APPEALS

INDUSTRY SPECIALTY PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY:	**Leasing Promotions**
ISSUE:	**Losses Reported From Inflated Basis Assets From Lease Stripping Transactions**
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SETTLEMENT GUIDELINES
LOSSES REPORTED FROM INFLATED BASIS ASSETS
FROM LEASE STRIPPING TRANSACTIONS
UIL 9226.01-00

STATEMENT OF THE ISSUE

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

COMPLIANCE POSITION

The theories upon which the Service might successfully 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; 269; and the Partnership Anti-Abuse Rule found in section 1.701-2(a)-(d) of the Income Tax Regulations.

On December 3, 2001 the Compliance Industry Specialization Program Coordinated Issue Paper on Losses Reported From Inflated Basis Assets From Lease Stripping Transactions was approved. Therein the following theories are discussed:

A. Sham/Lack of Economic Substance Theories

B1. Reduction of Stock Basis
- a. Section 358(d)(1)
- b. Section 357(b)(1)(B)
- c. Section 358(h)

2. Section 351 Lack of Business Purpose
3. Section 269 Acquisitions
4. Treasury Regulation § 1.701-2
5. Section 482 Reallocation

C1. Section 6662 Accuracy-Related Penalty
2. Section 6663 Fraud Penalty
3. Section 6664(c)(1) Reasonable Cause Exception

Appeals Officers, Team Case Leaders, and Team Managers should consult with the Appeals ISP Coordinator, Corporate Tax Shelters-Leasing Promotions, with respect to such alternative positions.

BACKGROUND

Inflated basis transactions are transactions in which assets with bases that exceed their fair market values are created in conjunction with lease stripping transactions. (An earlier Compliance Coordinated Issue Paper (CIP), effective July 21, 2000, addresses the abuses in lease stripping transactions. See also Appeals Settlement Guidelines (ASG), Lease Stripping Transactions, effective May 21, 2003). The inflated basis assets are then transferred to entities that utilize the built-in losses from the assets to reduce their taxable income.

The ability of the Service to disallow the tax attributes associated with inflated basis transactions is dependent on the facts and circumstances of each case.

EXAMPLE INFLATED BASIS TRANSACTION

A, a corporation, owns depreciable equipment subject to a pre-existing user lease with a 4-year term. B, a partnership, purchases the equipment from A in exchange for a $100x note; B immediately leases the equipment back to A for a term of four years and total lease payments due of $99x. B then sells the property (subject to the user leases) to I, another corporation, in exchange for I's $100x note; I immediately leases the property back to B for a term of four years and total lease payments due of $99x. The residual value of the property is minimal or zero.

B then sells its right to receive the rent payments from A, accelerating the income due under the lease. B uses the sale proceeds to satisfy its note to A. B allocates 99% of the income to C, its 99% majority partner. C is not subject to United States taxation.

Next, B transfers its I note to D, a corporation, in exchange for D preferred stock and D's assumption of B's liability to make lease payments to I. D's parent, E, makes a simultaneous transfer of property to D as a party to the purported section 351 transaction. B takes the position that this exchange qualifies as a section 351 exchange and that its basis in the D preferred stock is equal to its basis in the I note ($100x), unreduced by the amount of the liability assumed by D.

Thereafter, B transfers its D preferred stock to F, in exchange for F preferred stock. F's parent, G, makes a simultaneous transfer of property to F as a party to the purported section 351 transaction. The fair market value of the F preferred stock received by B is $1x. The parties take the position the transaction qualifies as a section 351 exchange with the result that F's basis in the D preferred stock is the same as B's basis in the D preferred stock ($100x). F then sells the D preferred stock to H for its fair market value ($1x), claiming a $99x loss. The sale to H is prearranged when B transfers its D preferred stock to F. H is acting as an accommodation party.

TAXPAYER'S POSITION

Taxpayers assert that the basis results from bona fide third party indebtedness and unrelated end uses. 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 inflated basis cases is highly dependent upon the facts and circumstances. The following is a discussion of the legal theories advanced by the Service in response to losses and deductions reported from assets with inflated bases traceable to lease stripping transactions.

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).

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; 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 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." ACM Partnership, T.C. Memo. 1997-115, aff'd. 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. See Knetsch, supra. 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). 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.

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 D preferred stock lacked economic substance, B's basis in the D preferred stock is limited to the value of the property B contributed in exchange for that stock. As a result, B would have minimal or zero basis in the D preferred stock for F to assume under Internal Revenue Code section 362.

Moreover, because F had no business purpose for acquiring and selling the stock of D, 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 CIP 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.

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

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. 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).

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 pay rent to I in accordance with the terms of the lease. A straightforward application of section 358(d)(1) requires that the basis of the D stock received by B be reduced by the amount (measured by its value) of the assumed liability.

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 D's payment of B's rental liability to I is not a deductible expense to D. Accordingly, the basis of the stock is reduced by a straight-forward application of section 358(d)(1).

For further discussion of this argument, or the application of this argument to the fact pattern used in the Compliance Coordinated Issue Paper (CIP), contact the Appeals ISP Coordinator, Corporate Tax Shelters-Leasing Promotions.

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 D's assumption of B's liability to make rental payments to I is to enable taxpayers to report noneconomic tax deductions through either rent deductions or inflated basis stock. 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 make rental payments 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 D preferred stock is thus reduced by the value of the liability to make rental payments assumed by D.

For further discussion of this argument, or the application of this argument to the fact pattern used in the CIP, contact the Appeals ISP Coordinator, Corporate Tax Shelters Leasing Promotions.

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. 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.

Under section 358(h), B's basis in the preferred stock of D would be reduced (but not below fair market value) 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 carry over 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.

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

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 of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation. Sections 351(a) and 368(c). The 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 and the primary purpose of the transfer by that transferor was to qualify other transferors for section 351 treatment. See Treas. Reg. § 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. The transferee corporation does not recognize any gain or loss on the transaction. See section 1032. However, both the transferor and the transferee (B and D in the first purported 351 transaction and B and F in the second purported 351 transaction) have a cost basis in the property received determined in accordance with the provisions of section 1012 and the regulations thereunder. Accordingly, B does not acquire the D stock with an inflated basis. See Treas. Reg. § 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, it would be treated as a taxable exchange under section 1001, providing F with a fair market value basis in its D preferred stock.

3. SECTION 269

Section 269(a) provides that, if

(1) any person or persons acquire, directly or indirectly, control of a corporation, 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 which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

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 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. Treas. Reg. § 1.269-3(c)(1).

In the fact pattern presented here, the primary purpose is to create noneconomic tax deductions through either rent deductions or inflated basis stock. Even if a particular taxpayer asserts a business purpose, the Service believes 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.[1] Where all the requirements of either section are satisfied, section 269 should be asserted to disallow any loss claimed from the sale of the stock.

4. 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. B then sells its J 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. Treas. Reg. § 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 shift in loss allocations is accomplished by K's purchase of B's partnership interest in J before J sells the D preferred stock. After the sale, under Treas. Reg. § 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

[1] Note that in our fact pattern, where B is a partnership, section 269(a)(2) is inapplicable. However, in the event the entity acting in B's capacity is a corporation, section 269(a)(2) may apply if the transaction satisfies all the other requirements of that code section.

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. Treas. Reg. § 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 use of a partnership, lacking a § 754 election, 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 Treas. Reg. § 1.701-2. Compare, Treas. Reg. § 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. That is, PRS was a bona fide partnership, the liquidating distribution a bona fide transaction, and the ultimate tax results clearly contemplated by Section 754. For these reasons the transaction is treated as satisfying the proper reflection of income standard and will be respected.

Here, B's contribution of the D preferred stock to J partnership and the sale of B's interest in J partnership to K were part of a plan to duplicate losses through the absence of a section 754 election. B contributed high basis, low fair market value D preferred stock to J partnership in exchange for an interest in J. B then sold its J partnership interest to K and presumably recognized a tax loss. Since J did not make an election under section 754, J's adjusted basis in the D preferred stock remained high. Upon the sale of the D preferred stock, J partnership reports a loss, which is allocated to K. K uses the losses to offset other gains.

The transactions here are subject to recharacterization under Treas. Reg. § 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, K 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 partners' 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 J partnership, B would have sold the D preferred stock directly to K rather than contributing the D preferred stock to J 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 J partnership allowed K to claim capital losses, which it used to offset capital gains. Because B and K conducted the activities through J 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 partners' 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 J 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, the Service may conclude that the contribution by B of the D preferred stock to J partnership, and the subsequent sale of the J 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 J partnership.

C. APPLICABILITY OF PENALTIES

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. Treas. Reg. § 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% (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). 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 or intentional disregard of rules and regulations

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 Treas. Reg. § 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. 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. Treas. Reg. § 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 a 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. Treas. Reg. § 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. Treas. Reg. § 1.6662-3(b)(2).

Substantial understatement

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 any item of a taxpayer other than a corporation which is attributable to a tax shelter, 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 Treas. Reg. § 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. Treas. Reg. § 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.

Substantial valuation misstatement

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 claimed 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 claimed 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 the basis of an asset sold); Smith v. Commissioner, T.C. Memo. 1992-353 (holding that fraud existed with respect to a return on which taxpayer had overstated the basis of an 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 223-224.

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. Treas. Reg. § 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. 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. Treas. Reg. § 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 purpose) 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. Treas. Reg. § 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. Treas. Reg. § 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. <u>See</u> <u>Novinger v. Commissioner</u>, 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. <u>See</u> <u>Addington v. United States</u>, 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); <u>Freytag v. Commissioner</u>, 89 T.C. 849 (1987), <u>aff'd</u>, 904 F.2d 1011 (5^{th} 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); <u>Goldman v. Commissioner</u>, 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); <u>Collins v. Commissioner</u>, 857 F. 2d 1383 (9^{th} 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. Treas. Reg. § 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 <u>Neonatology Associates P.A. v. Commissioner</u>, 299 F.3d 221, <u>aff'd</u>, (3d Cir. 2002) 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. Treas. Reg. § 1.6664-4(e)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(e)(2)(i).

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

SETTLEMENT GUIDELINES

Each inflated basis case is unique and hence the issues raised may differ. Many of the arguments and points addressed herein, in particular in section A, may apply to alternative issues and transactions. For this reason it is recommended that the reader review the contents of each of the various theories and coordinate as appropriate with the Appeals ISP Coordinator, Corporate Tax Shelters-Leasing Promotions.

Any settlement should attempt to close out all potential years and preclude the filing of a refund claim. As such, Form 906 (Closing Agreement on Final Determination Covering Specific Matters) should be executed upon any settlement. The Appeals ISP Coordinator for Corporate Tax Shelters-Leasing Promotions should be consulted prior to discussing a settlement position with the taxpayer.

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 principles 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.

A. Primary Arguments

Sham/Lack of Economic Substance

Although the courts have yet to render a decision on the merits of inflated basis transactions, the courts have rendered decisions on lease stripping transactions. Inflated basis transactions are transactions in which assets with bases that exceed their fair market values are created in conjunction with lease stripping transactions. In Andantech v. Commissioner, T.C. Memo. 2002-97, aff'd in part and remanded in part, 331 F.3d 972 (D.C. Cir. 2003), 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 deductions because there was no true sale and the seller financing did not constitute bona fide debt.

On appeal, the D.C. Circuit agreed that the parties never intended to join together as partners to run a business and that the partnership had no legitimate non-tax purpose. See Andantech, 331 F.3d 972 (D.C. Cir. 2003). As a result, it affirmed the Tax Court's holding that the Andantech partnership should be disregarded for tax purposes and remanded the other issues for further proceedings consistent with its opinion.

In Nicole Rose Corp. v. Commissioner, 117 T.C. No. 27 (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 into that corporation. 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 liabilities 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 Tax 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.

Moreover, the courts have provided a wealth of insight into transactions that are structured to produce results that are not intended by Congress. In those instances where the evidence establishes such orchestration, the courts have found for the Commissioner. Based upon the facts and circumstances exhibited to date, there is strong support for the Service's position that inflated basis transactions are abuses that Congress had not intended. When coupled with the fact that inflated basis transactions, taken as a whole, have no business purpose independent of tax considerations and lack economic substance, the Service is posed with limited hazards in litigation. Although this is one of the Service's strongest theories, there may be instances where the Appeals Officer finds that an alternative position is 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 inflated basis 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 such as <u>Andantech</u> and <u>Nicole Rose</u>, <u>supra</u>, indicate 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 an inflated basis 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? Did tracing it back to a lease stripping transaction derive the basis of the asset? Is the lease stripping transaction under audit or has it been settled? 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 are transactions in which assets with bases that exceed their fair market values are created in conjunction with lease stripping transactions; and whether the inflated basis assets (preferred stock) are then transferred to entities that utilize the built-in losses from the assets to reduce their taxable income. Under these circumstances the courts would find that the transactions have no business purpose and lack economic substance. See supra Nicole Rose; Andantech.

Although the Service has been successful in litigating lease stripping cases, in other tax shelter areas it has experienced recent setbacks. United Parcel Service of America, 254 F.3d 1014 (11th Cir. 2001); IES Industries, 253 F.3d 350 (8th Cir. 2001); Compaq v. Commissioner, 277 F.3d 778 (5th Cir. 2002). Lease stripping transactions are distinguishable from the offshore reinsurance structure in UPS and the ADR foreign tax credit issue in IES and Compaq.

In United Parcel Service of America, et al. v. Commissioner, T.C. Memo.1999-268, the Tax Court 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 U.S. 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, however, was short-lived.

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. The majority reasoned that a transaction has business purpose 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).

In ACM Partnership v. Commissioner, supra, the Third 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 expense. These losses were distinct from the ratable basis recovery rule under section 453.

Inflated basis transactions typically do not involve transactions that are separable and economically substantive. Should such a transaction exist, one must evaluate the risks in litigation given the Third 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, 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.

<u>Settlement Guidelines</u>

Assuming that the Service is able to establish facts similar to those set forth in the examples addressed in this ASG or in the CIP, the Service has a substantially stronger case than the taxpayer. Given the recent judicial climate with respect to tax shelters, it is the taxpayer who is posed with significant hazards in litigation.

Based on the strength of the Service's position that inflated basis assets originating
from lease stripping transactions are not to be respected for tax purposes, #
#
. Appeals concession applies to the aggregate of #
the taxpayer's claimed losses from the inflated basis transaction including open and
closed years. Typically, #
#
. The presumption is that the bases from the #
original lease stripping transaction are not correct. Therefore, this would be sufficient
evidence to support the Service's position on the issue #
#
. The strength of the case development #
will dictate the appropriate percentage of the claimed losses allowed for settlement purposes. It should be emphasized that the taxpayer is faced with significant hazards in litigation because of the pre-arrangement of the transactions and bifurcation of the gain/loss positions that gave rise to the inflated basis asset.

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.

Step Transaction:

The CIP did not address the step transaction doctrine but because the Tax Court has applied the step transaction doctrine even when it did not find a sham transaction, this doctrine should be considered in addition to the economic substance argument. <u>See Packard v. Commissioner</u>, 85 T.C. 397, 419(1985).

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. <u>Andantech</u>, <u>supra</u>; <u>Penrod v. Commissioner</u>, 88 T.C. 1415, 1428 (1987). 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. <u>Greene v.</u>

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).

Inflated basis transactions lend themselves to being collapsed. The question is whether the transitory steps added anything of substance or were nothing more than intermediate devices whereby inflated basis assets are transferred to entities that utilize the built-in losses from the assets to reduce their taxable 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. This test is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny. Because the transaction in the present scenario does not span over a long period of time or involve a binding commitment to pursue successive steps, the binding commitment test is not applicable.

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. 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 original lease stripping transaction, consideration of side agreements, and review of explicit promotional materials as well as other evidence supporting the parties' understanding of the transaction is equally important. The intended result from the outset is to use inflated basis assets, which are created in conjunction with a lease stripping transaction, and then transfer the inflated basis assets to entities that can utilize the built in losses from the assets to reduce their taxable income.

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 applying the step transaction doctrine to the example addressed in this ASG, it may be possible to eliminate certain transitory steps that serve no valid non-tax business purpose. The Andantech Court applied this doctrine to disregard the participation of certain partners in the transaction before the Court. Note that Andantech involved a section 351 transaction in which an interest in a partnership holding the underlying equipment (as opposed to a rental liability) was transferred. Where the step transaction doctrine would be asserted in a case involving a rental liability transferred in a section 351 transaction, the Appeals ISP Coordinator for Corporate Tax Shelters – Leasing Promotions should be consulted prior to discussing a settlement position with the taxpayer.

B. SECONDARY ARGUMENTS

As in the CIP, the theories contained in the remainder of the paper assume that neither the lease stripping transaction 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 away from the taxpayer under audit to other parties to the transaction.

1. Reduction of stock basis due to assumption of transferor's liabilities

The reduction of stock basis due to the assumption of transferor's liabilities pursuant to either section 358(d)(1), section 357(b)(1)(B) or (in the case of transactions on or after October 18, 1999) section 358(h) is addressed above regarding a specific form of transaction in which a lease strip is used to create an inflated basis asset. In a case involving an asset with an inflated basis obtained from a transfer of equipment subject to an obligation to provide the use of the equipment, such as the transfer from B to D in the lease stripping transaction described in the December 3, 2001 Losses from Inflated Basis Assets from Lease Stripping Transactions Coordinated Issue Paper, contact the Appeals ISP Coordinator for Corporate Tax Shelters-Leasing Promotions for guidance.

2. Section 351

As in the Compliance CIP, the arguments contained in the 351 Section above assume that the existence of the transferee corporation could not be ignored under one of the sham transaction theories.

If, upon analyzing the purported section 351 exchanges, it is determined that any exchange fails to qualify as a section 351 exchange, that exchange is a taxable transaction subject to section 1001. In that case, the tax consequences are as follows. The transferors recognize gain or loss at the time of the exchange. The transferee corporation does not recognize any gain or loss on the transaction. See section 1032. However, both the transferor and the transferee, (B and D in the first purported section 351 transaction; B and F in the second such transaction) have a cost basis in the property received in accordance with the provisions of section 1012 and the regulations thereunder. See Treas. Reg. § 1.1012-1(a), which provides that such property will take a basis equal to the fair market value of the property exchanged. Accordingly, the transferee would not assume the transferor's basis.

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.

As was stated in the discussion section of this document, section 351 has both business purpose and technical requirements. In contrast to the technical requirements, judicial authority imposing a business purpose requirement 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 the sham/lack of economic substance theories 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.

3. SECTION 269

The CIP notes that 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. Section 269(a)(1) does not apply to a loss claimed on the sale of the preferred stock unless the transferor acquired control of the transferee in the acquisition of the preferred stock. Thus, the transferee corporation will need to be a newly formed corporation, or a corporation not previously controlled by any transferor, in order for section 269(a)(1) to apply. Additionally, section 269(a)(2) does not apply to a loss claimed by F on the sale of the D preferred stock unless the entity transferring such stock (B in our fact pattern) is a corporation.

4. Alternate Transaction: Transfer to Partnership – Reg. § 1.701-2

a. Application of the Anti-Abuse Rule, in General

On June 19, 1995, the Subchapter K Anti-Abuse Rule Regulation Section 1.701-2 Coordinated Issue Paper was approved. The related Appeals Settlement Guideline (ASG) was issued September 23, 1998. Both documents consider, in general, the application of Subchapter K Anti-Abuse Rule section 1.701-2 ("the partnership anti-abuse rule").

The Losses Reported from Inflated Basis Assets from Lease Stripping Transactions Coordinated Issue Paper discusses the application of the partnership anti-abuse rule to a specific fact pattern, i.e., the fact pattern involved in the partnership variation of the lease stripping transaction. Likewise, this ASG will discuss the application of the partnership anti-abuse rule to the specific facts in the partnership variation of the lease stripping transaction.

The discussion of the specific application of the partnership anti-abuse rule in this ASG should be read in conjunction with the discussion of the general application of the partnership anti-abuse rule in the ASG covering Subchapter K Anti-Abuse Rule section 1.701-2.

b. Field Coordination with the National Office

The Subchapter K Anti-Abuse Rule Regulation Section 1.701-2 Coordinated Issue Paper requires that the application of the partnership anti-abuse rule be coordinated with both a Partnership Technical Advisor[2] and with the National Office.

The Losses Reported from Inflated Basis Assets from Lease Stripping Transactions Coordinated Issue Paper, approved December 3, 2001, requires Compliance personnel to coordinate with the Leasing (Promotions) Technical Advisor and with Chief Counsel.

Therefore, when applying the partnership anti-abuse rule to the partnership variation of the lease stripping transaction, Compliance personnel are required to coordinate with a Partnership Technical Advisor, the Leasing (Promotions) Technical Advisor, and Chief Counsel (National Office).

<u>Settlement Guidelines</u>

The administrative file should contain documentation that the issue has been properly coordinated prior to Appeals consideration of the application of the partnership anti-

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2 The Subchapter K Anti-Abuse Rule section 1.701-2 Coordinated Issue Paper refers to the Issue Specialist on the Partnership Industry Specialization Program team. Since the issuance of that Coordinated Issue Paper, the Internal Revenue Service has been reorganized. The comparable position after the reorganization is the Partnership Technical Advisor.

abuse rule.

c. Application of the Partnership Anti-Abuse Rule to the Specific Facts of the CIP

Taxpayers may take the position that, per sections 723 and 704(c) and Treas. Reg § 1.704-3(a)(7), the proper reporting of the partnership variation of the transaction is as follows:

1. B contributes D preferred stock to J Partnership. J Partnership takes a carryover basis in the D preferred stock. Since the basis of the D preferred stock exceeds its fair market value, the D preferred stock has a built-in loss that will be allocated to B upon disposition of the D preferred stock.

2. B sells its partnership interest to K, a party that can utilize the built-in losses to offset other gain. The built-in loss that had been allocated to B is now allocated to K.

3. J Partnership sells the D preferred stock. The loss is allocated to K.

The Service's position is that the partnership anti-abuse rule supports denying the losses reported by J Partnership from the sale of the D preferred stock.

Discussion

When a partner transfers property to a partnership in exchange for a partnership interest, neither the partnership nor the partner recognizes any gain or loss. Section 721. [3]

A partnership's basis in contributed property is equal to the contributing partner's basis in the asset immediately prior to the asset's transfer to the partnership. Section 723.

If the contributed property's basis is not equal to its fair market value, then the built-in gain or loss must be allocated to the contributing partner. Section 704(c).

If the contributing partner transfers its partnership interest, the built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Treas. Reg. § 1.704-3(a)(7).

The partnership anti-abuse rule, Treas. Reg. § 1.701-2(b), provides that if the principal purpose of a partnership transaction is to substantially reduce the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of

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3 The facts and legal analysis in the Coordinated Issue Paper assume that the partnership receiving the assets is not an investment partnership covered by Section 721(b). This ASG makes the same assumption.

subchapter K, then the Commissioner can recast the transaction to achieve tax results that are consistent with the intent of subchapter K.

Section 1.701-2(c) provides that 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. Under Treas. Reg. § 1.701-2(c) there are seven factors that may indicate that a partnership was used inconsistently with the intent of subchapter K. The presence or absence of any factor described in Treas. Reg. § 1.701-2(c) does not create a presumption that a partnership was (or was not) used in such a manner. Generally, the factors are:

1. The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's activities directly;

2. The present value of the partners' 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;

3. One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities, or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

4. Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

5. Partnership items are allocated in compliance with the literal language of Treas. Reg. §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations;

6. The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

7. The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related partner).

Section 1.701-2(d), Example 8, provides an example of a plan to duplicate losses through the absence of a section 754 election and concludes that this is a use of a partnership that is not consistent with the intent of subchapter K.

On these facts, the regulation holds that any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes. Accordingly, the transaction lacks a substantial business purpose. Also, PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K because:

1. The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets directly. Treas. Reg. § 1.701-2(c)(1).

2. The present value of the partners' aggregate federal tax liability is substantially less than if separate transactions that are designed to achieve a particular end result are treated as steps in a single transaction. Treas. Reg. § 1.701-2(c)(2).

3. Substantially all of the partners are related to one another. Treas. Reg. § 1.701-2(c)(4).

On these facts, PRS is not bona fide, and the transaction is not respected under applicable substance over form principles. Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss.

Therefore, under Treas. Reg. § 1.701-2(b) the Commissioner can recast the transaction to achieve tax results that are consistent with the intent of Subchapter K. But see, Treas. Reg. § 1.701-2(d), Example 9 (providing an example in which the lack of an election under section 754 is determined to be consistent with the intent of subchapter K).

Settlement Guidelines

The ability of the Service to recast transactions under the partnership anti-abuse rule is dependent on the facts and circumstances of each case. Development of the issue must be thorough and complete.

In order to recast a transaction under the partnership anti-abuse rule, a principal purpose of the transaction must have been to substantially reduce the present value of the partners' aggregate federal tax liability and this reduction must be inconsistent with the intent of subchapter K.

Compliance relies on Treas. Reg. § 1.701-2(b) for its authority to recast the transaction at issue. Whether a partnership was formed or availed of with a principle 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 the facts and circumstances. Section 1.701-2(c) lists various factors indicative of 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. The presence or absence of any factor described in Treas. Reg. § 1.701-2(c) does not create a presumption that a partnership was (or was not) used in such a manner.

The transactions here are subject to recharacterization under Treas. Reg. § 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, K 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 partners' 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 J partnership, B would have sold the D preferred stock directly to K rather than contributing the D preferred stock to J 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 J partnership allowed K to claim capital losses, which it used to offset capital gains. Because B and K conducted the activities through J 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 partners' aggregate federal tax liability is substantially less than would be the case if the purportedly separate transactions that were 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 J 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, the Service may conclude that the contribution by B of the D preferred stock to J partnership, and the subsequent sale of the J 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 J partnership.

It is very likely that a court would hold that a principal purpose for the transaction at issue was to substantially reduce the present value of the partners' aggregate federal tax liability. It is also highly likely that a court would hold that there is no substantial business purpose for the transaction because 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. Therefore, the Commissioner should be able to recast the transaction.

Taxpayers are expected to argue that the transaction at issue more closely resembles Treas. Reg. § 1.701-2(d) Example 9 than Treas. Reg. § 1.701-2(d) Example 8. However, as stated above, it is highly likely that the court will find that there is not a substantial business purpose for the transaction. Accordingly, without a substantial business purpose, the court should not find that the transaction is contemplated by section 754.

In summary, in order to recast a transaction under the partnership anti-abuse rule, (1) a principal purpose of the transaction must have been to substantially reduce the present value of the partners' aggregate federal tax liability and (2) this reduction must be inconsistent with the intent of subchapter K. Therefore, because it is likely that the government would be able to establish both of these factors, it is expected that a court would uphold the Commissioner's right to apply the anti-abuse rule to recast the transaction.

C. PENALTIES:

The Compliance CIP recommends assertion of the Accuracy Related Penalty under section 6662 or the Fraud Penalty under section 6663. Whether penalties apply to underpayments attributable to inflated basis transactions must be determined on a case-by-case basis based upon the application of the legal standard for the penalty (as set forth in the Discussion section of this guideline) to the specific facts and circumstances of each case.

The accuracy related penalty has been sustained in the tax shelter area. In Nicole Rose Corp. v. Commissioner, supra, petitioner relied on qualified advisors concerning an issue of first impression. The court rejected this argument finding that the scheme was so clear and obvious that the participation of professionals could not shelter petitioners from the penalties. Also, in Neonatology Associates P.A. v. Commissioner, supra, the court concluded that taxpayers could not prevail on a reliance-on-professional defense because they received advice only from Cohen, an insurance agent who stood to profit considerably from the participation of Neonatalogy. The individual taxpayers did not make a proper investigation or exercise due diligence to verify the program's tax legitimacy.

In determining whether a penalty applies the following factors are relevant: the sophistication of the taxpayer, whether the taxpayer obtained an outside opinion; the contents of any outside opinion; the timing of the receipt of the opinion in relation to the filing of the tax return; whether the opinion was given by an advisor connected with the promotion or promoter in contrast to the taxpayer's regular advisor; whether the promoter arranged for the opinion; the contents of the opinion; and any efforts to conceal the transaction, mislead the Service, or fail to cooperate in the examination of the transaction. If any of these factors are present then they should be considered in connection with the assertion or settlement of the penalty raised.