and/or law firm. They may also assert that their in-house experts evaluated the values. One must look to the reliability of the appraisal, acceptability of methodology utilized, the scope of subsequent appraisal opinions and the scope of the engagement by outside accountants and attorneys.

In lease stripping transactions it is important to consider whether or not it was realistic for the investor to derive an economic benefit (without the tax benefits) by the time the wrap leases expire, notes are paid off, and remarketing fees disbursed. This is especially true if the initial values are overstated, excessive remarketing fees are in place, equipment had been on the market for a few years prior to the lease stripping transactions, or when the projected residual values exceed the industry norms. Careful attention must be given to the reliability of the projections that were prepared to support the profit potential. This is especially true when the investor fails to make an independent inquiry into the residual

values attested to in an appraisal furnished by the seller. Caution should be exercised when evaluating an opinion of an appraisal, which is distinguishable from a bona fide independent appraisal, because the opinion may be a cursory review.

Although the appraisal and forecasts will suggest a profit potential, lease stripping activities typically do not generate an economic profit (exclusive of tax benefits) because the projected residual values are overstated. However, once the tax benefits are factored in, the taxpayer's post-tax economic gain surpasses their cash investment. This is true even when the investment residuals turn out to be zero.

In situations where computers are involved, taxpayers will often argue that the actual residual values were the result of an unexpected turn in the market for used computers. While these arguments may have been persuasive during the early 80's, the computer markets of the late 80's and 90's have been fairly predictable. Decline in value is typically not the result of an unexpected downturn but rather, the normal life cycle of technology. It should be noted that with respect to the computer leasing activities, regardless of the year of investment, make and model of equipment, and term of the leases, these activities have not performed as predicted by the appraisals secured by the promoters. In the typical lease stripping case, residuals have not been sufficient to return the taxpayer's initial investment. Because the financing is often non-recourse, no further investment is required. In most instances, short of the initial cash investment, these activities do not carry risk or significant opportunity to make a profit.

Taxpayers will undoubtedly argue that this is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities that was not shaped solely by tax avoidance motives. Therefore, it is important that the examiner fully develop the case to determine whether the taxpayer can support its position through documentation or other evidence. The examiner's full development of the facts supporting the economic substance argument will reduce the Service's hazards on this issue.

Although the Service has been fairly successful in tax shelter litigation, there have been several cases in which we have been unsuccessful. See, e.g., UPS of Am., 254 F.3d 1014 (11th Cir. 2001); IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001) and Compaq Computer Corp. v. Commissioner, supra. Those cases did not involve lease stripping transactions, however, and were decided before the Service's wins in Andantech, supra and Nicole Rose, supra.

In United Parcel Service of America, et al. v. Commissioner, T.C. Memo 1999-268, Judge Ruwe observed that, while there was minimal documentation of UPS's business purpose for forming its offshore reinsurance subsidiary, there was plenty of paperwork to establish that UPS was motivated by the reduction in US federal income tax by transferring the excess value income to the offshore subsidiary. Because the establishment of the subsidiary was motivated by tax avoidance, as opposed to business realities, the Tax Court found that it was a sham. This victory was short lived, however.

The Eleventh Circuit, reversing the Tax Court, was persuaded that the risk of loss had actually been shifted away from UPS to National Union, concluding that the transaction had real economic effect. Judge Cox reasoned that a transaction has business purpose when discussing a going concern as long as it figures in a bona fide profit seeking business. The Court noted that the UPS transaction simply altered the form of an existing bona fide business, thus neutralizing any tax avoidance motive. The Eleventh Circuit reversed and remanded the case back to the Tax Court for consideration of the alternative arguments couched under sections 482 and 845(a). This case is pending before the Tax Court.

In assessing the merits of lease stripping cases, one should consider whether the risk of loss has shifted to the taxpayer and whether the lease strip transaction is an integral part of an existing on-going business. This is especially true when an appeal lies within in the 11th Circuit. That is not to say that the 11th Circuit cannot be persuaded that a transaction lacks economic substance, as evidenced by the Winn-Dixie Stores, Inc. and Subsidiaries v. Commissioner, 254 F.3d 1313 (2001) decision sustaining the Tax Court's finding that the COLI transactions lacked economic substance. Incidentally, Winn-Dixie had been argued the same day as UPS, supra.

In ACM Partnership v. Commissioner, supra, the 3rd Circuit allowed a relatively small portion of the losses; those associated with the LIBOR notes that were distinctly separate from the transactions orchestrated by Colgate to take advantage of the section 453 regulations. The Court noted that these transactions alone were separable, economically substantive elements that gave rise to deductible interest deductions. These losses were distinct from the ratable basis recovery rule under section 453.

Lease stripping transactions typically do not involve transactions that are separable and economically substantive. Should such a transaction exist, in the context of a lease stripping transaction, one must evaluate the risks in litigation given the 3rd Circuit's decision. It should be stressed that ACM does not stand for the proposition that transaction costs associated with the shelter activity or any other investment amounts are deductible. In instances where the courts have found that a transaction lacks economic substance or is a sham in substance, no deductions have been allowed.

It should be emphasized that if the taxpayer chooses not to settle the issue, the Service will continue to argue that the taxpayer is not entitled to any deductions relative to the investment, inclusive of their cash investment, a/k/a transaction costs.

Settlement Guidelines

Assuming that the Service is able to establish facts similar to those set forth in the example provided in the CIP, the Service has a substantially stronger case than the taxpayer. Given the recent judicial climate with respect to tax shelters and especially lease stripping transactions, it is the taxpayer who is posed with significant hazards in litigation.

Based on the strength of the Service's position that the lease stripping activity is not to be respected for tax purposes and that the taxpayer is essentially paying for tax write-offs, generally the Service

. For administrative convenience, the allowable amount can be deducted in the initial year of the investment, or first open year if later, in which the taxpayer claimed deductions or losses from the lease stripping transaction. The amount otherwise allowable will be reduced (but not below zero) by the amount of the net deductions claimed and allowed in taxable years that are not open years. The factors enumerated in this ASG should be used in evaluating the hazards of litigation

.

. It should be emphasized that the taxpayer is still faced with significant hazards in litigation because of the pre-arrangement of the transactions,

bifurcation of gain/loss positions, and introduction of the tax neutral participant for purposes of absorbing the gain.

In some instances, it may also be more appropriate to settle the case on the basis of one of the alternative theories. After all, it is the strength of the overall case that should be reflected in the settlement.

The settlement should attempt to close out all potential years. *If the lease stripping transaction extends to years not yet filed, the Closing Agreement should cover the settlement for those years*. As such, Form 906 (Closing Agreement on Final Determination Covering Specific Matters) should be executed upon any intermediate settlement.

Since lease stripping is a coordinated issue, the ISP Coordinator for Leasing Promotions should be consulted prior to discussing a settlement position with the taxpayer.

b. Sham the Partnership/Partner

Some of the leases stripping transactions seen to date have exhibited factual evidence in support of this position. Often this issue will be raised in conjunction with sham/lack of economic substance argument and alternative theories. Note that the sham the partnership argument may result in the income being attributed to the taxpayer as well as the deductions, rather than just the disallowance of the deductions under the economic substance theory. This will result in a different adjustment.

The Examination CIP offers two scenarios for applying the partnership/partner sham argument to the example provided therein:

1. Participation of B and its partners (C tax neutral, 98% partner and other 2% investor, typically promoter/agent) has no business purpose independent of tax considerations and should be disregarded, thereby leaving a basic sale-leaseback transaction between D and A.

2. The nature of B's involvement in this transaction should be recharacterized as that of a broker or accommodation party, and thus the E consolidated group (rather than B) would be required to recognize the accelerated income arising from the sale of the rent stream to the bank.

With respect to scenario 1, the arguments raised under section (a) are equally applicable in the context of shamming a partnership/partner. Provided the issue is properly developed, the positioning of the issue in relation to 1a (i.e., primary v. alternative position) is not crucial. Further, this issue may be raised in conjunction with the benefit and burdens of ownership issue, thereby warranting further inquiry under the criteria addressed therein.

Much of the strength of this issue will come from the development of the relationships between the parties and ascertaining their true purpose for entering the transactions. As with the economic substance argument, the capital investment and risk of the parties warrants evaluation, as does the potential for profit. In order for a valid partnership to exist for federal income tax purposes, the parties must establish that they intended to join together to share in profits and losses of an enterprise. Evidence supporting the tax-neutral participant's entry into the transaction for the sole purpose of receiving a fee in return for utilization of temporary usage of its tax neutral status provides strong proof that the partnership is invalid.

In instances where shamming the partnership/partner is viewed as a stronger position than the economic substance (1a.) argument, it may be appropriate to settle the case by eliminating the straw participant (in CIP example, B) thereby leaving a sale-leaseback transaction between the original lessor/seller and the taxpayer.

With respect to scenario 2, often the lease income has already been stripped from the activity prior to the shelter investor entering into contracts or even having been identified as the participant for that particular equipment, making it difficult to assert an agency relationship. For this reason, the Service is faced with greater hazards in litigation under the latter scenario. However, if the issue is raised in conjunction with substance v. form or the step transaction doctrine, the Service's position is strengthened.

The settlement of this issue should be reflective of the Service's ability to persuade a trier of fact of the underlying substance of the transactions. Crucial evidence will include pinpointing the relationships and agreements between parties to establish that the initial partnership/partner was put in place to act as an agent on behalf of the ultimate shelter purchaser.

The ISP coordinator for Corporate Tax Shelters – Leasing Promotions should be contacted before discussing the settlement with the taxpayer. Also, if the resolution of this issue impacts other years, a Form 906 Closing Agreement should be secured to effect the settlement.

c. Step Transaction

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. In Andantech, the Tax Court disallowed deductions from petitioner's involvement in a lease stripping transaction. The court stated that, "Andantech acted as a mere shell or conduit to strip the income from the transaction and avoid income taxation and, under the step transaction doctrine, should be disregarded".

In lease stripping deals, the Service must look at each step to determine whether each was undertaken for a valid business purpose and not merely to avoid income taxes. Applying the step transaction doctrine to the example provided in the CIP, Exam proposes the following. In this transaction, the nature of B and C's involvement may support the conclusion that steps involving B and C should be eliminated from the transaction. In this event, D could be required to recognize the accelerated income arising from the purported sale of the rent stream to the bank. Therefore, through the consolidated return, E would recognize the income, and thereby match the income with the deductions. Depending upon the facts, alternative steps may be collapsed to cause the deductions to be allocable to the tax neutral participant.

The question then is whether the transitory steps added anything of substance, or were nothing more that intermediate devices used to enable the taxpayer to acquire the property stripped of its future income and provide rental expense deductions, which can be used to offset other income. Much of the success of this argument will rest with the weight of the evidence supporting a preconceived plan. If it can be established that the parties intended from the onset to orchestrate a shelter whereby one tax neutral participant recognizes the income and the other, tax shelter investor, recognizes the tax attributes, a step transaction argument has merit. The weight of the merit of the issue is highly dependent upon the Service's ability to establish one of the three tests: binding commitment, end result or

interdependence test.

Under the binding commitment test, if there is even a fleeting moment where the parties were not under a binding obligation to undertake the later steps, the steps cannot be integrated. Intent of the parties is irrelevant under this test. Because of the sophistication of the plan participants, it is highly unlikely that the evidence can support a binding commitment argument. In contrast, the end result and interdependence test may prove fruitful.

Under the end-result test, if a series of formally separate steps are prearranged parts of a single transaction intended from the outset to achieve a final result, the transactions will be combined together. Key is establishing the intent of the parties. Documentation and testimony depicting the activities of the parties from the commencement of the initial step through the entry of the investor is extremely helpful in supporting this theory. Analysis of the sales and leasebacks that occur on or near the same day, consideration of side-agreements, and review of explicit promotional materials as well as other evidence supporting the parties understanding of the transactions, is equally important. Of the three tests, this is the one that is most suited for lease stripping transactions.

Under the interdependence test, consideration is given to whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without completing the series of transactions. Query whether the tax neutral entity would have entered the transaction without some sort of guarantee of their fees and limitation of their involvement. Would the end investor have participated if they had not been assured that the income had already been stripped from the deal prior to their entry? Consideration should be given to each of the parties' understanding of the transaction as a whole, as well as the individual components.

The step transaction doctrine issue works well in conjunction with the sham argument 1(a) and shamming of the partnership/partner issue in 1(b). However, it is not necessary that the Service assert both. In Packard v. Commissioner, 85 T.C. 397 (1985), the court applied the step transaction doctrine even though the court did not find the cattle feeding venture to be a sham.

Unlike the shamming argument, there is no need to question whether a valid partnership existed. Under the step transaction doctrine, a partnership may very well exist, but the transactions engaged in may be collapsed, leaving the transaction between the original lessor and the investor. It is for this reason that the step transaction doctrine is a viable alternative to issue1 (b).

In light of the Supreme Court's decision in Schlude v. Commissioner, 372 U.S. 128 (1963), requiring accrual basis taxpayers to recognize income when payment is received, as opposed to when due, the step transaction doctrine may be the appropriate avenue to reallocate the income from the functionally tax neutral participant to the U.S. taxpayer entity.

This is a fact intensive issue. Assuming that the Service has fully developed the case, inclusive of supporting evidence reflecting the transitory nature of accommodating parties to support a finding that a step/steps should be collapsed, the Service would have a reasonable position in litigation. The strength of the evidence to support the prearrangement for the purpose of generating tax losses would also be an important factor in considering the relative hazards in litigation. Typically this issue is seen as presenting greater hazards to the Service than the economic substance and shamming of the partnership/partner argument.

It should be emphasized that if the Service recasts the transactions into the same number of steps as the form of the transactions, or causes new steps to be introduced, the Service's position will be substantially weakened. See Esmark Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 88 F.2d 1318 (7th Cir. 1989) and Tracinda Corp. v. Commissioner, 111 T.C. 315 (1998). In situations where the case cannot be made to collapse and thereby reduce the number of steps, Chief Counsel has advised examiners to abandon the issue altogether.

If the issue is raised in conjunction with other positions, the settlement should reflect the merits of the strongest position advanced, and the ISP Coordinator – Leasing Promotions should be contacted before discussing the settlement with the taxpayer. Also, if the resolution of this issue impacts other years, a Form 906 Closing Agreement should be secured to effect the settlement.

2. Section 351

As set forth in the Examination CIP, the arguments contained in the section 351 argument assume that the existence of B could not be ignored under one of the sham transaction theories.

In the example provided in the CIP, the Service proposes the following. The purported section 351 transaction would not be respected; instead, a taxable event would have occurred. D would still recognize no gain or loss on the transaction under section 1032; however, D would determine its basis in the property it receives under section 1012. Under Treas. Reg. § 1.1012-1(a), D takes a basis in the equipment equal to the fair market value of the stock D distributes in the exchange. The fair market value of the preferred stock D distributes in the exchange is typically less than B's basis in the equipment. Consequently, D and, through the consolidated return, E, would not be able to take depreciation deductions in the claimed amounts. Depreciation deductions would instead be calculated based on D's section 1012 basis in the equipment. As a taxable exchange under section 1001, B would recognize gain or loss on the exchange and determine its basis in the D preferred stock it receives under section 1012. The contribution of capital that E made to D would be respected. The transactions that followed would be treated as if D purchased the leased asset for its fair market value that is equal to the value of the preferred stock given to B in the exchange.

The Service's general rule for issuance of advance rulings is that property is not of relatively small value for purposes of Treas. Reg. §1.351-(a)(1)(ii) if the fair market value of the property transferred is worth 10% or more of the fair market value of the stock already owned by the transferor. Rev. Proc. 77-37, 1977-2 C.B. 568, 570. Taxpayers will assert that, provided they meet the 10% test, section 351 will apply. Note that this is the Service's test for ruling on the matter, it does not equate to a safe harbor provision for taxpayers.

Bearing in mind that section 351 is congressionally mandated and that the section 351 argument has not been tested in the context of tax shelters, there is particular uncertainty as to how the issue will be viewed by the courts. Judicial authority imposing a business purpose on section 351 transactions is limited. Further, it appears that the business purpose requirement under section 351 may be relatively easy to meet.

Given the broad latitude that taxpayers are given in conducting their affairs, the arguments and evidence would have to convince a judge that the taxpayer was acting outside the box intended by Congress. For this reason, the development that is required with respect to

Issue 1 a – c is equally pertinent to this issue. The success of this issue will be predicated upon the development of the facts supporting the lack of business purpose.

Although the transaction may present a viable argument for disqualification under section 351 by virtue of the business purpose requirement, the courts have not exhibited a tendency to require a strong showing in order to establish the section 351 business purpose requirement. See Caruth, supra. Consequently, unless the examiner has furnished strong persuasive evidence of a lack of business purpose, the issue presents greater hazards to the government than those posed in the previously discussed theories. If the issue is raised in conjunction with other positions, the settlement should reflect the merits of the strongest position advanced.

The ISP Coordinator-Leasing Promotions should be contacted before discussing the settlement with the taxpayer. Also, if the resolution of this issue impacts other years, a Form 906 Closing Agreement should be secured to effect the settlement.

3. Benefits and Burdens of Ownership - Sale v. Financing

The Examination CIP offers one scenario, though others are feasible. Assuming the facts indicate that the transaction between A and B was a financing and not a sale, then the partnership, B, would not be the owner of the equipment, and thus could not transfer the equipment along with depreciation or other related deductions to D for the benefit of the E consolidated group.

This scenario assumes that B is in a position to finance A's transactions. However, the facts indicate that A already owns the depreciable equipment subject to pre-existing user leases. As such, the equipment has already been financed or purchased outright by A. Conversely, B, a thinly capitalized partnership, would not have been in the position to finance A's activities. Under the facts presented in the CIP example, the Service is posed with significant litigating hazards in asserting that B is financing A's transactions.

Even if a sale-leaseback is not a sham, there may be a question of whether there was a sale for federal income tax purposes. Levy v. Commissioner, 91 T.C. 838, 859-62 (1988).The issue is whether the buyer of the equipment (B) acquired the benefits and burdens of ownership. This is a question of fact as evidenced by the written agreements read in light of the attendant facts and circumstances. See Levy, supra., Gefen v. Commissioner, 87 T.C. 1494; Falsetti v. Commissioner, 85 T.C. 348 and Estate of Thomas v. Commissioner, 84 T.C. 436 for factors. Because the ultimate resolution of this issue will rest with the substance of the transaction, these issues are often cited as alternatives or in conjunction with sham/economic substance arguments. For this reason, the reader is referred back to section 1 of the Settlement Guidelines.

Alternatively, although not explicitly raised in the CIP, the Service may argue that the accelerated future rental income, rent/lease stripping, was not a sale of the rent stream but rather a financing transaction. If the transaction were recast in this manner, B would not include the borrowed funds in gross income. United States v. Centennial Savings Bank FSB, 499 U.S. 573, 582 (1991), 1991-2 C.B. 30.

In general, federal income tax consequences are governed by the substance of the transaction. Gregory v. Helvering, supra. A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996). Generally, courts examine a number of factors to determine whether a transaction is a sale or something else, such as a financing or a

lease. Levy v. Commissioner, supra; Larsen v. Commissioner, 89 T.C. 1229, 1266-68 (1987); Casebeer v. Commissioner, supra; and Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981) (establishing eight factors).

Where the assignment involves the right to receive future income in exchange for consideration, the courts have generally focused on the risk of loss and treated a transaction as a sale when the assignee bears the risk that the anticipated income will not be paid, or where the assignment involves the right to receive future income in exchange for consideration. Estate of Stranahan v. Commissioner, 472 F.2d 867, 870-71 (6th Cir. 1973); Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1437 (1986), acq. in result in part, 1990-2 C.B. 1. Conversely, when the assignee is certain that it will be fully repaid, that certainty is characteristic of a loan. Mapco Inc. v. United States, 556 F.2d 1107, 1110 (Ct.Cl. 1977). An assignment will be considered a loan when the assignee receives a security interest in the property generating the income and the assignor guaranteed that the income would be paid. Watts Copy Systems v. Commissioner, T.C. Memo 1994-124.

To establish that an assignment is a secured financing, the Examiner would need to establish that the assignee received a security interest in the leased equipment, the assignor expressly guaranteed the payment of the future income; or the assignor implicitly guaranteed the payment of the future income. Watts Copy Systems, Inc., supra. An implicit guarantee can be found where the assignor agrees to repurchase a lease in default or where the assignor provided the assignee with indirect collateral. See Mapco Inc., supra wherein the court concluded that certificates of deposits issued by a bank and held by the taxpayer were indirect guarantees intended to protect the bank against default even though the taxpayer was not personally liable to the bank for the borrower's loan. Hydrometals, Inc. v. Commissioner, T.C. Memo 1972-254, aff'd 485 F.2d 1236 (5th Cir. 1973).

Unless the Examiner has shown that the assignor expressly or implicitly guaranteed the payment of the future income or that the assignee received a security interest in the leased equipment, it will be very difficult for the Service to prevail in litigation. However, if the facts are fully developed to support the argument that such protection exists for the assignee, then the government's case has merit. In most instances, this argument will be raised in conjunction with one of the positions in section 1 and should be settled in accordance with the strongest arguments.

The ISP Coordinator-Leasing Promotions should be contacted before discussing the settlement with the taxpayer. Also, if the resolution of this issue impacts other years, a Form 906 Closing Agreement should be secured to effect the settlement.

END OF DOCUMENT