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COORDINATED ISSUE
ALL INDUSTRIES
LOSSES REPORTED FROM INFLATED BASIS ASSETS FROM LEASE STRIPPING TRANSACTIONS
UIL 9226.01-00

ISSUE

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

CONCLUSION

The theories upon which the Service will challenge losses and deductions from assets with bases traceable to lease stripping transactions must be determined on a case-by-case basis depending on the specific facts and circumstances of each case. In appropriate cases, the bases of the assets either will be limited to their fair market value or reduced by the amount of liabilities assumed in the initial Internal Revenue Code § 351 transaction, so that a taxpayer's later taxable sale of these assets will result in no deductible loss. In other cases, the transaction will be recast as a direct sale (rather than through a partnership) thus eliminating the losses created by absence of a § 754 election.

The Service will disallow such losses for one or more reasons, including but not limited to the following theories and Code sections: the economic substance doctrine and various substance-over-form arguments, §§ 351, 357, 358, 269, and 482; and the partnership anti-abuse rule found in § 1.701-2 of the Income Tax Regulations. To assist in adequately developing the facts and to ensure that the appropriate theories are identified for pursuit in a particular case, examination personnel are encouraged to coordinate with the Intermediary and Inflated Basis Transactions Technical Advisor and to seek the advice of their local counsel.

OVERVIEW

The initial steps of the transaction described below, that purportedly create either an inflated basis stock interest or an inflated basis partnership interest, are designated as listed transactions pursuant to Notice 2003-55, 2003-34 I.R.B. 395 ("Accounting for Lease Strips and other Stripping Transactions").

The transactions in question involve a series of exchanges, several of which purport to comply with § 351. In one configuration of the transaction, a partnership (the "transferor") that is 99% owned by tax neutral partners transfers a third party note to a corporation (the "transferee") in exchange for preferred stock of the transferee, and the transferee's assumption of a transferor liability that is roughly equal to the amount of the note. The transferor asserts that its basis in the transferee's stock equals the transferor's basis in the third party note, unreduced by the amount of the liability assumed (thereby inflating the basis of the transferee's stock). The transferor subsequently exchanges the transferee's stock for stock of a second corporation (the "second transferee") in a purported § 351 exchange. The second transferee claims a carryover basis in the stock of the transferee. The second transferee sells the alleged inflated basis stock, and claims a capital loss. In an alternative configuration of the transaction, the tax neutral partners (the "transferors") of the partnership, who claim an inflated basis in their partnership interest as a result of § 705(a)(1)(A), purport to transfer their partnership interest to a corporation (the "transferee") in a § 351 transaction. Once again, the transferee in such exchange purports to have a carryover basis in the partnership. When the transferee subsequently sells the partnership interest, it asserts that it is entitled to a substantial loss deduction.

While there will be differences among the various cases with respect to the purported business purpose and the structure of these transactions, it is Service position that any business purpose is far outweighed by the taxpayers' interest in generating deductible losses. Adequate factual development is necessary to evaluate and assess the taxpayers' purported business reasons for entering into these transactions. Many of the legal arguments require adequate factual development, and not all arguments will be applicable to each case.

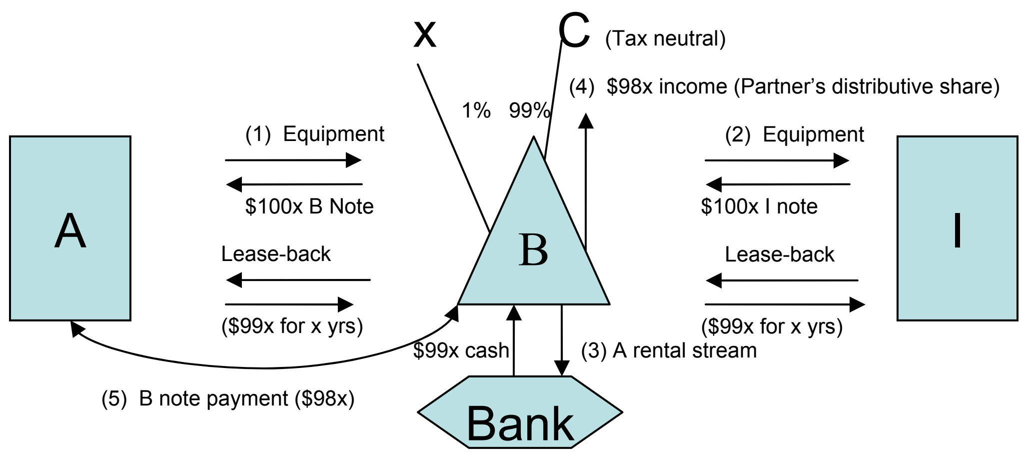
FACTS (See Diagrams Below)

A, a corporation, owns depreciable equipment subject to a pre-existing user lease with an X year term. B, a partnership, purchases the equipment (subject to the user lease) from A in exchange for a $100x note. B immediately leases the equipment back to A for a term of X years and total lease payments due of $99x. B then sells the equipment (subject to the user lease) to I, another corporation, in exchange for I's $100x note; I immediately leases the equipment back to B for a term of X years and total lease payments due of $99x. The residual value of the equipment at the end of X years is minimal or zero.[1]

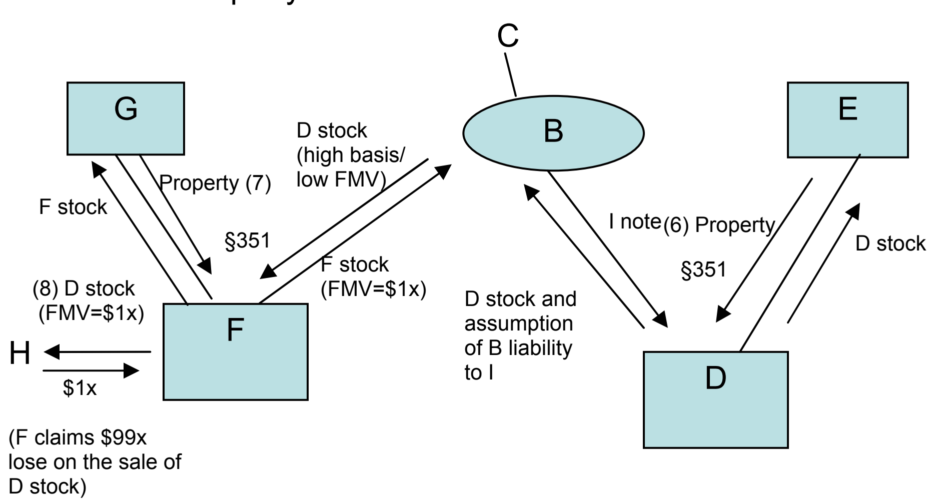
B then sells its right to receive rental payments from A to an unrelated party (a bank), thereby accelerating the income due under the lease. B allocates 99% ($98x) of the income to C, its 99% majority partner. C, which had contributed a negligible amount for its interest in B, is a tax neutral entity. Under § 705(a)(1)(A), C's basis in B is increased by approximately $98(x), which is the amount of C's distributive share for the taxable year in which the income due

[1] The Lease Stripping Coordinated Issue Paper (July 21, 2000) addresses the theories upon which the Service might successfully challenge the tax consequences reported from lease stripping transactions. See also Notice 2003-55, supra 2003-34 I.R.B. 395.

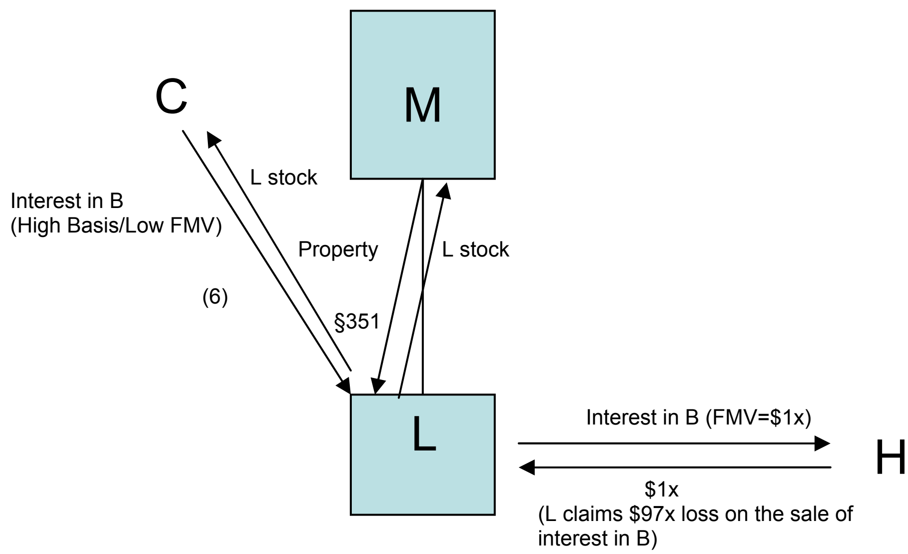
under the lease was accelerated. B uses the sale proceeds to satisfy its note to A.



Thereafter, two possible transactions take place. In the first configuration of the transaction, B transfers its I note to D, a corporation, in exchange for D preferred stock and D's assumption of B's liability to make lease payments to I. D's parent, E, makes a simultaneous transfer of property to D as a party to a purported § 351 transaction. B takes the position that this exchange qualifies as a § 351 exchange and, thus, that its basis in the D preferred stock is equal to its basis in the I note ($100x), unreduced by the amount of the liability assumed by D. See §§ 357(c)(3) and 358. B transfers its D preferred stock to F in exchange for F preferred stock. F's parent, G, makes a simultaneous transfer of property to F as a party to the purported § 351 transaction. The fair market value of the F preferred stock received by B is $1x. The parties take the position the transaction qualifies as a § 351 exchange with the result that under § 362, F's basis in the D preferred stock is the same as B's basis in the D preferred stock (purportedly $100x). F then sells the D preferred stock to H for its fair market value ($1x), claiming a $99x loss. When B transfers its D preferred stock to F, F's sale of the D stock to H may have been prearranged. H is acting as an accommodation party.



In the second configuration of the transaction, after B sells A's rental obligation to the bank and uses the proceeds to pay off its note to A, C transfers its interest in B to L, a corporation, in exchange for L preferred stock. L's parent, M, makes a simultaneous transfer of property to L as a party to a purported § 351 transaction. The fair market value of the interest in B received by L is approximately $1X. The parties take the position the transaction qualifies as a § 351 exchange with the result that under § 362, C's basis in B carries over to L. C's purported basis in B was approximately $98x, which is C's 99% distributive share of B's income reported from the sale of the right to receive rent payments from A. See § 705(a)(1)(A) (providing that a partner's distributive share of the taxable income of the partnership increases that partner's basis in the partnership). L then sells the B interest to H for its fair market value ($1x), claiming a $97x loss. The sale to H is prearranged when C transfers its interest in B to L. H is acting as an accommodation party.



This coordinated issue paper addresses various legal arguments that may be raised to prevent a taxpayer from deducting a loss arising from a sale of an inflated basis asset (such as the D preferred stock and the B partnership interest), when the basis of such asset is traceable to a lease stripping transaction.[2]

[2] Although the discussion that follows focuses on the inflated bases of the D preferred stock and the B partnership interest, the inflated bases from those assets can be transferred to a variety of other assets through subsequent transactions. This Coordinated Issue Paper applies to any asset with an inflated basis traceable to a lease stripping transaction.

DISCUSSION

A. Primary Argument

LACK OF ECONOMIC SUBSTANCE

When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for Federal income tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Nicole Rose Corp. v. Commissioner, 117 T.C. 328, 336 (2001), aff'd, 320 F.3d 282 (2d Cir. 2003); ACM Partnership v. Commissioner, 157 F.3d 231, 246-47 (3d Cir. 1998), aff'g in part and rev'g in part T.C. Memo 1997-115; United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994); Andantech L.L.C. v. Commissioner, T.C. Memo. 2002-97, aff'd in part and remanded in part, 331 F.3d 972 (D.C. Cir. 2003); Long Term Capital Holdings v. United States, 330 F. Supp.2d 122, 171 (D. Conn. 2004).

The lack of economic substance hinges on all of the facts and circumstances surrounding the transaction. No single factor will be determinative. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). Whether a court will respect the taxpayer's characterization of the transaction depends on whether there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978); ACM Partnership v. Commissioner, supra, at 246-48; Casebeer v. Commissioner, 909 F.2d 1360, 1362-64 (9th Cir. 1990), aff'g Sturm v. Commissioner, T.C. Memo. 1987-625; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279-80 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001).

An evaluation of whether the lease stripping transaction lacked economic substance requires separate, but interrelated, inquiries: (1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an inquiry into the objective economic effect of the transaction. See ACM Partnership, supra at 247-48; Casebeer, 909 F.2d at 1363; Kirchman v. Commissioner, 862 F.2d 1486, 1490, 1491 (11th Cir. 1989).

To satisfy the business purpose inquiry, the transaction must be "rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation." ACM Partnership, T.C. Memo. 1997-115, aff'd in relevant part, 157 F.3d 231 (3d Cir. 1998); see Kirchman, supra, at 1490-91.

To satisfy the objective economic effect inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. Knetsch v. United

States, 364 U.S. 361, 366 (1960); ACM Partnership, supra at 248. Offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. See Knetsch, supra; Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543, 1549 (9th Cir. 1987); Bealor v. Commissioner, T.C. Memo. 1996-435 and cases discussed therein; Waegemann v. Commissioner, T.C. Memo. 1993-632. 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. Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, supra, at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-68 (1990). In conducting this economic review, it is appropriate to focus on the taxpayer's calculations at the outset of the transaction. ACM Partnership, supra, at 257.

In ACM Partnership, the Tax Court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. T.C. Memo. 1997-115. The Tax Court further stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. Id. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

The transactions outlined above, taken as a whole, have no business purpose independent of tax considerations. Because the lease stripping transactions in which B acquired the D preferred stock and in which C acquired the basis of its interest in B lacked economic substance, B's basis in the D preferred stock is limited to the value of the property B contributed in exchange for that stock, and C's basis in the interest in B is limited to the negligible amount it contributed in exchange for that interest. As a result, B would have minimal or zero basis in the D preferred stock for F to assume under § 362, and C would have minimal or zero basis in the B partnership interest for L to assume under § 362.

Moreover, because F and L had no valid business purpose for acquiring and selling the stock of D and the B partnership interest, respectively, those transactions lacked economic substance. As a result, F and the G consolidated group, and L and the M consolidated group, are not entitled to the losses reported from the transactions.

B. Secondary Arguments

The theories contained in the remainder of the paper assume that the lease stripping transactions, F's acquisition and sale of the D preferred stock, and L's acquisition and sale of the B partnership interest, were not transactions lacking economic substance. Although some of the facts that support the economic substance theory also support the following theories, a court's decision that a given transaction has sufficient economic substance under the Primary Argument section of this paper will not preclude the Government from arguing and prevailing upon the following theories. Moreover, some of the following arguments may assume that, solely for purposes of a specific argument, certain steps of the transactions are to be respected. This does not preclude the Government from arguing that these steps should not be respected in other arguments. The arguments should thus be set up in the alternative. Finally, Agents should be aware that many of these arguments target a taxpayer by reallocating losses and deductions away from the taxpayer under audit, to other parties to the transaction.

1. SUBSTANCE OVER FORM ANALYSIS

To curb inappropriate tax avoidance transactions, courts have created a broad array of common law doctrines that are designed to limit or eliminate unreasonable tax benefits. The central question in each of these doctrines is whether the form of a transaction reflects its real economic substance. If not, the Government may recharacterize a transaction so that its economics determine the tax consequences. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935).

The various doctrines, which all apply a "substance over form" analysis, go by a variety of names, including the substance over form doctrine, the step transaction doctrine, the business purpose doctrine, the sham transaction (or entity) doctrine, and the assignment of income doctrine. No bright line delineates when effective tax planning ends and abusive tax avoidance begins. The Government's success rate in applying these doctrines is unpredictable, even in cases with seemingly similar facts. The outcomes vary by jurisdiction. Generally, it makes little difference which doctrine a court uses to uphold a substance over form analysis because each doctrine will ultimately achieve a tax consequence that reflects the economic reality of the transaction. Accordingly, Examiners must develop the underlying facts of these transactions so that the most effective doctrines can be asserted according to the particular facts of each case.[3] In the end, the actual framing of an argument will depend on these facts, as well as on the jurisdiction in which any litigation may occur. A brief description of the some of the various doctrines follows.

[3] Andantech v. Commissioner, supra and Long Term Capital Holdings, et al. v. United States, supra, contain particularly good examples of the factual development that needs to be made in these transactions.

First, the substance over form doctrine allows the Service and the courts to recharacterize the form of a transaction if its economic substance is clearly at odds with its form. Gregory v. Helvering, supra. As with all these doctrines, its application is highly dependant on the underlying factual background of the transaction.

Similar to substance over form is the step transaction doctrine. Under this doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused towards a particular result. Courts have developed three alternative step transaction tests. The binding commitment test collapses separate steps only if, at the time the first step was taken, there was a binding commitment to undertake the later transactions. The end result test ignores formally individual steps if they constitute prearranged parts of a single transaction intended from the outset to reach a specific end result. Courts focus on whether the parties intended from the outset to reach a particular result, and on whether that result was actually achieved; the focus is not on whether the taxpayer had a tax avoidance motive. Finally, the interdependence test looks to whether the legal relations created by one step would have been fruitless without the completion of later steps. Steps are generally accorded independent significance if, standing alone, they were undertaken for valid and independent economic or business reasons.

The business purpose doctrine requires a taxpayer to have a valid business purpose for entering into a transaction, other than tax avoidance. When a transaction merely follows the literal letter of the Code, solely to achieve a tax result that was neither contemplated by the drafters of the statute, nor reflective of the transaction's economic reality, the tax results can be successfully challenged under this doctrine. As stated by the Supreme Court, "[T]he question for determination is whether what was done, apart from tax motive, was the thing which the statute intended." Gregory v. Helvering, supra at 469.

A fourth weapon in the Government's arsenal is the sham transaction doctrine. In some circumstances, factual development may uncover that the purported transaction never actually occurred. In other transactions, the economics are such that no actual change in the legal or economic positions of the parties occurred (due to circular cash flows, guarantees and/or the unwinding of certain steps of the transaction shortly after the purported tax consequences were achieved). In these cases, the formalistic steps of a purported transaction may be ignored for tax purposes.

Finally, the assignment of income doctrine provides that a taxpayer may not shift income it has earned to another taxpayer.[4] For purposes of the transactions under consideration here, the principles underlying this doctrine may be relevant for determining who actually sold a built-in-loss asset, or alternatively, who

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[4] Though the assignment of income doctrine is a common law doctrine, its principles have been codified to some extent in § 482.

actually owns the property generating the loss. The deduction should be recognized by the party who economically sustained it.

Obviously, there is a great deal of overlap between the facts that support each of these doctrines (as well as the economic substance requirement set forth in the Primary Argument section of this paper). The application of one or more of these doctrines may be appropriate where, as here, a complex series of formalistic steps creates a desired tax benefit, and each step cannot be shown to have an independent business purpose that is necessary to achieve the stated business goal.

Examiners must develop a factual record that flushes out the economic reality of the transaction. Important questions concern the transaction's non-tax business purpose, and whether such purpose was actually achieved, who actually financed and negotiated the transaction, who could actually profit from it, and who carried a legitimate risk of loss. The presence of certain factors increases the likelihood that the Government will prevail on a substance over form argument. These include: the presence of a promoter of tax avoidance transactions; tax neutral parties that take income or gains into account, while deductions flow to a taxable entity; newly created, transitory entities that are formed solely for the purpose of facilitating in the creation of a tax benefit; transitory "ownership" interests in entities or assets having built-in losses, especially when such interests have little relation to the historic business of the acquirer; transactions that "unwind" themselves shortly after the tax benefit is achieved; circular or illusory transfers of property; and contractual arrangements that limit a participant's risk of economic loss and/or possibility of economic gain, apart from the tax consequences.

Because the transactions under study here take many different forms and utilize many different structures, it is difficult to determine, in advance of the development of a complete factual record, which doctrine will be most effective for challenging the taxpayer's chosen form. Accordingly, Examiners need to develop a complete factual record that that will allow the Service to craft an effective argument tailored to the specifics of each case. If the factual record shows that tax avoidance or evasion was the primary or sole motivation for the participants engaging in these convoluted transactions, then it is appropriate to insert into the Statutory Notice of Deficiency every doctrine that could be applicable to the case. The final determination of which of these doctrines is likely to prove most effective can only be made in light of the factual record, taking into consideration the jurisdiction in which the case will be tried.

2. SECTION 351

Each purported § 351 transfer must be closely scrutinized to determine if all the technical requirements and the business purpose requirement of § 351 are satisfied. If the exchange fails to qualify under § 351, the transaction is taxed as a § 1001 exchange. Thus, each transferor and transferee would have a fair market value basis in any property received.

Section 351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock[5] in such corporation, and, immediately after the exchange such person or persons are in control of the corporation. For purposes of § 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.[6]

In addition to the above statutory requirements, courts have developed a business purpose requirement in § 351.[7] See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of § 351's business purpose requirement is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). Whether a valid business purpose underlies a transaction in which a taxpayer acquires an inflated basis asset traceable to a lease stripping transaction is a factual issue. Generally, a purported § 351 transaction will have sufficient business purpose if a taxpayer can substantiate that it had any valid business purpose for the

[5] Note that for transactions occurring after June 8, 1997, the terms of the stock received in a purported § 351 exchange should be closely scrutinized to determine if the stock is nonqualified preferred stock within the meaning of § 351(g). For purposes of § 351(g), preferred stock is defined as stock which is limited and preferred as to dividends and that does not participate in corporate growth to any significant extent. Section 351(g)(3)(A). Preferred stock that meets this definition will be considered nonqualified preferred stock if it satisfies any one of several objective conditions set forth under § 351(g)(2)(A). Consideration should be given to the following: whether the stock is restricted; whether the rate of return on the stock is fixed or predetermined; whether there are repurchase and sale options and the likelihood that such options will be exercised, and whether the transferor has retained all business risks. If the transferor receives stock other than nonqualified preferred stock in the transaction, then the nonqualified preferred stock would be treated as other property, and its basis would be limited to its fair market value under § 358(a)(2).

[6] Generally, to determine "control", a group of transferors may include all of the transferee stock owned directly (or, in the case of a transferor that is a member of a consolidated group, stock owned by any member of the transferor's group [§ 1.1502-34]) by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. However, a transfer of transferee stock to an existing shareholder of the transferee will not be considered a part of the § 351 exchange if the value of the new stock issued to that transferor is relatively small compared to the value of the transferee stock already owned by that transferor and the primary purpose of the transfer to that transferor was to qualify other transferors for § 351 treatment. See § 1.351-1(a)(1)(ii) and § 3.07 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570.

[7] It has similarly been held that a transaction cast as a contribution under § 721 will not be given effect for tax purposes unless a valid business purpose motivated the transfer. Jacobson v. Commissioner, 96 T.C. 577, 590 (1991), aff'd, 963 F.2d 218 (8th Cir. 1992).

transaction other than just pure tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191.

As noted above, if the transfer fails to qualify as a § 351 exchange, it is subject to § 1001. The transferor recognizes gain or loss at the time of the exchange.[8] The transferee generally does not recognize any gain or loss on the transaction. See § 1032.[9] Both the transferor and the transferee (B and D, and B and F, in the purported § 351 transactions involving D's preferred stock, and C and L in the purported § 351 transaction involving the transfer of the B partnership interest) would have a cost basis in the property received, determined in accordance with the provisions of § 1012 and the regulations thereunder. Thus, if the purported § 351 transaction involving B and D did not qualify as a § 351 exchange, B would have a fair market value basis in the D stock. Further, even assuming B's basis in the D stock was inflated as a result of the first § 351 transaction, if the purported § 351 transaction between B and F is successfully challenged, F would acquire the D stock with a fair market value basis. See § 1.1012-1(a) (providing that such property will take a basis equal to the fair market value of the property exchanged). Similarly, if the transaction between C and L fails to qualify for § 351 treatment, L's basis in the B partnership interest would be its fair market value, and no loss would be realized on L's subsequent sale of the B partnership interest to H.

In sum, each purported § 351 transaction must be carefully scrutinized to determine whether the requirements of § 351 have been satisfied. Examining agents should review the stock agreements to verify compliance with § 351. If any exchange fails to qualify under § 351, it should be treated as a § 1001 transaction.

3. REDUCTION OF STOCK BASIS DUE TO ASSUMPTION OF A TRANSFEROR'S OBLIGATIONS

When a transferor has a liability or obligation assumed in an exchange, there are numerous alternative arguments that may be raised to reduce the transferor's basis in the property received. Accordingly, in the transaction in which B transferred I's note to D in exchange for D's preferred stock and an assumption by D of B's rental obligation to I, the following arguments may be available to reduce B's basis in the D preferred stock.

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[8] Note that if the transferor and the transferee are members of the same consolidated group, recognition of any gain or loss will be deferred.

[9] Section 1032 provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation.

a. Section 357(b)(1)(B)

Even if a court were to determine that the transaction between B and D qualified as a § 351 exchange, if the principal purpose for D's assumption of B's rental liability to I was to enable D to report noneconomic rent deductions while facilitating the creation of a high basis, low fair market value asset (D's stock), the disposition of which would result in a substantial capital loss, then B's basis in the D preferred stock must be reduced by the amount of D's liability assumption. See § 357(b)(1)(B).

Under § 357(a), a liability assumption (or an acquisition of an asset subject to a liability) generally is not considered "other property or money received by the taxpayer" in an otherwise tax-free exchange. However, under § 357(b)(1)(B), if, taking into consideration the nature of the liability and the circumstances under which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption was not a bona fide business purpose, then such assumption will, for purposes of § 351, be considered as money received by the taxpayer on the exchange. Moreover, a taxpayer must prove by a clear preponderance of the evidence, that the principal purpose of such assumption was a bona fide non-tax business purpose.[10] Section 357(b)(2). If § 357(b) applies to the transaction, pursuant to § 358(a), B's basis in the D stock is reduced by the amount of its liabilities that were assumed by D.

The legislative history of what is now § 357(a) indicates that it was designed to protect assumptions and transfers of liabilities occurring in the ordinary course of converting a business from one form to another. The provision that is now § 357(b) was enacted to prevent the tax deferment rule in § 357(a) from encouraging schemes to avoid taxes. Campbell v. Wheeler, 342 F.2d 837, 838 (5th Cir. 1965); Simpson v. Commissioner, 43 T.C. 900, 915 (1965), acq. 1965-2 C.B. 6. These provisions should be applied consistent with the legislative purpose they were designed to serve. Griffiths v. Commissioner, 308 U.S. 355 (1939).

In determining the principal purpose of the taxpayer, the statute requires consideration of "the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made". Complex series of transactions must be evaluated in their entirety in determining whether a liability assumption violates § 357(b). Investment Research Associates v. Commissioner, T.C. Memo. 1999-407. All relevant facts relating to the structuring of the transaction should be analyzed, including: the timing of the

[10] Section 357(b)(1)(B) applies if the taxpayer's principal purpose is not a bona fide business purpose. Thus, section 357(b) can apply even if the taxpayer in fact has some business purpose, as may arguably be the case in some of the transactions under consideration.

transaction, tax advice received, structuring to avoid capital gains, and the business activities of the parties to the transaction, before and after the liability assumption. The nature of the liability should also be analyzed. The circumstances surrounding the transaction and the nature of the liability will bear upon whether the principal purpose of the taxpayer is a bona fide non-tax business purpose.

Courts have distilled several factors that are relevant in determining whether the primary purpose of a liability assumption is a bona fide business purpose within the meaning § 357(b) (or its predecessor § 112(k)). Among the factors are the following:

> 1) Whether the assets subject to the liabilities assumed were also transferred. Stoll v. Commissioner, 38 T.C. 223 (1962).
>
> 2) Whether the liability assumption was incident to the transfer of a business, or closely related to the taxpayer's business, or motivated primarily by business, not personal, considerations. Campbell v. Wheeler, 342 F.2d at 841.
>
> 3) Whether the taxpayer incurred the liabilities to which the transferred property was subject immediately prior to the transfer and in anticipation thereof. Drybrough v. Commissioner, 376 F.2d 350 (6th Cir. 1967).

As noted, taxpayers have a high, statutorily imposed, evidentiary hurdle to overcome in demonstrating that they have a bona fide business purpose as their principal purpose for entering into the liability assumption. The burden of proof rests with the taxpayer to prove by a clear preponderance of the evidence that such assumption should not be treated as money received by the transferor. And yet, in spite of this high burden, the parties have specifically structured these transactions to have the liability (B's obligation to pay rent to I) transfer without the transfer of the corresponding asset (that is, the right to use the property to which the rental expense relates). Further, there is no transfer of any ongoing business activity to D. And finally, in the typical transaction, the tax savings resulting from the transfer of the liability far outweigh any non-tax profit from the transaction.

In the present transaction, the primary purpose for D's assumption of B's rental obligation is to enable D to report noneconomic rent deductions, while at the same time creating an inflated basis asset (D's stock) that can be sold by another taxpayer to create a substantial capital loss. These are not bona fide business purposes. Thus, D's assumption of B's liability to make rental payments to I is squarely within the scope of § 357(b)(1)(B), which results in treating the liability assumption as a distribution of money to B. Accordingly, under § 358(a)(1)(A)(ii), B's basis in the D preferred stock is reduced by the value of the liability assumed by D. That reduced basis carries over to F, reducing or eliminating the loss on F's sale of the D stock to H.

For further information on this argument, contact the Intermediary and Inflated Basis Transactions Technical Advisor.

b. Because D's liability assumed by B is not within the scope of § 357(c)(3), § 358(d)(1) operates to reduce B's basis in the D stock by the amount of the liability assumed.

Even if a court were to determine that the transaction in which B acquired the D preferred stock qualified as a § 351 exchange and that the liability assumed were not within the scope of § 357(b), then B's basis in the D stock would be decreased by the amount of B's assumed liability, pursuant to § 358(d)(1) and § 358(a)(1)(A).

As a general rule, for purposes of § 358, § 358(d)(1) requires an assumption of a transferor's liability to be treated as money received by the transferor. The only exception to this rule is an assumed liability that is excluded under § 357(c)(3). Section 358(d)(2). All other assumed liabilities of the transferor continue to be treated as money received, thereby reducing the basis of the property received by the transferor by the amount of the liability assumed. Section 358(a)(1)(A). Taxpayers engaging in these transactions may argue that they are within the scope of § 358(d)(2). However, because the deduction for the liability assumed in these transactions remains with the transferor, it is not the type of liability Congress intended to exclude under § 357(c)(3). Accordingly, B's basis in the D preferred stock must be reduced by the amount of B's liability assumed by D.

Section 357(c)(3) provides that liabilities, "the payment of which . . . would give rise to a deduction", are not subject to the general rule of § 357(c)(1). Liabilities may be excluded from § 357(c)(1) only to the extent payment thereof by the transferor would have given rise to a deduction. To the extent the liability had already been deducted by the transferor, or the incurrence of the liability resulted in the creation of, or increase to, the basis of any property, the liability is not excluded from § 357(c)(1). See Senate Report for the Technical Corrections Act of 1979, S. Rep. No. 96-498 (1979), 1980-1 C.B. 517, 546. See also S. Rep. No. 95-1263 (1978) and Pub. L. 95-600 (General Explanation of the Revenue Act of 1978). While the flush language in § 357(c)(3) does not specify whether the deduction must be deductible by the transferor or the transferee after the transfer, the legislative history expressly states that § 357(c)(3) was intended to codify the approach taken in Focht v. Commissioner, 68 T.C. 223 (1977) (emphasis added), which set forth the rule that:

> The assumption of a deductible obligation of a cash method taxpayer is a nonrealizable event because it is improper to treat the assumed liability as income to the transferor and deny him the tax benefit for its satisfaction. However, a cash basis taxpayer transferring a nondeductible liability realizes gain irrespective of whether he enjoyed a prior tax benefit, as actual payment would generate no additional tax deduction.

This language, in conjunction with the legislative history cited above, compels the conclusion that Congress adopted §357(c)(3) because it concluded that taxing a transferor on the assumption of a deductible liability for which it would never get a deduction produced an incorrect tax result. Thus, the Service position is that § 357(c)(3) pertains to an assumption of a transferor's deductible liability only if the transferor losses its right to the deduction as a result of the transfer. And, it is only this narrow range of transferor liability assumptions that Congress intended to exclude from the general basis reduction rules of § 358(d)(1) and (a)(1)(A), under § 358(d)(2).[11] All other liabilities of a transferor assumed in a § 351 transaction must reduce the transferor's basis in the transferee's stock.

D's assumption of B's liability to I is not a § 357(c)(3) liability because B retains its right to a deduction when D pays the rental expense. There are several principles compelling this conclusion. First, D's payment to I does not give rise to a deductible expense by D because D's assumption of B's rental obligation is simply a part of D's cost of acquiring the I note.[12] Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946), see also Smith v. Commissioner, 418 F.2d 589, 596 (5th Cir. 1969); Buten v. Commissioner, T.C. Memo. 1972-44.[13] Additionally, under § 162, the payment of B's obligation to I is not a deductible business expense of D. Deputy v. du Pont, 308 U.S. 488, 494 (1940)(no deduction allowed to an individual for payment of corporate expenses).[14] Rather, the deduction accrues to B. Hood v. Commissioner, 115 T.C. 172 (2000)(legal fees paid by a corporation on behalf of its shareholder are deductible as an ordinary and necessary expense of the shareholder).

B will ultimately get the tax benefit associated with the payment of the rental obligation. Thus, D's assumption of B's liability it is not within the scope of § 357(c)(3). Because the liability assumed in the present transaction is not within the intended scope of § 357(c)(3), § 358(a)(1)(A) and (d)(1) require a reduction of B's basis in the D stock equal to the amount of the liability assumed.

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[11] Congress provided § 357(c)(3) liabilities with an exemption from the normal basis reduction rules because, if a transferor were required to reduce its basis in the transferee's stock by the amount of the assumed liability, the basis reduction would ultimately have the effect of taxing the transferor on the very liability assumption that Congress had concluded it would be incorrect to tax. As a result of § 358(d)(2), the tax benefit of the deduction to the transferor is preserved in the basis of the transferee stock, to be realized on its later sale.

[12] Note that D's basis in the I note is determined under § 362; therefore, D's payment of B's liability to I gives rise to no additional basis. See Ways and Means Committee Report, H. Rept. No. 855, 76th Congress 1st Sess. (1939), 1939-2 C.B. 518, 519.

[13] Although Rev. Rul. 95-74, 1995-2 C.B. 36, permits a corporate transferee to claim deductions accruing upon payment of assumed liabilities, it applies only if there is a transfer of a trade or business and, at the time of the § 351 exchange, the transferor had no plan to dispose of the stock received. In the transaction here, neither of these requirements is satisfied. Therefore, the transaction is not within the scope of Rev. Rul. 95-74, and D is subject to the rule set forth in Holdcroft, supra.

[14] Section 162 permits deductions only for a taxpayer's own ordinary and necessary business expenses. It does not permit deductions of expenses paid or incurred for the benefit of another person or entity. Welch v. Helvering, 290 U.S. 111, 113 - 114 (1933).

For further information on this argument, contact the Intermediary and Inflated Basis Transactions Technical Advisor.

c. Section 358(h): Stock acquired in transactions occurring after October 18, 1999

Section 358(h)(1) provides that if, in a transfer to which § 358(a) applies, after application of the other provisions of § 358, the basis of the property permitted to be received on the exchange exceeds its fair market value, then such basis shall be reduced (but not below fair market value) by the amount of any liability assumed (unless the assumption was treated as money received by the transferor under § 358(d)(1)). Except as provided by the Secretary, § 358(h)(2)(A) excludes the assumption of any liability that is assumed in connection with the transfer of the trade or business with which the liability is associated; § 358(h)(2)(B) provides a similar exclusion for the assumption of a liability in connection with the transfer of substantially all of the assets with which the liability is associated. The term "liability" is broadly defined for purposes of § 358(h). Section 358(h) was added to the Code by § 309(a) of the Community Renewal Tax Relief Act of 2000, P.L. 106-554, and is effective for transfers after October 18, 1999.

If a court were to determine that § 358(d)(1) does not apply to B's assumed liability, then, in a transaction occurring on or after October 18, 1999, under § 358(h), B's basis in the preferred stock of D would be reduced (but not below fair market value) by the amount of liabilities assumed by D. That basis carries over to F, reducing or eliminating any loss on F's sale of the D stock to H.

Until regulations under § 358(h) are promulgated, the application of § 358(h) to transactions covered by this coordinated issue paper should be coordinated with the national office through the Intermediary and Inflated Basis Transactions Technical Advisor.

d. If a taxpayer claims, and a court agrees, that B's rental obligation to I is not a "liability" for purposes of § 358(d), then, under § 358(a)(1)(A)(i), B's basis in the D preferred stock must be reduced by the fair market value of D's agreement to pay that obligation, because D's agreement is a form of consideration ("other property") received by B on the exchange

Taxpayers may argue that, because B has not yet used the rental property, B's future rental obligation is not a "liability" for Federal income tax purposes. If a court were to conclude that the rental obligation is not a "liability", then § 358(d)(1) would not operate to treat D's assumption of B's rental obligation as money received by B, and thus B's basis in the D preferred stock would not be reduced under § 358(a)(1)(A)(ii). However, if D's promise to pay B's future rental obligation is not a "liability" assumption for purposes of § 358, it must be a form of consideration or "other property" received by B on the exchange. Section

§ 358(a)(1)(A)(i) operates to decrease B's basis in the D preferred stock by the fair market value of this consideration.

As noted above, § 351(a) provides that no gain or loss is 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. By statute, the only non-stock consideration a taxpayer may receive in a § 351 exchange, without potential gain recognition, is an assumption of liabilities not in excess of the basis of the property transferred. See §§ 351, 357. All other consideration continues to be treated as money or other property (i.e., "boot") that may result in the transferor's recognition of gain, and a reduction to the basis of the property received by the transferor on the exchange.

Under the facts presented here, B transferred I's $100x note to D in exchange for D's preferred stock (that was worth $1x), and D's agreement to fulfill B's future rental obligation to I. The negligible fair market value of the D preferred stock, as compared to the value of the I note, is objective evidence that D's agreement to pay B's future rental obligations constitutes a form of consideration received by B that induced B to transfer the note. Accordingly, if, in a transaction similar to the one presented here, a court were to conclude that B's future rental obligation is not a "liability" for Federal income tax purposes, then D's agreement to pay B's rental obligation is a form of taxable consideration received by B, which reduces B's basis in the D stock under § 358(a)(1)(A)(i).

4. SECTION 269

Section 269(a) provides that, if

(1) any person or persons acquire, directly or indirectly, control of a corporation, or

(2) any corporation acquires, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of § 269, control means ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. Section 1.269-3(c)(1).

Under § 1.269-3(a)**,** if the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, then the acquisition is subject to the provisions of § 269. The comparison is based on all the facts and circumstances. Bobsee Corp. v. United States, 411 F.2d 231, 238 (5th Cir. 1969).[15] The requisite purpose must exist at the time of the acquisition.

Some of the factors that courts have considered when deciding this question include: (1) whether the taxpayer had a policy of, or predisposition to, tax avoidance, (2) whether the taxpayer made contemporaneous statements and actions showing its dominant purpose to be the use of tax benefits, (3) whether subsequent transactions indicated that federal income tax consequences were an important aspect of the deal, (4) whether obtaining the acquired assets was a significant purpose for the acquisition, (5) whether the acquirer had a substantial interest in carrying on the business or businesses it acquired, (6) whether the value of the acquisition outweighed the value of the tax benefits, (7) whether the acquisition served a formally documented expansion plan of an ongoing business, (8) whether the acquired/acquiring business providing the tax benefits was an inoperative shell, and (9) whether the tax benefits were not otherwise able to be used by the taxpayer. See U.S. Shelter Corp v. U.S, 13 Cl. Ct. 606 (1987), Federated Department Stores Inc. v. United States, 170 B.R. 331 (S.D. Ohio 1994); Cromwell Corp. v. Commissioner, 43 T.C. 313 (1964); VGS Corp. v. Commissioner, 68 T.C. 563 (1977).

In the transactions presented here, both F and L acquired property with a basis that was determined by reference to the transferor's basis in such property. Further, the principal purpose for F's acquisition of the D stock and L's acquisition of the B partnership interest was to secure F and L the benefit of noneconomic tax losses from the inflated bases of the D stock and B partnership interest, respectively (and even if F or L were to assert a business purpose, it would be out weighed by their principal purpose of avoiding Federal income tax). However, because F and L neither acquired control of a corporation, as required by § 269(a)(1), nor acquired property from another corporation, as required by § 269(a)(2), § 269 is inapplicable to the facts presented in this paper.

In a case under audit, if a party to one of the § 351 transactions acquired control of a corporation within the meaning of § 269, or if the entity acting in B's capacity were a corporation, the acquisition should be carefully scrutinized to determine whether the additional requirements of either § 269(a)(1) or (2) are satisfied. When all the requirements of either section are satisfied, § 269 should be asserted to disallow any loss claimed from the disposition by F and L of the D stock and B partnership interest, respectively.

[15] Some courts have determined "the principal purpose" of a transaction by grouping all of the tax avoidance purposes of the transaction together and all of the business purposes of the transaction together, and then weighing the two groups against each other. See Bobsee Corp. v. United States, supra; U.S. Shelter Corp v. U.S., 13 Cl. Ct. 606 (1987).

5. SECTION 482

Under section 482, the Service may allocate losses between entities owned or controlled by the same interests in order to prevent the evasion of taxes or clearly reflect income. Control is defined to include any kind of control, direct or indirect, whether legally enforceable, and however exercised. 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. §1.482-1(i)(4). The analysis of control focuses on the reality of control, rather than rigidly on equity ownership. Ach v. Commissioner, 42 T.C.114 (1964), aff'd. , 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966).

In cases in which the taxpayer that reports the loss from the inflated-basis asset is under common control with the party from which it received the asset, section 482 provides the Service with authority to allocate any loss from the disposition of the asset from the taxpayer that reports the loss to the party from which it received the inflated-basis asset, where such an allocation is necessary to clearly reflect income or to prevent the avoidance of tax. The application of section 482 to allocate income and deductions from lease stripping transactions has received special scrutiny. In Rev. Rul. 2003-96, 2003-34 I.R.B. 386, the Service ruled that section 482 should not be applied to reallocate income and deductions arising from property subject to a lease stripping transaction entered into and effected among unrelated parties solely on the basis that the parties were acting in concert, regardless of any arbitrary shifting of income. Revenue Ruling 2003-96 expressly reserved, however, on whether section 482 control could be established as a result of parties joining together in a purported section 351 transaction.

In cases where the party who receives an inflated-basis asset in a nonrecognition transaction disposes of that asset a short time after the transfer, section 482 may potentially apply to allocate the loss back to the contributor of the inflated-basis asset. In National Securities v. Commissioner, 137 F.2d 600 (3d Cir. 1942), the Third Circuit Court of Appeals sustained the allocation of built-in loss from a subsidiary to its parent in the same taxable year, where the subsidiary disposed of stock it had received from the parent ten months earlier. Pursuant to the principles of National Securities, since codified in regulations, the Service will consider the application of section 482 to allocate such losses on a case-by-case basis. Treas. Reg. §1.482-1(f)(1)(iii). In appropriate cases, the facts may demonstrate that unrelated parties were "acting in concert" to effect a transfer of inflated basis property and a subsequent disposition of that property by the transferee. In evaluating a potential application of section 482 based on a theory that parties acted in concert in making a nonrecognition transfer, a relevant factor is whether the parties had, at the time of the transfer, a plan to effect the realization of losses by the transferee. For example, in situations where the contributor of the inflated basis asset redeems its stock in the transferee prior to the transferee's disposition of the asset, section 482 may still potentially apply where a plan existed prior to the time the asset was transferred. See generally

DHL v. Commissioner, T.C. Memo. 1998-461, 106-06 (1998) aff'd in part, rev'd in part on other grounds, 285 F.3d 1210 (9th Cir. 2002) (common ownership for purposes of control under section 482 evaluated at the time parties bind themselves to a transaction).

In making this determination, the Service will give due consideration to the amount of time elapsed between the transfer and the subsequent disposition of the inflated basis assets and the relationship between the contributor and the taxpayer that reports the loss. In evaluating section 482 in this context, the Service will carefully scrutinize the factors in National Securities, including the year the property is received and disposed of, the amount of time the property is held, the amount of the built-in loss at the time the property is received, and the amount of loss sustained at the time of the disposition.

Section 482 control might also be established by proving as a factual matter actual control of one partner or shareholder over another partner or shareholder. In accordance with Revenue Ruling 2003-96, actual control cannot ordinarily be established merely as a result of the contractual dealings between the parties. See also Treas. Reg. §1.482-1(i)(9) (defining true taxable income). However, where contractual dealings involve the irrevocable surrender of shareholder or partnership rights of control by one party in favor of another party, where as a result of receiving the rights the party controls the entity, actual control has been found despite the ceding party's retention of majority economic ownership. See Charles Town, Inc. v. Commissioner, 372 F.2d 415, 417-418 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967).

6. ALTERNATE TRANSACTION: TRANSFER TO PARTNERSHIP

In one variation on the transaction described above, B contributes D preferred stock to a partnership J, instead of contributing the D stock to a corporation. B then sells its J partnership interest to K, a party that can utilize the built-in losses to offset other gain. In this situation, the anti-abuse regulation § 1.701-2 supports denying the losses reported by J from the sale of the D preferred stock.

If B contributes property in exchange for a partnership interest in J, under § 723, J partnership would take a carryover basis in the D preferred stock that exceeds its fair market value. Under these circumstances § 704(c) would apply. That section provides that where a partner contributes property to a partnership and the property has a fair market value that is different than the basis of the property to the partnership, then under regulations prescribed by the Secretary, gain or loss with respect to the property shall be shared among the partners so as to take into account the variation. In other words, losses from built-in loss property such as the D preferred stock must be allocated to the partner that contributed the property. Treasury Regulations issued under Code § 704(c) explain that its purpose is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Treas. Reg. § 1.704-3.

Section 1.704-3(a)(7) provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Thus, under this fact pattern, J and B may attempt to rely on that provision to allocate the built-in loss from the preferred stock to K, a pre-existing partner of J, with sufficient basis to take the loss. This shift in loss allocations is accomplished by K's purchase of B's partnership interest in J before J sells the D preferred stock. After the sale, under Treas. Reg. § 1.704-3(a)(7), the loss inherent in the D preferred stock is allocated to K, who uses the loss to offset other gain.

Section 1.701-2, the partnership anti-abuse rule, in pertinent part, provides that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements: (1) the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) the form of each partnership transaction must be respected under substance over form principles; and (3) except as otherwise provided, the tax consequences under subchapter K to each partner of the partnership operations and of transactions between the partnership and the partner must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement is treated as satisfied with respect to a transaction that satisfies requirements (1) and (2) to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by the provision.

Section 1.701-2(b) provides that if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of subchapter K. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K: (1) the purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Treas. Reg. § 1.701-2(c). Section 1.701-2(c) lists various factors that may be considered in making the determination.

Section 1.701-2(d), Example 8, provides an example of a plan to duplicate losses through the use of a partnership, lacking a § 754 election, that is not consistent with the intent of subchapter K. In Example 8, A wanted to sell land to B with a basis of $100x and a fair market value of $60x. A and B devised a plan a principal purpose of which was to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. A, C, and W formed a partnership ("PRS"). A contributed the land and C and W each contributed $30x. PRS invested the $60x in an investment asset. In year 3, at a time when the values of the partnership's assets had not materially changed, PRS agreed with A to liquidate A's interest in exchange for the investment asset held by PRS. Under § 732(b), A's basis in the asset was $100x. A sold the investment asset to X, an unrelated party, recognizing a $40x loss.

PRS did not make an election under § 754. Accordingly, PRS's basis in the land contributed by A remained at $100x. PRS sold the land to B for $60x, its fair market value. Thus, PRS recognized a $40x loss that was allocated equally between C and W, and they each reduced the bases in their partnership interests to $10x. Thus, upon liquidation of PRS (or their interests therein), each of C and W would recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. In § 1.701-2(d), Example 8, PRS was used with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under § 707), the Commissioner can recast the transaction as appropriate under Treas. Reg. § 1.701-2. Compare, Treas. Reg. § 1.701-2(d), Example 9, in which the use of a partnership for which no election under § 754 had been made is consistent with the intent of subchapter K. That is, PRS was a bona fide partnership the purpose of which was to conduct joint business activity through a flexible arrangement, and the ultimate tax results were clearly contemplated by § 754. For these reasons the transaction is treated as satisfying the proper reflection of income standard and will be respected.

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

The transactions here are subject to recharacterization under Treas. Reg. § 1.701-2, based on the following factors:

First, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transactions were respected for federal tax purposes. If the transactions were respected for federal tax purposes, K would be allocated capital losses (resulting from transactions in which K did not sustain a corresponding economic loss), which K would use to offset capital gains.

Second, the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly. If B and K had conducted the activities directly rather than through J partnership, B would have sold the D preferred stock directly to K rather than contributing the D preferred stock to J partnership. Upon the sale of the preferred stock to K, B would have recognized a tax loss. K would have taken a cost basis in the preferred stock equal to the fair market value of the preferred stock. Upon the subsequent sale of the preferred stock at fair market value, K would not have recognized a capital loss, which it claimed through the partnership. Conducting the activities through J partnership allowed K to claim capital losses, which it used to offset capital gains. Because B and K conducted the activities through J partnership, K's aggregate federal tax liability was substantially less than it would have been if B and K had dealt directly.

Third, the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. As discussed above, the present value of K's federal tax liability was substantially less than would be the case if the transactions were integrated into a direct sale of B's D preferred stock to K. It was contemplated that B, whose J partnership interest was necessary to allocate the purported built-in loss in the preferred stock to K, would hold the interest for a transitory period, until the sale to K.

Accordingly, the Service may conclude that the contribution by B of the D preferred stock to J partnership, and the subsequent sale of the J partnership interest to K, were in substance a sale by B of the D preferred stock to K and a subsequent contribution by K of the D preferred stock to J partnership.

C. APPLICABILITY OF PENALTIES

1. The Accuracy-Related Penalty

Section 6662 imposes an accuracy related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement under chapter 1. There is no stacking of the accuracy related penalty components. Treas. Reg. § 1.6662-2(c). Thus, the maximum accuracy related penalty imposed on any portion of an underpayment is 20% (40% in the case of a gross valuation misstatement) even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). The accuracy-related penalty provided by § 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under § 6663. I.R.C. § 6662(b).

Negligence or intentional disregard of rules and regulations

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Neely v. United States, 775 F.2d 1092, 1095 (9th Cir. 1985); Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g in part, remanding in part 43 T.C. 168 (1964). Negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii). If the facts establish that a taxpayer reported losses from a transaction that lacked economic substance or reported losses or deductions from assets with bases traceable to lease stripping transactions that would have seemed, to a reasonable and prudent person, to be "too good to be true," then the accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to ascertain the correctness of the claimed losses or deductions. The focus of inquiry is the reasonableness of the taxpayer's actions in light of the taxpayer's experience and the nature of the investment. See Henry Schwartz Corp. v. Commissioner, 60 T.C. 728, 740 (1973); see also Sacks v. Commissioner, 82 F.3d 918, 920 (9th Cir. 1996) (stating that whether a taxpayer is negligent in claiming a tax deduction "depends upon both the legitimacy of the underlying investment, and the due care in the claiming of the deduction").

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of a notice or revenue ruling.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. If the position relates to a reportable transaction within the meaning of Treas. Reg. § 1.6011-4(b), however, the position must also be disclosed in accordance with Treas. Reg. § 1.6011-4. Treas. Reg. § 1.6662-3(c)(1). This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Treas. Reg. § 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Treas. Reg. § 1.6662-3(b)(2). This exception for positions with a realistic possibility of success does not apply to reportable transactions, however. Id.[16]

Substantial understatement

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies). I.R.C. § 6662(d)(1); Custom Chrome, Inc. v. Commissioner, 217 F.3d 1117, 1127-28 (9th Cir. 2000).[17] Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there is or was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. § 6662(d)(2)(B).

[16] The rules with respect to reportable transactions are effective for returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Treas. Reg. § 1.6662-2(d)(5).

[17] For taxable years ending after October 22, 2004, an understatement of income tax by a corporation (other than an S corporation or personal holding company) is substantial if it exceeds the lesser of (1) 10 percent of the tax required to be shown on the return (or, if greater, $10,000) or (2) $10,000,000. The American Jobs Creation Act (“AJCA”), P.L. 108-357, sec. 819.

In the case of any item of a taxpayer other than a corporation which is attributable to a tax shelter, exception (2) above does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. I.R.C. § 6662(d)(2)(C)(i).[18] In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) above applies. I.R.C. § 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies unless the reasonable cause exception discussed below at section 3 applies. See Treas. Reg. § 1.6664-4(f) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. I.R.C. § 6662(d)(2)(C)(iii). For transactions entered into before August 6, 1997, the relevant standard was whether tax avoidance or evasion was the "principal purpose" of the entity, plan, or arrangement. Treas. Reg. § 1.6662-4(g)(2)(i). If the facts establish that an understatement attributable to the disallowance of losses or deductions from assets with bases traceable to lease stripping transactions exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies), the substantial understatement component of the accuracy-related penalty may apply.

Substantial valuation misstatement

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. I.R.C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." I.R.C. § 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20 percent accuracy-related penalty under § 6662(a) is increased to 40 percent. I.R.C. § 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Long Term Capital Holdings, 330 F.Supp.2d at 199; Gilman v. Commissioner, 933 F.2d 143, 149-52 (2d Cir. 1991). If the facts establish that the claimed adjusted basis of an asset with a basis traceable to a lease stripping transaction is 200 percent or more of the correct

[18] For taxable years ending after October 22, 2004, there is no reduction in the amount of the understatement attributable to tax shelter items for both corporate and noncorporate taxpayers. AJCA, sec. 812(d).

amount, then a substantial valuation misstatement exists; if the facts establish that the claimed adjusted basis of an asset with a basis traceable to a lease stripping transaction is 400 percent or more of the correct amount, then a gross valuation misstatement exists.

2. The Fraud Penalty

Section 6663 imposes a penalty for fraud in an amount equal to 75 percent of the portion of the underpayment that is attributable to fraud. Fraud is established if it is shown that a taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983). Knowingly understating income by overstating basis can constitute evidence of fraud. Slaughter v. Commissioner, T.C. Memo. 1954-58 (holding that fraud existed with respect to return on which taxpayer had reported a loss by overstating the basis of an asset sold); Smith v. Commissioner, T.C. Memo. 1992-353 (holding that fraud existed with respect to a return on which taxpayer claimed an asset was "placed in service" earlier than it was in order to claim depreciation and an investment tax credit), aff'd without published opinion, 993 F.2d 1539 (4th Cir. 1993). The existence of fraud is a question of fact to be resolved based on the entire record. Mensik v. Commissioner, 328 F.2d 147, 150 (7th Cir. 1964); Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), aff'd without published opinion, 578 F.2d 1383 (8th Cir. 1978). Fraud is never presumed and must be proven by clear and convincing evidence. Stone v. Commissioner, 56 T.C. 213, 220 (1971), acq. in result, 1972-2 C.B. 3.; Beaver v. Commissioner, 55 T.C. 85, 92 (1970). Fraud may, however, be proven by circumstantial evidence and, as a result, a taxpayer's entire course of conduct can be considered in determining whether fraud exists. Rowlee v. Commissioner, supra; see also Stone v. Commissioner, supra at 223-24.

Facts establishing that a taxpayer attempted to conceal or mislead, such as by deliberately mislabeling an item, incorrectly reporting the relevant facts, or reporting an item so as to reduce the likelihood that it would be identified for examination, can constitute evidence of fraud. Spies v. United States, 317 U.S. 492, 499 (1943). Similarly, implausible or inconsistent explanations of behavior are indicia of fraud. Grosshandler v. Commissioner, 75 T.C. 1, 20 (1980). In addition, failing to cooperate during an examination is evidence of fraud. Korecky v. Commissioner, 781 F.2d 1566, 1568 (11th Cir. 1986); Marcus v. Commissioner, 70 T.C. 562, 578 (1978), aff'd without published opinion, 621 F.2d 439 (5th Cir. 1980). If factors discussed above are present, then the fraud penalty may be applicable.

3. The Reasonable Cause Exception

The accuracy-related and fraud penalties do not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. I.R.C. § 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Id.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Nicole Rose Corp. v. Commissioner, 320 F.3d 282, 284-85 (2d Cir. 2002), aff'g 117 T.C. 328 (2001) (sustaining a finding that a tax avoidance scheme "was so clear and obvious that the participation of professionals could not shelter [the taxpayer] from the penalties"). Reliance on professional advice constitutes reasonable cause and good faith only if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1). In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. Treas. Reg. § 1.6664-4(c)(1). The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. Treas. Reg. § 1.6664-4(c)(1)(i). For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purpose) for entering into a transaction and for structuring a transaction in a particular manner. Id. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. Id. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Treas. Reg. § 1.6664-4(c)(1)(ii). For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Id.

Further, where a tax benefit depends on nontax factors, the taxpayer also has a duty to investigate such underlying factors. See Novinger v. Commissioner, T.C. Memo. 1991-289 (stating that taxpayer cannot avoid the negligence addition to tax merely because his professional advisor has read the prospectus and had advised the taxpayer that the underlying investment is feasible from a tax perspective, assuming the facts presented are true). If the tax advisor is not versed in these nontax factors, mere reliance on the tax advisor does not suffice. See Collins v. Commissioner, 857 F.2d 1383, 1386 (9th Cir. 1988) (holding that taxpayer's reliance on tax advice from accountant who knew nothing firsthand about the venture was unreasonable); Freytag v. Commissioner, 89 T.C. 849, 887-89 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (holding reliance on tax advice unreasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Goldman v. Commissioner, 39 F.3d 402, 408 (2d Cir. 1994) (taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was unreasonable where accountant lacked industry knowledge).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. Treas. Reg. § 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a § 6662(a) accuracy-related penalty, the Tax Court in Neonatology Associates P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002), stated that the taxpayer has to satisfy the following three-prong test: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer gave to the advisor the necessary and accurate information; and (3) the taxpayer actually relied in good faith on the advisor's judgment.

Reliance on representations by insiders or promoters is an inadequate defense to negligence. See LaVerne v. Commissioner, 94 T.C. 637, 652-53 (1990), aff'd without published opinion, 956 F.2d 274 (9th Cir. 1992); Neonatology Associates, P.A. v. Commissioner, 115 T.C. at 98-100. Similarly, it is unreasonable to rely on tax advice given by a tax advisor who has an inherent conflict of interest, such as a tax advisor retained by a promoter to draft a tax opinion. See Addington v. Commissioner, 205 F.3d 54, 59 (2d Cir. 2000) (holding it was unreasonable to rely on tax advice from lawyer hired by promoter to provide tax opinion for tax shelter); Goldman v. Commissioner, 39 F.3d at 408 (holding it was unreasonable to rely on tax advice from accountant with conflict of interest); Carroll v. Commissioner, T.C. Memo. 2000-184, aff'd, 22 Fed.Appx. 52 (2d Cir. 2001) (holding it was unreasonable to rely on tax advice from law firm hired by promoter to provide tax opinion for tax shelter).

When a portion of the underpayment results from a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), and the taxpayer failed to disclose that transactions in accordance with Treas. Reg. § 1.6011-4, there is a strong presumption that the taxpayer did not act in good faith with respect to that portion of the underpayment. Treas. Reg. § 1.6664-4(d). This rule applies to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Treas. Reg. § 1.6664-1(b)(2)(ii). Note, however, that the preamble to the temporary regulations under I.R.C. § 6011 promulgated in February 2000 stated that failure to disclose a reportable transaction in accordance with Treas. Reg. § 1.6011-4T (which at that time applied only to corporate tax shelter transactions) "could" indicate that the taxpayer had not acted in good faith. *See* Preamble to T.D. 8877 (2/28/2000).

Rules for determining reasonable cause for purposes of a substantial understatement attributable to tax shelter items of a corporation

Special rules apply with respect to determining reasonable cause for purposes of applying the substantial understatement component of the accuracy-related penalty to underpayments attributable to tax shelter items of a corporation. A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if, at a minimum, there is substantial authority within the meaning of Treas. Reg. § 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(f)(2)(i).

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

Although satisfaction of the "substantial authority" and "reasonable belief" requirements is necessary to find that a corporation had reasonable cause for an underpayment attributable to a tax shelter item of a corporation for purposes of the substantial understatement penalty, that may not be sufficient. For example, reasonable cause may still not exist if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. Treas. Reg. § 1.6664-4(f)(3).