DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE

MEMORANDUM FOR DISTRICT COUNSEL BROOKLYN
CC:NER:BRK
Attn: Andrew Mandell

FROM: Associate Chief Counsel (Corporate)
CC:CORP

SUBJECT: Lease Stripping Transactions

DISCLOSURE STATEMENT

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 becomes necessary, please contact this office for our views.

This Chief Counsel Advice responds to your memorandum dated March 1, 2000. In accordance with I.R.C. § 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

In your incoming memorandum, you requested guidance on several issues arising in transactions detected by the lease stripping ISP. Your question concerning the application of section 482 was addressed separately by CC:INTL. Their response is attached.

The attached memorandum assumes, for purposes of the section 482 analysis, that the series of transactions described therein qualify as successive section 351 exchanges, and that the transferor corporation properly receives inflated basis stock of the transferee corporation. This assumption does not alter the position taken in our March 13, 2001 memorandum to you, which details the necessary analysis to be undertaken in order to determine whether a particular transaction actually qualifies for section 351 treatment, as well as how to determine the correct basis of the transferee corporation stock.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views prior to any disclosure.

Assistant Chief Counsel (Corporate)

By: ____________________________________

Alfred C. Bishop
Branch Chief (CC:CORP:6)

SPRO-105569-00

Internal Revenue Service

memorandum

CC:INTL:BR5
MMCahn

date: March 29, 2001

to: Arturo Estrada, CC:DOM:FS:CORP
from: Paul Epstein, CC:INTL:BR5

subject: Lease Stripping Transactions

Introduction

You have requested assistance regarding the application of section 482 to a later stage of a lease strip transaction. The information provided describes a hypothetical transaction that does not identify specific participants by name. We understand that the facts of each case may differ slightly.

Conclusion

Section 482 is implicated when a partnership ("Partnership") transferred its high basis, low fair market value stock in a subsidiary of Corporation X to Company A in a section 351 transaction, followed by Company A selling the subsidiary's stock at its fair market value to Company B, which is controlled by the promoter of the overall transaction. These transactions were part of a preconceived plan to allow Company A to shelter a large capital gain. Section 482 is implicated since Partnership and the promoter, who (indirectly) owned the remainder of Company A's stock, "acted in concert or with a common goal or purpose" within the meaning of section 1.482-1(i)(4) in transferring property to a corporation which they together both controlled, with the intent to shift the tax loss to Company A. Although Partnership transferred the subsidiary's stock as part of a nontaxable transaction, in which the transferee takes a carryover basis in the stock, section 482 permits the Commissioner to allocate the built in loss on the stock back to Partnership, since the transfer was effected solely for tax avoidance purposes.

Discussion

Facts

In the early stage of the transaction at issue, in November 1994, there was a lease strip transaction, at the conclusion of which Partnership owned 150 shares of preferred stock in a subsidiary of , whose shares purportedly had a high basis of $30 million, and low fair market value of $150,000. The subsidiary received $30 million from C Ltd. in payment of nonrecourse notes which it held. The subsidiary had previously assumed Partnership's liability to pay "rent" on the equipment which Corporation X, the end user, placed in service in its trade or business. We assume consistently with other similar transactions we have evaluated, that Partnership's majority interest is held by a foreign person that is not subject to tax on gains in the United States, or otherwise by a tax neutral entity.

Company A is an unrelated corporation, the stock of which is owned by five individuals, who have decided to sell their interests in Company A. Company A owns assets with a fair market value of $60 million, and an adjusted basis of $40 million. Company A has a built in gain with respect to its assets of $20 million which may affect the sale price of the shares to the five individuals.

In order for the Company A's five shareholders to sell their shares of Company A without decreasing the sales price to account for the tax liability with respect to built in gains, the promoter structured the following transaction:

On April 30, 1996, the promoters formed a partnership and contributed $10,000 in exchange for a partnership interest. The partnership formed Company A Acquisition Corp. ("AAC"), contributing the $10,000 in exchange for all its outstanding stock. AAC then borrowed $60 million from an unrelated bank, and purchased all the stock of Company A, for $60 million. AAC was then merged into Company A. At the end of this series of transactions, the interim results to the overall transaction are as follows: Company A's original shareholders received $60 million for their stock in Company A., the promoters own all the stock of Company A, and Company A is saddled with $60 million of debt to the unrelated bank.

Also on April 30, 1996, Partnership then entered into a section 351 transaction with Company A, in which it transfers 75 shares of the Corporation X subsidiary's preferred stock, in exchange for 20 shares of Company A's common stock. Apparently, the promoters also contributed property so that the transaction would qualify under section 351. Although not stated in the facts submitted to us, we assume that Partnership, through its 20 shares of Company A's common stock, owns only a nominal interest in Company A's voting rights and fair market value.

On May 1, 1996, Company A sold its assets (other than the Corporation X subsidiary stock) to an unrelated corporation for $62 million, the fair market value of its assets.[1] Company A recognized a capital gain of $20 million. $60 million was used to pay off its liability to the bank, and the remaining $2 million was used to pay fees and other liabilities. On June 28, 1996, Company A then sold the Corporation X subsidiary stock for $65,000, and claimed a capital loss in the amount of $14,952,477, *i.e.*, $15,017,477, its purported basis in the 75 shares of the Corporation X subsidiary preferred stock, and $65,000, its amount realized for the shares.

We analyze whether section 482 can be applied to this transaction. For purposes of this discussion we assume that Partnership's basis in its 150 shares of the Corporation X subsidiary's preferred stock is $3,034,954, and that the Partnership's transfer of 75 shares of the Corporation X subsidiary's preferred stock to Company A otherwise qualifies as a section 351 transaction.

Law and Analysis

A. Section 482 -- Generally

Section 482 provides the following:

> In any case of two or more organizations, trades, or businesses owned or ***controlled*** directly or indirectly by the ***same interests***, the Secretary may distribute apportion, or allocate gross income, deductions... between or among such organizations...if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations. [Emphasis Added.]

Thus, in order for section 482 to apply to a transaction, the transaction must be between two or more entities owned or controlled by the same interests. Accordingly, the first issue is whether for purposes of section 482 the parties, *i.e.*, Partnership, Promoters and Company A are controlled by the same interests, notwithstanding that Partnership only owned 20 shares of Company A's common stock. We then discuss whether section 482 can be applied to this transaction, notwithstanding an otherwise valid section 351 transaction, which would dictate that Company A's basis in the the Corporation X subsidiary preferred stock was approximately $15 million, and that Company A should recognize its loss in the amount of the difference of adjusted basis and fair market value.

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[1] It is unclear why the purchaser would pay $2 million more than the value of the assets.

B. Legal Standard for Control

There are alternative sets of regulations covering different periods that potentially apply to control issues under section 482. Because you have requested information on how section 482 may generally apply to lease stripping transactions, this analysis includes discussion and citation of both current and prior regulations. The 1968 regulations apply to taxable years beginning on or before April 21, 1993; the 1993 regulations apply to taxable years beginning after April 21, 1993; and the 1994 regulations apply to taxable years beginning after October 6, 1994, unless an election is made to apply them to all prior open years. Treas. Reg. § 1.482-1T(h) (1993); Treas. Reg. § 1.482-1(j)(2) (1994). Apparently only the 1994 regulations are applicable to the current pattern that we discuss in this memorandum, since the taxable year at issue is 1996. However, similar transactions may involve years for which the 1968 or 1993 regulations are applicable. Consequently, we will refer to each set of regulations, and to the extent necessary distinguish between the regulations by referring to their year of promulgation (in parenthesis) when a specific set of regulations is referred to.

The section 482 regulations define control "[to include] any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." Treas. Reg. § 1.482-1(a)(3), 1968-1 C.B. 218; Treas. Reg. § 1.482-1T(g)(4), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4), 1994-2 C.B. 93. *See also Appeal of Isse Koch & Company, Inc.*, 1 B.T.A. 624, 627 (1925), *acq.,* 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument."). The regulations also state that "[i]t is the reality of control that is decisive," rather than a rigid focus on record ownership of the entities at issue. *Id. Accord Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert denied*, 385 U.S. 899 (1966); *Grenada Indus., Inc. v. Commissioner*, 17 T.C. 231 (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; Rev. Rul. 65-142, 1965-1 C.B. 223, 224; *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (4th Cir. 1967), *aff'g,* T.C. Memo. 1966-015, *cert. denied*, 389 U.S. 841 (1967).

Moreover, the 1968 regulations provide that a "presumption of control arises if income or deductions have been arbitrarily shifted." Treas. Reg. § 1.482-1(a)(3) (1968). *See Dallas Ceramic Co. v. Commissioner*, 598 F.2d 1382, 1389 (5th Cir. 1979), *rev'g*, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that based on Treas. Reg. § 1.482-1(a)(3) (1968), the Service properly argued that proof of income shifting between two corporations establishes a presumption of common control). *Accord Hall v. Commissioner*, 294 F.2d 82 (5th Cir. 1961), *aff'g,* 32 T.C. 390 (1959), *acq.*, 1959-2 C.B. 4 (referring to Reg. 111 § 29.45-1). The 1993 and 1994 regulations also contain this presumption, and add that control may exist as a result of the actions of "two or more taxpayers acting in concert with a common goal or purpose." Treas. Reg. § 1.482-

1T(g)(4) (1993); Treas. Reg. § 1.482-1(i)(4) (1994). *Accord DHL Corp. v. Commissioner*, T.C. Memo. 1998-461 ("[W]hen 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 [in determining whether the control requirement under the 1968 regulations is satisfied]."). Thus, under the regulations, joint, legal ownership, or overlapping ownership, is not required for unrelated corporations to come within the purview of section 482 if income or deduction shifting is present, or if there is common goal to shift income or deductions. *But See Lake Erie & Pittsburgh Railway Co. v. Commissioner*, 5 T.C. 558 (1945), *acq.*, 1945 C.B. 5, *acq. withdrawn and substituted for nonacq.*, Rev. Rul. 65-142, 1965-1 C.B. 223; *B. Forman v. Commissioner*, 54 T.C. 912 (1970), *rev'd in relevant part*, 453 F.2d 1144 (2nd Cir. 1972), *cert denied*, 407 U.S. 934 (1972), *reh'g denied*, 409 U.S. 899 (1972), *nonacq,* 1975-2 C.B. 3 (nonacquiescence relates to Tax Court opinion only, as the Second Circuit adopted an interpretation of control that is consistent with 1968, 1993, and 1994 section 482 regulations). Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of section 482 by establishing a shifting of income and deductions. *Dallas Ceramic Co.*, at 1390.

C. <u>Legal Standard for "Same Interests"</u>

If control is found to exist, the Service may allocate income and deductions among members of the "controlled group." Treas. Reg. § 1.482-1(b)(1) (1968); Treas. Reg. § 1.482-1T(a)(2) (1993); Treas. Reg. § 1.482-1(a)(2) (1994). A controlled group or controlled taxpayer is defined to mean the entities owned or controlled by the "same interests," and includes the taxpayer that owns or controls other taxpayers. Treas. Reg. § 1.482-1(a)(5) (1968); Treas. Reg. §§ 1.482-1T(5), (6) (1993); Treas. Reg. §§ 1.482-1(i)(5), (6) (1994). Unlike the term "control," the phrase "same interests" is not defined in the section 482 regulations. Case law as well as the legislative history of section 482 provide guidance, however.

Section 482 was enacted to prevent the artificial shifting of income between controlled taxpayers to avoid Federal taxes, and thereby "milk" a taxable entity, *i.e.,* placing deductions in one entity and income related to those deductions in another entity. *Brittingham v. Commissioner*, 598 F.2d 1375, 1377 (5th Cir. 1979), *citing,* H. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. *See also* H. Rept. No. 350 and S. Rept. No. 275, 67th Cong., 1st Sess. (1921). In using the term "same interests," Congress intended to include more than "the same persons" or "the same individuals." *Brittingham*, at 1379; *South Texas Rice Warehouse Co. v. Commissioner*, 366 F.2d 890, 894-5 (5th Cir. 1966), *aff'g*, 43 T.C. 540 (1965), *cert. denied*, 386 U.S. 1016 (1967); *Appeal of Rishell Phonograph Co.*, 2 B.T.A. 229, 233 (1925). *See also*

LXI-Part 6 CONG. REC. 5827 (1921) (statement of Sen. King referring to the “same forces” controlling a number of corporations). Different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute. *South Texas Rice Warehouse*, at 894-5. *See also Brittingham*, at 1378-9, *citing, Ach,* 42 T.C. at 125-6 (The phrase, “same interests,” should not be narrowly construed to frustrate the intent of section 482); *Appeal of Rishell Phonograph Co.,* at 233 (“If `the same interests’ was intended to mean only `the same persons,’ it would have been easy for Congress, by using the latter term, to have avoided all ambiguity.”). *Accord Grenada Indus., supra.*

Thus, it is not necessary that the same person or persons own or control each controlled business before section 482 can be applied, but there must be a common design for the shifting of income in order for different entities to constitute the "same interests." Indeed, this definition of same interest is identical to the definition of control (and the presumption relating thereto) in the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests will be met. *See Hall v. Commissioner*, *supra*, 32 T.C. at 409-10 (An arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of section 482 -- whether or not ownership exists.).

D. <u>Invoking Section 482 in the Section 351 Transfer of High Basis Stock</u>

This transaction, the transfer of built in loss property in a purported section 351 transaction, involves Partnership contributing its preferred stock in the Corporation X subsidiary to Company A, as part of a section 351 transaction. In this transaction Partnership transfers stock in which it claims to have a high basis in a manner so that Company A takes the Partnership’s high basis in the stock as a carryover basis. We believe section 482 may be applied to this transaction. The control element is met since Partnership, acting in concert with other shareholders of Company A, engaged in a section 351 transaction, so that the built in loss inherent in the stock of the Corporation X subsidiary is transferred to Company A. See Treas. Reg. § 1.482-1(i)(4). In a similar situation the Second Circuit, in *B. Forman Company, Inc. v. Commissioner*, 453 F.2d 1144 (2d Cir. 1972), rev’g 54 T.C. 913 (1970), held that section 482 may be applied in a situation where two totally unrelated parties, McCurdy and Forman each owned 50% of another corporation, Midtown. Section 482 was invoked concerning transactions between the two parent corporations and Midtown, to the extent that McCurdy and Forman together controlled Midtown, and concerning the loans at issue, acted in concert when dealing with Midtown. *But see*, *B. Forman Company, Inc. v. Commissioner*, 54 T.C. 913 (1970), *rev’d*, 453 F.2d 1144 (2d Cir. 1972); *Lake Erie & Pittsburgh Railway Co. v. Commissioner*, 5 T.C. 558 (1945).

Lastly, a presumption of control arises under the facts at issue in that the built in loss, which had been suffered (to the extent that basis of the shares of the Corporation X subsidiary exceeded their fair market value) by Partnership, was arbitrarily shifted to Company A. *See* Treas. Reg. § 1.482-1(i)(5).

Assuming the Secretary has proven that the parties are controlled by the same interests, he "may distribute, apportion, or allocate . . . deductions . . . 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 clearly to reflect the income of any such organizations, trades or businesses." Section 482. Generally, the Commissioner's determinations under section 482 must be sustained absent an abuse of discretion. *G.D. Searle and Co. v. Commissioner*, 88 T.C. 252, 358 (1988). The taxpayer must meet a heavier than normal burden of proof and demonstrate that Commissioner's determinations are arbitrary, capricious, or unreasonable in order for the courts to set aside the Commissioner's determinations. Id.

E. Section 482's Role in Nonrecognition Transactions

We next discuss the interaction of sections 482 and 351. Pursuant to his authority to make allocations under section 482, if necessary to prevent the avoidance of tax or to clearly reflect income, the Commissioner may allocate to the transferor with respect to a nonrecognition transaction, the built in loss from a sale of property which had previously been transferred in a nonrecognition transaction. Treas. Reg. § 1.482-1(d)(5) (1968); Treas. Reg. § 1.482-1T(d)(1)(iii) (1993); Treas. Reg. § 1.482-1(f)(1)(iii) (1994). Courts have sustained the Commissioner's reallocation of gain or loss on taxable dispositions to the transferor with respect to the previous nontaxable transfer of the property under sections 351 or 311 (as then in effect), when the sole or primary purpose of the transfer was to avoid taxation, *e.g*., when the transferee was better able to use the loss, absorb the capital gain, or use the deduction for charitable contributions. *Ruddick Corp. v. United States*, 3 Cl. Ct. 61, 83-2 U.S.T.C. P 9480 (1983), *on remand from* 643 F.2d 168 (Ct. Cl. 1981), *aff'd*, 732 F.2d 168 (Fed. Cir. 1984) (Commissioner's reallocation of capital gain to the subsidiary -transferor was sustained when a wholly owned subsidiary distributed appreciated stock to its parent in a tax free distribution under section 311 as then in effect so that the parent could offset the capital gain from the disposition of the stock with its net operating loss); *Northwestern National Bank v. United States,* 556 F.2d 889 (8th Cir. 1977) (Commissioner's reallocation of charitable contribution deduction to the wholly owned subsidiary was sustained when the subsidiary distributed the appreciated stock to the parent corporation, and the parent contributed the stock to a charitable organization, so that the parent corporation could make use of the charitable deduction); *National Securities Corp. v. Commissioner*, 137 F.2d 600 (3d Cir. 1943) (sustaining

Commissioner's reallocation of capital loss to the parent corporation when the parent corporation contributed built in loss stock to its wholly owned subsidiary in a transaction tax free under the predecessor of current section 351, so that ten months later upon sale of the stock, the subsidiary can make use of the capital loss deduction); *Southern Bancorp. v. Commissioner*, 67 T.C. 1022, 1027 (1977). In this regard it is particularly noteworthy that in *Southern Bancorp. v. Commissioner*, the Commissioner's allocation of gain to the distributing bank subsidiary was sustained notwithstanding that the court noted that the dividend had a business purpose, since the primary purpose for the dividend was tax avoidance. In *Southern Bancorporation* a bank under section 581, distributed appreciated U.S. Treasury notes as a dividend to its nonbank parent, and a few days later the parent sold the notes and realized capital gain. Had the subsidiary sold the Treasury notes, it would have realized ordinary gain. Although the court recognized that "admittedly the payment of a dividend . . . had a business purpose . . . to provide [the parent corporation] with the funds necessary to carry on its business", 67 T.C. at 1027, the court, sustained the Commissioner's reallocation, since the subsidiary's primary business purpose for distributing the Treasury notes as a dividend in kind was tax avoidance. Id. *See also*, *Ruddick Corp. v. United States*, 643 F.2d 747 (Ct. Cl. 1981) at 751-52 (stating that the tax evasion prong of section 482 was applied when a significant element of tax avoidance existed, and conversely that section 482 should not be applied in nonrecognition transactions in which no tax avoidance was present); *but see Eli Lilly and Co. v. Commissioner*, 84 T.C. 996 (1985), *aff'd in part, rev'd in part*, 856 F.2d 855 (7th Cir. 1988), at 1117, 1119 (stating the tax evasion prong of section 482 as situations when the sole purpose of the nonrecognition transfer was for tax avoidance); *G.D. Searle and Co. v. Commissioner,* 88 T.C. 252, 365 (1987) (same). Accordingly, under the cases and principles cited, when Partnership transferred its Corporation X subsidiary stock to Company A in a section 351 transaction and Company A subsequently sold the stock, the built in loss may be allocated to Partnership assuming the purpose of the transaction was solely or primarily for tax avoidance.

We have no information as to Company A's purported business purpose, if any, for acquiring the preferred stock of the subsidiary of X Corporation. As stated above, we argue that section 482 may be invoked assuming Company A's sole or primary purpose in acquiring the subsidiary's preferred stock was to realize the built in capital loss inherent in the stock. Some cases state that section 482 may only be invoked in a nonrecognition transaction when the taxpayer's *sole* purpose for the transaction was tax avoidance. *Eli Lilly and Co. v. Commissioner*, 84 T.C. 996 (1985), *aff'd in part, rev'd in part*, 856 F.2d 855 (7th Cir. 1988), at 1117, 1119; *G.D. Searle and Co. v. Commissioner,* 88 T.C. 252, 365 (1987). As discussed above, *Southern Bancorp. v. Commissioner*, 67 T.C. 1022, 1027 (1977), held that section 482 also may be applied in a nonrecognition transaction when the *primary* purpose of the transaction is tax avoidance, although the taxpayer may also have a nontax business purpose for the transaction.

It should be noted that both *Eli Lilly and Co.* and *G.D. Searle* are distinguishable from the situation in this case because both *Eli Lilly and Co.* and *G.D. Searle* involve situations when taxpayers' investments in Puerto Rico were encouraged by Congress, and the particular assets which were transferred in section 351 transactions were not disposed of. In addition, the courts stated that substantial nontax business purposes existed for the transfers.

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