Office of Chief Counsel
Internal Revenue Service
memorandum

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EJLaubach;JLWahl

date: May 16, 2003

to:
Technical Advisor - Abusive Promotions
SBSE, Compliance Enforcement

from: Edward J. Laubach, Jr. and Julia L. Wahl
Senior Attorneys SB/SE

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subject: Request for Advice

re:
UIL: 167.15-00, 165.04-00

Years:

This memorandum responds to your request for advice dated April 3, 2003. This memorandum should not be cited as precedent.

ISSUES

1. Whether taxpayers are entitled to claim depreciation deductions on payphones they allegedly purchased from . during the years

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2. Whether the taxpayers are entitled to claim a theft or capital loss on their payphone investment.

CONCLUSIONS

1. Taxpayers cannot claim deprecation on the payphones since they did not acquire a depreciable interest in the payphones. All risk of loss concerning the payphones, including theft, casualty, damage, liability, repair, service, and maintenance, was placed on Payphones rather than the investors. Moreover, the investors did not have a risk of loss since they could return the payphones to the seller for their full purchase price. continued to possess the benefits and burdens of ownership of the payphones even after their sale.

2. We are still gathering the facts concerning the impact of the bankruptcy plan of reorganization on the investors. Unless the payphone was disposed of prior to , no loss would be recognizable before the taxable year .
More facts are needed to determine the type of loss allowable and when there was no longer a reasonable prospect of recovery.

FACTS

is a business corporation created in . The stock of was owned by , its founder and principal operating officer. is headquartered in . has wholly owned subsidiaries,

had branch offices located in

The major source of income for was the sale and leaseback of payphones to investors. began selling payphones to investors in late . had a strong need to acquire new payphone locations in order to pay the ever growing list of investors. Acquisitions of other payphone companies increased dramatically during

. By , was the in the United States operating some payphones.

entered into approximately payphone sale- leaseback contracts during the years . sold payphones to investors for a purchase price ranging from $ to $ per phone. An investor would receive a Telephone Equipment Lease Agreement, Equipment Schedule which allegedly identified the location and serial number of the payphones purchased, and an Option to Sell

Agreement. The lease agreement with was for years with an option to renew for years. The stated fixed monthly rental payment was $ per unit. Under the net lease, handled all aspects of the payphone's location, operation, collections, and maintenance. assumed the entire risk of loss for the payphone and had "sole and absolute control"[1] of the payphone. The investor merely received a monthly check for a fixed amount. In many cases, the profitability of the payphone was not even sufficient to cover its operating costs or the rental payment to the investor. The monthly income paid to investors was thus frequently paid from the proceeds of the sale of new payphones to investors by . Under the option agreement, investors could receive the return of their original investment after years or, during the years, a full refund could be obtained upon days advance notice to .

The continuing need to pay monthly checks to investors eventually exceeded the number of new investors which could be found. As a result, filed for Chapter bankruptcy in . Prior to the filing, was sustaining losses of $ per month. In addition, the SEC and state securities regulatory agencies in states had commenced proceedings against to enjoin the sale of the payphones as unregistered securities.

On

This decision did not address any tax issues involving payphone investments since only federal securities laws were in issue there. also had separate class action lawsuits brought against it by payphone investors alleging that and others engaged in fraud.

On , the bankruptcy court confirmed a plan of reorganization for . Under this plan, agreed to purchase the payphones from the investors and it would then own and operate the phones. The investors received shares of common stock in the reorganized and would receive a cash payment from the which was established to pool monies obtained from

[1]Paragraph of the telephone lease agreement with .

the various lawsuits pending against . Alternatively, the investors could elect to opt out of this treatment and reduce their claim to $1 which would not be paid in the bankruptcy proceeding. The effective date of the plan of reorganization did not occur until .

LEGAL DISCUSSION

1. Deprecation of payphones

Unlike other payphone investment schemes, made no claims that its payphones complied with the Americans with Disabilities Act so that the payphones were eligible for the Disabled Access credit under I.R.C. ' 44. Instead, investors typically reported the payphone income on a Schedule E and claimed depreciation on the payphones which generated tax losses. The investors are not however entitled to claim depreciation on the payphones.

In order to claim a depreciation deduction, a taxpayer must establish that the property is used in a trade or business or held for the production of income, that the property is of the type subject to depreciation, and that the taxpayer has a capital investment, or depreciable interest, in the property. See I.R.C. ' 167.

A depreciable interest does not mean possession of bare legal title alone. The test is whether the taxpayer would suffer an economic loss as a result of a decrease in the value of the property due to depreciation or, in other words, does the taxpayer possess the economic benefits and burdens of ownership. In Helvering v. F. & R Lazarus & Company, 308 U.S. 252 (1939), the Supreme Court stated that the question is who bears the burden of exhaustion of the capital investment. See also Estate of Franklin v. United States, 544 F.2d 1045 (9th Cir. 1976). A number of factors have been identified by the courts in determining who has the benefits and burdens of ownership. These include (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether equity was acquired in the property; (4) whether the right of possession is vested in the buyer; (5) which party pays the taxes; (6) which party bears the risk of loss or damage to the property; and (7) which party receives the profits from the operation and sale of the property. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981); Harmston v. Commissioner, 61 T.C. 216 (1973), aff'd, 528 F.2d 55 (9th Cir. 1976) (A depreciable interest requires that the taxpayer possess the benefits and burdens of ownership of the asset).

An payphone investor did not possess the benefits and burdens of ownership of the payphone. The investor had no control whatsoever over the payphone. He or she had no role in the selection of the location of the payphone, either initially or thereafter. alone operated and maintained the payphones and made all collections from the phone. assumed all the risk of loss on the payphones and simply paid the investors a fixed monthly rental check unrelated to the profits of the payphone. had "sole and absolute control" over the payphone. More importantly, the investor had the right to resell the phone back to for its original purchase price upon days notice during the first years of the lease. This buy-back provision enabled the investor to shift the entire risk of loss from the investment to . The investor also had no right to share in any profits of the phone if its earnings exceeded the fixed monthly payment. In sum, the investors never acquired a depreciable interest in the payphones and are not entitled to claim any depreciation on the payphones on their tax returns.[2]

2. **Allowance of Loss**

A number of future events might affect the amount and timing of the taxpayers' losses. For example, investors could receive payment from the bankruptcy estate, from , or from the individual who sold them the investment. Any recovery would reduce their loss as would depreciation deductions not previously disallowed.

Any taxpayers who opted out of the bankruptcy plan provision may now have a recognizable loss, but not if they have claims pending against whoever marketed the investment to them.

Clearly, no loss is allowed prior to when the bankruptcy plan was effective (unless the taxpayer disposed of the phone at a loss prior to that year). We are still gathering facts to determine the nature of the potential losses(theft or capital) and the year of the loss.

This writing may contain privileged information. Any

[2] It should be noted that during the bankruptcy proceeding argued that it, rather than the investors, was the true owner of the payphones.

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

If you have any questions, please contact Attorney Edward J. Laubach, Jr. at 412-644-3443 or Attorney Julia L. Wahl at 412-644-3417.

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APPROVED:

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