DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSOCIATE CHIEF COUNSEL
(INCOME TAX & ACCOUNTING)
CC:ITA

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 12, 2000. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

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

LEGEND

Taxpayer =
Parent =
President =
Sub One =
Sub Two =
Partnership One =
Partnership Two =

Partnership Three	=
Company A	=
Company B	=
Company C	=
Company D	=
Individual One	=
Individual Two	=
Individual Three	=
Year One	=
Year Two	=
Date One	=
Date Two	=
Date Three	=
X shares	=
$A	=
$B	=
$C	=
$D	=
$E	=
$F	=
$G	=
$H	=
$J	=
$K	=
$L	=
$M	=
$N	=
$P	=

ISSUES

1. Whether Sub One failed to substantiate its entitlement to the capital loss and rent expense deduction.

2. Whether the series of transactions in which Sub One obtained and sold the assets lacked economic substance.

3. Whether the carryover bases in the partnership interest from Partnership One and the notes receivable involved in the leasehold position received from Partnership Two were derived from lease stripping transactions lacking economic substance.

4. Whether the capital loss and rent expense deduction may be allocated from Sub One to Partnership One and Partnership Two under the authority of I.R.C. § 482.

5. Whether Partnerships One and Two must recognize gain and loss on exchanges with Sub One (and whether Sub One takes a basis in the assets equal to their fair market value), on the theory that section 351 did not apply to the exchange.

6. Whether the rent expense deductions may be challenged on the ground that no rent expense was incurred.

7. Whether the transactional costs (promoter's fees, accounting and legal expenses) paid in connection with the issuance of the SPS shares and the subsequent sale transactions are deductible.

CONCLUSIONS

1. Under the facts as currently developed, Sub One has failed to substantiate its entitlement to the capital loss and rent expense deduction.

2. Under the facts as currently developed, the series of transactions in which Sub One obtained and sold the assets lacked economic substance.

3. Under the facts as currently developed, the carryover bases in the partnership interest from Partnership One and the notes receivable involved in the leasehold position received from Partnership Two were derived from lease stripping transactions lacking economic substance.

4. Under the facts as currently developed, the capital loss and rent expense deduction may be allocated from Sub One to Partnership One and Partnership Two under the authority of I.R.C. § 482.

5. Under the facts as currently developed, Partnerships One and Two must recognize gain and loss on exchanges with Sub One (and whether Sub One takes a basis in the assets equal to their fair market value), and the theory that section 351 did not apply to the exchange.

6. If none of the disallowance theories discussed in this advice are successful, the transfer between Sub One and Company C appears to have produced the section 162 deduction claimed by Sub One.

7. If the transactions that gave rise to the transactional costs (promoter's fees, accounting and legal expenses) paid in connection with the issuance of the

SPS shares and the subsequent sale transactions are found to lack economic substance, then the costs are not deductible.

FACTS

Taxpayer filed a consolidated return for Year One with Parent as the common parent of its two subsidiaries, Sub One and Sub Two. President is the president of Parent and owns all of its common stock and almost all of its voting stock in Year 1.

Parent owned all of Sub One's Class A common stock and all of its Restricted Preferred Stock, and almost all of Sub One's Class B stock. Historically, Parent was in the business of , while Sub One and Sub Two are in the business of .

On Date Two, Sub One made an extraordinary asset sale, resulting in ordinary gain of $A and net long term capital gain of $B. Also on that date, Sub One sold interests in property acquired 6 days earlier, on Date One, from two partnerships, claiming substantial ordinary ($C) and capital ($D) losses on the sales. The two partnerships involved were Partnership One and Partnership Two. On Date One, Partnership One and Partnership Two transferred property to Sub One in exchange for X shares each of a new class of Sub One stock, Senior Preferred Stock ("SP Stock"). Company B arranged the transfers. The property transferred by Partnership One was a limited partnership interest in Partnership Three. The property transferred by Partnership Two was an interest in "certain leasehold positions consisting of notes receivable with respect to certain furniture and fixtures on leases to" Store X. On Date Two, Sub One sold the interests it had received on Date One, from Partnership One and Partnership Two to Company C for $E each, reporting the losses referred to above. It appears Sub One may have redeemed its SP Stock from Partnership One and Partnership Two shortly after the purported section 351 exchange.

Parent alleges that it also contributed to Sub One a $F interest-free demand note issued by Sub One (supposedly, originally issued to Sub Two, which later assigned it to Parent) in exchange for 2X shares of SP Stock. The timing of this transaction is in dispute. Parent initially did not receive any Sub One SP Stock in connection with its transfer of the $F note. In fact, it was not until July of Year Two that the 2X shares of SP Stock that were issued to Parent in August of Year Two were authorized. Nonetheless, the taxpayer claims that it had always intended the transfers to qualify under section 351 and that the delay in issuance of the SP Stock was a mere oversight. Parent, Partnership One, and Partnership Two each executed a separate "Correction Subscription Agreement" dated Date Three, restating their agreement to contribute specific property to Sub One and consenting to and ratifying the alleged intent of the parties to make contemporaneous contributions as of Date One.

The interests transferred by Partnership One and Partnership Two to Sub One were related to earlier lease stripping transactions. (See Notice 95-53, 1995-2 C.B. 334, describing lease stripping transactions and stating the Sevice's intention to challenge the tax benefits arising from them). The limited partnership interest in Partnership Three that was transferred by Partnership One to Sub One in exchange for the Sub One SP Stock was a portion of the interest that had been acquired by Partnership One as part of a lease stripping transaction, in which Partnership One had transferred an obligation to pay rent to Company D and a note from Company D to Partnership Three in exchange for a limited partnership interest in Partnership Three. The underlying assets in the lease stripping transaction were purchased by Partnership One from a bank leasing concern and then leased to another entity.

The property transferred by Partnership Two to Sub One in exchange for the Sub One SP Stock consisted of a portion of its obligation to pay rent to Company A and a portion of the note it had received from Company A in connection with Partnership Two's sale to, and leaseback from, Company A of a residual interest in property that had been involved in an earlier, separate lease stripping transaction. The earlier lease stripping transaction was the subject of FSA 200013004 and involved one company's sale and leaseback of fixtures, with the ownership of the residual interest in the fixtures ending up with a second company. At the end of the lease stripping transaction that was the subject of the FSA, the second company had the residual interest in the fixtures, a right to receive rental payments from a subsidiary of the first company, and an obligation to make payments on its note held by the subsidiary. The second company sold these rights to, and had the obligation assumed by, a third entity, which in turn sold the rights to, and had the obligation assumed by, Partnership Two, which then sold the rights to Company A for Company A's note and leased rights back from Company A. Partnership Two then sold its right to the rental stream from the subsidiary to a fourth entity (in exchange for the fourth entity's assumption of the obligation to make payments on the note held by the subsidiary). Finally, Partnership Two transferred the Company A note to Sub One in exchange for the X shares of SP Stock and Sub One's assumption of Partnership Two's obligation to make rental payments to Company A.

The reported tax consequences were as follows: Sub One reported an $D short-term capital loss ($E sale price minus $G reported carryover basis) from the sale of its interest in Partnership Three. This loss was used to offset the $B of long-term capital gains from Parent's Date Two asset sale. Sub One also claimed an $C loss ($E sale price minus $H reported carryover basis) from the sale of its Partnership Two leasehold interest. The loss was reported as a rent expense deduction on

Taxpayer's Year One consolidated return and was used to offset ordinary income from the sale of other assets during Year One. As a result of the sale of the two contributed leasehold interests, Taxpayer reported a total loss on its Year One consolidated return of $J.

Furthermore, there is a relationship between Partnership One, Partnership Two and Company C through common officers. Individual One is the president and a director of Company C, the treasurer of Company B, and a former partner of both Partnership One and Partnership Two. Individual Two, is a general partner of both Partnership One and Partnership Two. Individual Three is the treasurer and a director of Company C who serves together with Individual Two as officers and directors of five other corporations.

LAW AND ANALYSIS

Issue One

The notice of deficiency determined that the $D capital loss reported from the sale of Sub One's interest in Partnership Three that it received from Partnership One is not allowable because Sub One failed to establish its basis in the asset. In addition, the notice determined that Sub One is not entitled to $C of the amount claimed as rent expense because Sub One failed to establish that the amount was an ordinary and necessary business expense, was expended, was expended for the designated purpose, or otherwise meets the requirements for deductions under the Internal Revenue Code. Sub One is not entitled to the loss and rent expense unless it substantiates its entitlement to them.

Issue Two

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998). Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequence of holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 T.C. at 769.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership, 157 F.3d at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

Moreover, claims of pre-tax profit are not dispositive. There has been some precedent that economic substance for a lease transaction will be satisfied if there is "some modicum" of economic substance, which may mean "some modicum" of pretax profit. See Rice's Toyota World, Inc. v. Commissioner, supra; Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985). In Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990), the Fourth Circuit found that a leasing transaction was a sham. In doing so, it described a $17,000 profit potential as "minimal" on an eight-year investment of $130,000. The Fourth Circuit also found evidence of tax motivation in the offsetting obligations to pay rent and debt service. The transaction also involved the use of related parties to avoid section 465. Under these facts, the court found that "the tax tail began to wag the dog." Hines, 912 F.2d at 741. Thus, small profits on a lease transaction may be overlooked when tax considerations have taken over the transaction. See also Pacheco v. Commissioner, T.C. Memo. 1989-296.

As currently developed, the facts indicate that the series of transactions in which Sub One obtained and sold the assets from Partnership One and Partnership Two lacked both economic substance and non-tax business purpose. As further discussed below, the facts also do not suggest a plausible business purpose for the contribution and sale transactions within a six-day period.

Instead, the facts suggest that current tax reduction was the sole motive for the transaction and that the transactions had no objective economic substance. Sub One exchanged the assets for preferred stock with a par value of $2L and then sold them six days later for $2E in what appears to be a pre-arranged step transaction. Although there is a $M difference in those amounts , the difference is insignificant compared to the amount Parent paid Company B for structuring and arranging the transactions, as well as the tax benefits resulting from the transactions. Parent's net economic cost (that is, loss), for the transaction was $N, while it generated a $P tax saving. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha v. Commissioner, 87 T.C. 1087 (1986); AMC Partnership v. Commissioner, 157 F.2d 231, 249 (3rd Cir. 1998), aff'g in part and reversing in part T.C. Memo. 1997-115. There appears to be no evidence that Parent expected to make a profit on its ownership of these assets.

Issue Three

As previously discussed, transactions devoid of economic substance are not recognized for federal income tax purposes. AMC Partnership v. Commissioner, 157 F.3d at 246. The basis of the assets that Partnership One and Partnership Two transferred to Sub One in the purported section 351 transaction appear to be traceable to lease stripping transactions. The tax consequences claimed from lease stripping transactions are challenged on the ground that they lack economic substance.

If [redacted] the original lease stripping transactions have no economic substance, then Partnership One and Partnership Two each would have a basis in the property transferred to Sub One that equals the fair market value of the property. Accordingly, even if the transfers to Sub One qualified for nonrecognition under section 351, Sub One would have a carryover basis in the property equaling its fair market value. Under these facts, Sub One cannot claim the respective $G and $H bases in the property transferred to it in the purported section 351 transactions and, therefore, cannot take a corresponding loss on the resale to Company C.

Issue Four

I. Section 482

A. Section 482-Generally

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394, 400 (1972); Barford v. Commissioner, 194 F.3d 782, 786 (7th Cir. 1999); Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967), *cert. denied,* 389 U.S. 841 (1967); Ach v. Commissioner, 42 T.C. 114, 125 (1964), *aff'd,.* 358 F.2d 342 (6th Cir. 1966), *cert. denied,* 385 U.S. 899 (1966). Cf. H.R. Rep. No. 2, 70th Cong., 1st Sess., 16-17. Section 482 provides in relevant part:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment,

> or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of any of such organizations, trades, or businesses...(emphasis added).

For the reallocation rule of section 482 to apply to a transaction, the transaction must involve at least two entities owned or controlled by the same interests. Section 482 imposes two requirements: (1) ownership or control must exist in some manner among the participants, and (2) the same interests must possess the control. Regarding the first requirement, because Partnership One and Partnership Two are unrelated to Taxpayer, the mutual ownership provision of section 482 will not apply. Therefore, Partnershhip One, Partnership Two, and Taxpayer must be found to be controlled by the same interests if we are to apply section 482 to the transaction that took place between them.

B. Legal Standard for Determining Control under Section 482

1. *Definition of control*

The regulations under section 482 define control to include any kind of control, regardless of whether such control is direct or indirect or legally enforceable. Treas. Reg. §1.482-1(i)(4). Case law supports the regulation's definition of control, indicating that it is actual and practical control which counts in the application of section 482 rather than record ownership or legally enforceable control,. Ach, 42 T.C. at 125; Grenada Industries, Inc. v. Commissioner, 17 T.C. 231, 254 (1951), *aff'd,* 202 F.2d 873 (5th Cir. 1953), *cert. denied,* 346 U.S. 819 (1953), *acq. in part* and *nonacq. in part,* 1952-2 C.B. 2, 5; 1972-2 C.B. 2. See also Appeal of Isse Koch & Co., Inc., 1 B.T.A. 624, 627, *acq.* 1925-1 C.B. 2 ("Control not arising or flowing from means legally enforceable may be just as effective in evading taxation as if founded on the most formal and readily enforceable legal instrument."); DHL Corp. v. Commissioner, T.C. Memo 1998-461 (1998) (holding that foreign investors did not have section 482 control over a corporation despite their ability to appoint a majority of its board of directors because domestic shareholders retained the ability to control day-to-day operations and major events); Charles Town, 372 F. 2d at 419 (holding that two shareholders were in control of a corporation in which they only owned two percent of the outstanding stock because of their possession of effective and practical control over the corporation).

Consequently, according to both the section 482 regulations and case law, none of the participants in this transaction is required to have legal control of another participant through majority ownership of that other participant's voting stock for control to exist as defined under section 482. The Service has the authority to determine whether control exists by considering the reality of the situation and examining whether the same interests effectively control the participants to the transaction involved, rather than basing the control determination solely on the taxpayer's percentage of ownership of voting stock or legal right to direct the participant's actions.

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

2. *Existence of control among Parent, Partnership One, and Partnership Two*

Under Treas. Reg. 1.482-1(i)(4) and the relevant case law, Taxpayer is not required to own an interest in Partnership One and Partnership Two, majority or otherwise, for the requisite control to exist under section 482. Instead, the Service may consider whether Taxpayer effectively controlled Partnership One and Partnership Two, despite Taxpayer's having no legal or contractual right to direct the actions of the two partnerships. In making this determination, the Service may apply the presumption of control provided for in Treas. Reg. 1.482-1(i)(4) and in the applicable case law. For the presumption to apply, the Service has the burden of establishing that income or deductions have been arbitrarily shifted between Taxpayer, Partnership One, and Partnership Two. See Dallas Ceramic Co., 598 F.2d at 1389.

From the facts provided to us, it appears as though a loss deduction has been arbitrarily shifted from Partnership One to Taxpayer. The limited partnership interest contributed by Partnership One in the section 351 transaction had a substantial built-in loss. By contributing the partnership interest to Sub One on Date One, six days prior to the date Sub One sold various assets at a substantial capital gain, Partnership One acted in concert with Taxpayer to shift a potential capital loss deduction from it to Taxpayer. Taxpayer realized the loss on the same day it sold Sub One's assets by selling the interest. Partnership One and Taxpayer had a common interest in shifting the loss deduction inherent in the partnership interest to Taxpayer because doing so allowed Taxpayer to fully offset the $B of long-term capital gain attributable to the asset sale and simultaneously provided Partnership One with $L of income (par value of $K multiplied by X shares of SPS) upon redemption of the SPS.

Similarly, the facts provided to us indicate that a deduction has also been arbitrarily shifted from Partnership Two to Taxpayer. The leasehold interest contributed by Partnership Two had a substantial built-in loss. Partnership Two's contribution of the leasehold interest to Sub One on Date One, resulted in the shifting of a loss deduction from Partnership Two to Taxpayer, which Taxpayer took as a rent expense deduction six days later by selling the interest. Partnership Two and Taxpayer had a common interest in shifting the loss deduction inherent in the leasehold interest to Taxpayer because doing so allowed Taxpayer to offset gains from the sale of other assets during Year One while providing Partnership Two with $L of income (par value of $K multiplied by X shares of SPS) upon redemption of the SPS.

Because an arbitrary shifting of loss deductions appears to have occurred between Partnership One and Taxpayer and Taxpayer and Partnership Two, Taxpayer is presumed to control Partnership One and Partnership Two for the purposes of section 482 pursuant to Treas. Reg. 1.482-1(i)(4) and the applicable case law.

Once it has been determined that one of the participants in a transaction controls another, section 482 next requires that the same interests possess the requisite control for the Commissioner to make a reallocation.

C. Legal Standard for Determining "the same interests" under Section 482

The regulations provide no guidance as to what the term "the same interests" means under section 482. Case law has indicated that in using the term "the same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979) (holding that different persons with a common goal or purpose for arbitrarily shifting income can constitute "the same interests" for purposes of section 482). See also B. Forman Co., Inc. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), *cert. denied*, 407 U.S. 934 (1972) (rejecting Tax Court's view that two independently owned corporations acting in concert together to make interest-free loans to a jointly owned corporation did not constitute the same interests within the meaning of section 482); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-95 (5th Cir. 1966), *cert. denied,* 386 U.S. 1016 (1967). Cf. Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233-34 (1925). But see The Lake Erie and Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), *acq.* 1945 C.B. 5, *acq. withdrawn* 1965-1 C.B. 5.

Case law indicates that the legal standard for determining whether "the same interests" control an entity is identical to the standard applied to determine whether control of an entity exists. Therefore, if different entities are found to have a common goal to shift income or deductions among each other, not only will control of the entities exist, but the entities will also constitute "the same interests" for the purpose of section 482. As previously discussed, there appears to exist a common plan among Partnership One and Taxpayer and Partnership Two and Taxpayer to shift deductions to Taxpayer. Consequently, Partnership One and Taxpayer and Partnership Two and Taxpayer constitute "the same interests" under section 482, meaning that the Service may reallocate the loss deductions claimed by Taxpayer to prevent the evasion of taxes or to clearly reflect income.

II. Application of Section 482 to this Transaction

Generally, there are two alternative bases to apply section 482 to a transaction: (1) prevention of the evasion of tax, and (2) the clear reflection of income.

A. Economic Substance/Tax Evasion Standards of Section 482

The application of section 482 has been upheld where the challenged transaction was arranged without a valid business purpose and solely in order to avoid taxes. Eli Lilly and Co. v. Commissioner, 84 T.C. 996 (1985), *aff'd in part and rev'd in part,* 856 F.2d 855 (7th Cir. 1988). When analyzing potential tax avoidance aspects of a transaction, the Commissioner will respect the transaction's contractual terms if consistent with the true economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B). The economic substance standard of the regulations overlaps with the economic substance and sham transaction doctrines developed in case law which allow the Service to consider the economic realities of a transaction and disregard transactions lacking a business purpose and entered into solely for tax avoidance motives.[1] However, the section 482 regulations expand upon case law guidance by providing additional guidance. Specifically, the regulations provide the following:

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[1] See Gregory v. Helvering, 293 U.S. 465 (1935); Knetsch v. Commissioner, 364 U.S. 361 (1960) (interest deductions disallowed where nothing of substance could be realized from the transaction other than a tax deduction); Frank Lyon Co. v. U.S., 435 U.S. 561, 572 (1978) ("The simple expedient of drawing up papers" is not controlling for tax purposes when the objective economic realities of a situation are to the contrary); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (transaction is a sham where taxpayer is motivated by no business purpose other than obtaining tax benefits in entering a transaction and where transaction has no economic substance because no reasonable possibility of profitability exists); ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), *cert. denied,* 526 U.S. 1017 (1999) (transaction devoid of economic substance cannot be the basis for a deductible loss).

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, great weight will be given to the actual conduct of the parties, and the respective legal rights of the parties.... If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. §1.482-1(d)(3)(ii)(B). Thus, section 482 provides an alternative approach to challenging a transaction for lack of economic substance by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions. See G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). We note that in the context of this transaction (and similar tax shelter transactions), this allocation authority would exist only where there is a common tax avoidance scheme among the participants to shift income and/or deductions arbitrarily. (Note that the prior sentence does not apply to the alternative theory discussed above for establishing control (the ability to direct the actions of certain participants)).

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

Applying the regulation's economic substance standard to the Parent-Partnership One-Partnership Two transaction, it appears as though the transaction had no economic substance other than to generate loss deductions to enable Taxpayer to offset gains from the sale of assets. The transaction has no apparent business purpose. Taxpayer claims that the purpose of the transaction was to balance President's investment portfolio. According to Taxpayer, the investment in Partnership One was chosen because President was personally familiar with the truck leasing business, and the investment in Partnership Two was chosen to balance his lease portfolio. Taxpayer claims that Company B wanted an "equity upside" in addition to its consulting fee but wanted to defer taxation on the stock transaction and was concerned about the stock being illiquid and difficult to value. Taxpayer explains that a section 351 transfer was chosen to allow investment in diversified, known leasing assets consistent with Company B's wishes to defer taxation on an illiquid, immeasurable asset such as preferred stock in a private company.

Taxpayer's explanation of the purpose of this transaction does not provide a credible or an adequate business purpose for the transaction. Taxpayer claims that the leasing investments were entered into to diversify President's portfolio, but when Partnership One and Partnership Two contributed the interests to Sub One, the interests had a minimal fair market value in relation to their basis. [redacted] See Sheldon v. Commissioner, 94 T.C. 738 (1990). Therefore, investment in the leasing interests would not serve to diversify President's portfolio but would put it at risk. Taxpayer did not even attempt to realize a profit from the interests contributed but immediately disposed of them after receipt, without giving them the opportunity to benefit or impact President's portfolio. Additionally, Taxpayer's attempt to claim that Company B's desire to defer taxation on their "equity upside" affords a business purpose to the nonrecognition transfer is equally lacking in merit since a tax avoidance motive in this context is not a proper business purpose for a transaction.

The large carryover bases of the interests compared to their fair market values ensured the generation of substantial loss deductions to Taxpayer upon the subsequent sale of the interests. [redacted] Taxpayer claims that the quick sale occurred due to a falling out between Company B and President which prompted President to want to end his involvement with the partnerships immediately. We find no support in the facts for this self-serving assertion. It appears as though the sale occurred to trigger the loss in the high basis, low value assets.

The contribution of the interests were timed to take place on the same day of the asset sale, towards the end of the taxable year when Taxpayer would have a reasonable estimation of its potential tax liability for the year emanating from the planned asset sale. The contribution and sale of the interests only six days later appears to be part of a prearranged transaction to avoid taxation of the gains from the asset sales taking place during the Year One taxable year.

The true economic reality of the Parent-Partnership One-Partnership Two transaction is that Partnership One and Partnership Two sold their potential loss deductions on the contributed interests to Taxpayer for the value of the stock they received. [redacted]

[redacted]

The Parent-Partnership One-Partnership Two transaction is the type of lease stripping transaction described in Notice 95-53, 1995-2 C.B. 334, that the Service indicated would result in the exercise of its authority to reallocate gross income, deductions, credits, or allowances between the participants in the transaction. The Partnership One and Partnership Two transfers to Sub One are described in part (a) of the Notice as a stripping transaction effected through a transferred basis transaction.

If the contractual terms of a transaction are inconsistent with its economic substance, the Commissioner may disregard its terms and impute terms consistent with the true economic substance of a transaction. Treas. Reg. 1.482-1(d)(3)(ii)(B). Based on our analysis of the facts described above, the transfers of the high basis, low value assets may be ignored and the losses claimed by Taxpayer allocated back to Partnership One and Partnership Two. As a result, the Commissioner may, pursuant to his authority under the economic substance/tax evasion standards of section 482, disallow and reallocate the losses that Taxpayer claimed on the sale of the interests back to Partnership One and Partnership Two to prevent Taxpayer from evading substantial capital gains taxes.

D. Clear Reflection of Income Standard of Section 482-

Even in the absence of tax avoidance motives, the Commissioner may make a section 482 allocation if necessary to clearly reflect income. When a 351 transfer is involved, the Commissioner may disregard the nonrecognition provisions of section 351 to make a section 482 allocation to clearly reflect income among the controlled taxpayers. Section 1.482-1(f)(1)(iii)(A) (to clearly reflect income or prevent the avoidance of taxes, the Commissioner may make an allocation under section 482 with respect to transactions that would otherwise qualify for nonrecognition of gain or loss under section 351). Additional authority exists through case law in support of the Service's position allowing the disregarding of nonrecognition provisions if necessary to clearly reflect income.

One such case in accord with the Service's position is National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), *cert. denied,* 320 U.S. 794 (1943), in which a parent corporation transferred stock with a substantial built-in loss to a wholly-owned subsidiary in a transaction which qualified as a nonrecognition transaction under the predecessor to section 351. The subsidiary sold the stock and claimed a loss deduction. Id. at 601. The Commissioner disregarded the nonrecognition transaction and treated the amount of the pre-contribution loss as sustained by the parent instead of the subsidiary under section 45 of the Revenue Act of 1936, the predecessor to section 482. Id. The taxpayer claimed that the subsidiary was entitled under the nonrecognition and basis provisions of the Code to claim a loss deduction by virtue of the carryover basis it received in the stock transfer. Id. at 602. The court rejected the taxpayer's argument, stating that in every case in which section 45 was applied its application would result in a conflict with the literal provisions of some other provision. Id. According to the court, the section could still be applied to clearly reflect income, despite a conflict with the literal provisions of another section of the Code. Id.

Other cases are in accord with National Securities Corp. that section 482 may be applied to clearly reflect income despite apparent conflict with the provisions of another section of the Code. See Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 215-16 (2d Cir. 1952), *cert. denied*, 344 U.S. 874 (1952) (Commissioner properly applied section 482 to reallocate deductions associated with property acquired in a reorganization to transferee to clearly reflect income); Dolese v. Commissioner, 811 F. 2d 543, 546 (10th Cir. 1987) (Commissioner has broad discretion under section 482 to correct distortion of income occurring through the strict application of other provisions of the Code and may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction); Aiken Drive-In Theater Corp. v. U.S., 281 F.2d 7, 9-11(4th Cir. 1960); Foster v. Commissioner, 756 F.2d 1430, 1433 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986) (Commissioner may invoke section 482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction). See also Rooney v. U.S., 305 F.2d 681, 686 (9th Cir. 1962) (Section 482 will control when it conflicts with section 351.); Eli Lilly, 84 T.C. at 1116-1118 (Section 482 may be applied in circumstances involving section 351 transactions if necessary to clearly reflect income or prevent the avoidance of tax.); G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). But see Ruddick Corp. v. U.S., 226 Ct. Cl. 426 (1981), 643 F.2d 747, *aff'd without opinion,* 732 F.2d 168 (Fed. Cir. 1984) (In the absence of tax avoidance motives, the Commissioner may not disregard section 351 transactions to apply section 482, even if doing so would be necessary to clearly reflect income.).

In the instant case, the subsequent disposition of the interests Taxpayer acquired in the 351 transfer resulted in a distortion of income. Taxpayer was able to achieve favorable tax consequences by disposing of the high basis, low value interests received in the 351 transfer at a substantial loss. As a result of the nonrecognition transfer, significant capital and ordinary gains income was sheltered at a low out-of-pocket cost to Taxpayer. Taxpayer effectively paid $2L ($K per share SPS multiplied by 2X shares) for the right to claim $J of losses, resulting in a significant distortion of the amount of taxable income Taxpayer reported in Year One upon the disposition of the interests. Applying the analysis adopted in the National Securities Corp. line of cases, the Service may disregard the section 351 transfer and allocate the losses Taxpayer claimed on the sale of the transferred interests back to the transferor entities, Partnership One and Partnership Two, to clearly reflect income. A section 482 allocation may be made despite the fact that its application would result in a conflict with the literal provisions of section 351, which would treat the transferee corporation, Taxpayer, as the true owner of the interests and allow it to claim the losses. As set forth in National Securities Corp., this conflict is inevitable and is not sufficient reason to prevent the application of section 482 to the instant transaction.

Issue Five

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. Section 1.351-1(a)(1) provides, “The phrase ‘immediately after the exchange’ does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.”

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 by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. But see Treas. Reg. § 1.351-1(a)(1)(ii) and section 3.07 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570, which negate transfers by a transferor that previously owned transferee stock if the value of the new stock issued to that transferor is relatively small compared to the value of the old stock owned by that transferor and the primary purpose of the transfer by that transferor was to qualify other transferors for section 351 treatment. Rev. Proc. 77-37 indicates property transferred to a corporation will not be considered of relatively small value if its fair market value is at least 10 percent of the value of the stock and securities already owned by the transferor.

I. Control immediately after

For section 351 to apply to the transfers of property from Partnership One and Partnership Two to Sub One, the transferors must be in control of Sub One immediately after the exchange of property for Sub One stock. Partnership One and Partnership Two will meet the "control immediately after" requirement only if Parent is also a transferor in the section 351 exchange. To be considered a transferor along with Partnership One and Partnership Two, Parent has to transfer the Sub One note to Sub One in exchange for Sub One SP Stock as part of a situation defined by the parties prior to the contributions by Partnership One and Partnership Two and Parent's transfer has to be executed expeditiously. It is unclear when Parent transferred the Sub One note to Sub One. It is clear, however, that Parent did not receive the 2X shares of Sub One SP Stock purported to qualify Parent as a transferor with Partnership One and Partnership Two until Date Three, eight months after the exchanges by Partnership One and Partnership Two. In fact, Parent could not have received Sub One SP Stock as part of the Partnership One and Partnership Two exchanges because Sub One authorized only enough shares for Partnership One and Partnership Two. Sub One did not authorize the additional 2X shares of SP Stock for Parent until seven months after the Partnership One and Partnership Two exchanges. We are unaware of any document dated on or before the date two days after Date One that contemplates contemporaneous transfers by Partnership One, Partnership Two, and Parent in exchange for Sub One SP Stock.

Furthermore, even if the taxpayer can establish that Parent, Partnership One, and Partnership Two were all transferors pursuant to the same section 351 exchange, Parent's pre-existing stock ownership of Sub One will not count toward meeting the "control immediately after" requirement if the value of the new stock issued to Parent is relatively small in comparison to the value of the Sub One stock already owned by Parent and the primary purpose of the transfer by Parent was to qualify Partnership One and Partnership Two as transferors. Preliminary valuations suggest that the SP Stock Parent received in exchange for the Sub One note was worth less than 2.5 percent of the Sub One stock already owned by Parent. Two and a half percent is certainly "a relatively small value." Parent likely transferred the Sub One note for Sub One SP Stock primarily to qualify the transfers of Partnership One and Partnership Two. Partnership One and Partnership Two had high basis, low value assets and Sub One needed to receive those assets with a transferred basis in order to offset its gain on the sale of its business assets.

Though the Taxpayer may argue, based on the "Corrected Subscription Agreement" dated Date Three, that Parent, Partnership One, and Partnership Two were all transferors in the same section 351 exchange, the better view is that Parent was not a transferor in the exchange by Partnership One and Partnership Two because

(1) Taxpayer has not proven that the rights and obligations of Parent, Partnership One, and Partnership Two as co-transferors were defined prior to the transfers by Partnership One and Partnership Two to Sub One, (2) at the time of the transfers by Partnership One and Partnership Two, Parent could not have transferred property in exchange for Sub One SP Stock because such stock was not authorized, and (3) even if Parent was a transferor in the same exchange, the new Sub One SP Stock it received was of relatively small value, therefore Parent's pre-existing stock ownership of Sub One does not count in determining control of Sub One immediately after the purported section 351 exchange.

II. Business purpose

In addition to satisfying the technical requirements of section 351, a transfer must have a bona fide business purpose in order to qualify as a section 351 exchange. See Rev. Rul. 55-36, 1955-1 C.B. 340; see also Caruth v. United States, 688 F.Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989) and the cases cited therein. Determining whether a bona fide non-tax business purpose motivated, at least in part, the section 351 transaction requires intensive factual development of the motives and intent of the parties, as gleaned through their written communications, contracts and agreements, their expertise on tax matters in general, as well as their conduct throughout the transaction. The Service and the various courts have distilled several factors that aid in determining whether a valid non-tax business purpose is present in a purported section 351 transaction. These factors include:

- whether the transfer achieved its stated business purpose,
- whether the transfer primarily benefitted the transferor or the transferee,
- the amount of potential non-tax benefit to be realized by the parties,
- whether the transferee corporation is a meaningless shell,
- whether the transferee's existence is transitory,
- whether the transferee corporation has any other assets of the type transferred,
- the number of times the property was transferred, both prior to and after the section 351 transaction,
- the amount of time each party held the property, both prior to and after the section 351 transaction,

- whether there were any pre-arranged plans concerning future dispositions of the property, and

- whether there were independent parties (such as creditors) that requested a specific structure for the transaction.

Based on the facts submitted, it does not appear that there was a purpose for the transactions apart from the generation of substantial tax losses. That is not a bona fide business purpose.

III. Step transaction

Section 351 contemplates a transfer of property in exchange for stock of the transferee. If the transaction does not, in fact, include a transfer of property to the transferee and receipt of stock by the transferor, section 351 cannot apply. In this transaction, Sub One sold the assets it received from Partnership One and Partnership Two only six days after it received them. Under these circumstances, Sub One should be considered a conduit for the sale of assets from Partnership One and Partnership Two to Company C. See Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998). Similarly, if Sub One redeemed Partnership One and Partnership Two's Sub One SP Stock shortly after its issuance, that is evidence that Partnership One and Partnership Two never really intended to be Sub One shareholders and should not be treated as transferors in a section 351 exchange.

IV. Summary

The transfers by Partnership One and Partnership Two do not qualify as a section 351 exchange. The transactions are taxable exchanges under section 1001. Sub One's basis in the assets it received from Partnership One and Partnership Two should be determined under section 1012. Sub One's basis in the assets equals the fair market value of the preferred stock it gave in exchange for them (section 1.1012-1(a)).

Issue Six

If factual development confirms that Sub One transferred to Company C an interest with a basis of $H in a note receivable and an obligation to pay rent in an equal amount, and if none of the foregoing theories apply, the issue is whether that transaction produces the rental expense deduction reported by Sub One. The general rule is that payments made by lessees to lessors to terminate leases are deductible under section 162 if no subsequent lease is entered into between the parties. U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998); Rev. Proc. 69-511, 1969-2 C.B. 23. Although Rev. Rul. 69-511 involved a payment by a lessee to a lessor to cancel a lease obligation, the result should be no different where the lessee makes a payment to a third party in exchange for its agreement to assume the lessee's obligations under the lease. Thus, if none of the disallowance theories discussed herein are successful, the transfer between Sub One and Company C would produce the section 162 deduction claimed by Sub One.

Issue Seven

Case law has generally precluded the deduction of out-of-pocket costs of investing in a transaction. In Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999), the taxpayer purchased life insurance on its employees and then borrowed back the cash value. The transactions were structured so that the premiums, fees and interest on the loans would exceed expected death benefits and net cash value. Despite producing an out-of-pocket economic loss each year, the transactions purported to produce substantial income tax benefits that more than offset the economic losses. After applying the sham transaction doctrine to disregard the transactions because they lacked economic substance, the court turned to the issue of whether administrative fees paid to the promoter of the scheme were deductible. Those fees constituted expenses of the taxpayer that contributed to the overall "out-of-pocket" economic loss suffered by the taxpayer as a result of its investment in the sham transaction. The court summarily disallowed these fees, stating that "[t]hey were incurred in connection with, and were an integral part of, a sham transaction and, as a result, are not deductible." Thus, under this reasoning, if a transaction is determined to be a sham transaction, a taxpayer would not be entitled to any expenses incurred in connection therewith, even though those expenses reflected actual economic losses.

Similarly in United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994), the Third Circuit stated, "Where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes. Deductions for expenses resulting from such transactions are not permitted."

In several instances, individual tax shelter investors argued that they were entitled to deduct their "out-of-pocket" expenses on the basis that they suffered a theft loss pursuant to section 165. The courts concluded that cash "investments" in limited partnerships designed to secure tax benefits are not theft losses. See, e.g., Viehweg v. Commissioner, 90 T.C. 1248 (1988); Marine v. Commissioner, 92 T.C. 958 (1989), aff'd, 921 F.2d 280 (9th Cir. 1991); Cross v. Commissioner, T.C. Memo. 1992-715.

Other expenses, such as interest deductions on loans incurred in a transaction lacking economic substance, have not always been disallowed by the courts. There have been instances where a court allowed an interest deduction on a loan that is part of a transaction that lacks economic substance. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985); ACM Partnership, 157 F.3d at 262;

Arrowhead Mountain Getaway, Ltd. v. Commissioner, T.C. Memo. 1995-54, 69 T.C.M. (CCH) 1805 (1995).

Nonetheless, a number of cases have disallowed interest deductions where they are an integral part of a transaction found to lack economic substance. See Wexler v. United States, 31 F.3d 117, 125-26 (3d Cir. 1994), cert. denied, 115 S. Ct. 1251 (1995); Sheldon v. Commissioner, 94 T.C. 738 (1990); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; Seykota v. Commissioner, T.C. Memo. 1991-541; Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966). The difference between the two scenarios is whether the loans are an integral part of transactions that lack economic substance.

Because sham transactions lack economic substance, they do not give rise to valid deductions or losses – even for the taxpayer's out-of-pocket cash investment. The only circumstances where some courts have permitted deductions related to sham transactions is where the deductions were attributable to separable economically substantive elements that were not the centerpiece or the principal tax benefit of the underlying sham transactions. In this case, the fees are not economically substantive elements, and therefore the deduction should be denied.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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[redacted]

Please call if you have any further questions.

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