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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate District Counsel, Phoenix

FROM: Associate Chief Counsel
Passthroughs and Special Industries, CC:PSI

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated January 23, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

DISCLOSURE STATEMENT

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

LEGEND:

Corp A =
Corp B =
Corp C =
Corp D =
Corp E =
Year 1 =
Year 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
$f =
$g =

$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
$u	=
$v	=
$w	=
$x	=
$aa	=
$bb	=
$cc	=
amount 1	=

ISSUE:

1. Whether Corp A, which had expiring capital loss carryovers, realized a capital gain in the amount of $f in Year 2 when it transferred to Corp D a promissory note and $g in exchange for a promissory note from Corp D.

2. Whether Corp A realized a capital gain in the amount of $r in Year 2 when, having acquired three Corp E notes from Corp B, Corp A received payments of $q on the Corp E notes.

CONCLUSION:

1. Corp A did not realize a capital gain in Year 2 when it transferred to Corp D a promissory note and $g in exchange for a promissory note from Corp D. First, the transaction is an economic sham. In addition, even if the form of the transaction is respected for federal income tax purposes, Corp A's amount realized on the exchange of the note did not exceed its basis in the note.

2. Corp A did not realize a capital gain in Year 2 when it received payment on the Corp E promissory notes. First, the transaction is an economic sham. In addition, even if the form of the transaction is respected for federal income tax purposes, Corp A's amount realized on the payment of the Corp E notes did not exceed its basis in the Corp E notes.

FACTS:

Transaction 1

Corp A is a holding company filing a consolidated tax return. In Year 1, Corp A sold stock in one of its subsidiaries resulting in a consolidated capital loss of $h. In Year 2, the year those losses were to expire if unused, Corp A entered into a number of transactions designed to generate capital gains.

Corp B owned certain equipment that, prior to the date the transaction was entered into, it leased to three lessees (the User Leases). The User Leases were not affected by any of the transactions entered into by Corp A. The lessees retained possession of the equipment and the terms of the leases remained the same. The leases had expiration dates of Date 1, Date 2, and Date 3. Further, Corp B, prior to the date the transaction was entered into, sold the right to the lease payments to Corp E.

On Date 4, Corp B sold the leased equipment to Corp C for a price of $i. In return for the equipment, Corp B received two promissory notes in the amount of $j and $k. On Date 4, Corp B and Corp C also entered into a Master Lease agreement under the terms of which Corp C leased the equipment back to Corp B.

On Date 5, Corp A purchased Corp B's rights in the promissory note Corp B received from Corp C and Corp B's rights under the Master Lease agreement. Corp A gave to Corp B $l and Corp A acquired the use of the equipment from the date the User Leases expire until Date 6, the date the Master Lease expires. Along with the receipt of Corp B's rights under the Master Lease agreement, Corp A was obligated to make the payments required by the Master Lease agreement. The payments required to be made by Corp A in connection with the Master Lease agreement matched Corp C's promissory note payments required to be made to Corp A.

On Date 5, Corp A sold to Corp D its interest in the promissory note from Corp C. In return, Corp A received a note payable from Corp D in the amount of $m. Corp A also paid Corp D a cash amount.

For Year 2, Corp A reported a capital gain of $f in connection with this Transaction 1. In computing its capital gain on the exchange, Corp A contended that its basis in the Corp C note prior to the exchange was $n, the $l paid for the Corp C note plus the amount accrued on the Master Lease prior to Corp A's acquisition of the rights under the Master Lease.

Transaction 2

Three limited partnerships owned certain equipment leased to various users under numerous lease agreements (the User Leases). On Date 7, the partnerships and Corp B entered into three Master Lease agreements under which Corp B agreed to lease the equipment for periods after the User Leases expire. Also on Date 7, the partnerships agreed to assign all of their rights and obligations under the User Leases to Corp B.

On Date 8, Corp B sold its lessor rights under the User Leases to Corp E. Corp B received three promissory notes from Corp E.

On Date 9, Corp A acquired Corp B's rights under the Master Lease in return for a payment of $o and assumption of certain Corp B obligations to the partnerships. Also on Date 9, Corp B made payable to Corp A the three promissory notes from Corp E.

On Date 10, Corp A paid Corp E $p. Corp E then paid Corp A $q, which was a payoff of the three promissory notes. For Year 2, Corp A reported a capital gain of $r in connection with this Transaction 2.

LAW AND ANALYSIS:

It is well settled that the economic substance of transactions, rather than their form, governs for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). Thus, a transaction that is entered into primarily for the purpose of obtaining tax benefits with no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752 (1975); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978). When a transaction is treated as a sham, the form of the transaction is disregarded and the proper tax treatment of the parties to the transaction is determined.

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved by the transaction's tax benefits. Thus, where a taxpayer seeks to claim tax benefits not intended by Congress by means of transactions serving no economic purpose other than tax benefits, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3rd Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir. 1966), aff'g 44 T.C. 284 (1965); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3rd Cir. 1998).

Whether a transaction has economic substance is a factual determination. This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The stated purpose of the transaction and the reasons for the means chosen to engage in the transaction must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha v. Commissioner, supra; ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. The two inquiries use interrelated factors to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, supra at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner, supra.

All of the facts and circumstances surrounding the transactions must be considered. No single factor will be determinative. Courts will respect the taxpayer's characterization of the transactions if 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, supra; Casebeer v. Commissioner, supra.

Transaction 1

Economic substance analysis

Transaction 1 was entered into for the purpose of Corp A incurring a capital gain to offset capital losses set to expire in Year 2. Because most aspects of the transaction as it relates to Corp A have no economic or commercial objective beyond the tax benefits derived by Corp A, we believe the form of the transaction should not be respected and, based on the true economic substance of the transaction, should be treated differently for federal income tax purposes.

First, in determining whether a transaction has sufficient economic substance to be respected for tax purposes, courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. For example, in Knetsch v. United States, 364 U.S. 361 (1960), the taxpayer purchased an annuity bond using nonrecourse financing. However, the taxpayer repeatedly borrowed against increases in the cash value of the bond. As a result, the bond and the taxpayer's borrowings constituted offsetting obligations and 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 to provide the taxpayer only with tax benefits.

In the present case, Transaction 1 was structured so that the timing and amount of the payments required to be made by Corp A purportedly for use of the equipment matched precisely the timing and amount of the payments to be received by Corp A on the Corp C promissory note. Prior to Corp A's transfer of the note to Corp D, Corp A was to receive amount 1 from Corp C. Not coincidentally, Corp A's obligation to Corp C for the use of the equipment from the date the User Leases expire until Date 6, the date the Master Lease expires, was also amount 1. This circular cash flow and offsetting obligation eliminated any real economic significance to that part of the transaction. Further, when Corp A transferred the note to Corp D in exchange for a promissory note from Corp D, nothing of economic significance changed concerning Corp A. That is, Corp A, rather than receiving amount 1 from Corp C, instead receives that same amount 1 from Corp D. Thus, Corp A's obligation to make payments of amount 1 to Corp C is completely offset by Corp A's right to receive payments from Corp D.

Finally, on Date 10, Corp A, Corp C, and Corp D arranged for the payments required to be made by Corp C for the purchase of the equipment to be made by Corp D and the payments required to be made by Corp A to Corp C, purportedly for the use of the equipment, to be made by Corp D. Thus, because Corp A's obligations to Corp C were fully defeased by Corp D's obligation to Corp A, Corp D simply made the payments to Corp C, further demonstrating the offsetting and circular nature of the payments in this transaction.

Another factor in determining whether a transaction has sufficient economic substance to be respected for tax purposes is whether the transaction consists of a series of pre-arranged steps. Such a plan is evidence that the taxpayer had no regard for the economic implications of the steps, but rather intended to pursue the steps primarily to receive the resulting tax benefits. In ACM Partnership v. Commissioner, supra, the IRS was successful in showing that a series of pre-arranged transactions involving the purchase and sale of debt instruments in an attempt to shift accelerated installment sale gain to a tax-neutral partner and manufacture a loss for another partner lacked economic substance. In the case, the Commissioner argued that the purchase and sale of debt instruments were pre-arranged and pre-determined, devoid of economic substance, and lacking in economic reality. The court found that the taxpayer desired to take advantage of a tax result 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. The opinion, therefore, demonstrates that the court will disregard a series of otherwise legitimate transactions where the Commissioner is able to show that the facts, when viewed as a whole, have no economic substance.

In the present case, it is apparent that Corp A engaged in a series of pre-arranged steps in which Corp A's intent in pursuing the various steps was to obtain tax benefits. The entire series of transactions arose as a result of a presentation by Corp B to Corp A. Clearly, Corp A did not seek out and negotiate with Corp D on the sale of the Corp C note to Corp D. Rather, that step of the transaction, which occurred on the same day Corp A obtained the Corp C note, was arranged by Corp B as an integral part of the entire transaction. It appears that all of the steps in the complex transaction were in place when Corp A acquired the rights to lease the equipment from Corp B and Corp C's note in exchange for Corp A assuming Corp B's leasehold obligations and $l, and were in place in an attempt to allow Corp A to utilize expiring capital losses and take ordinary operating deductions in subsequent years.

A third factor in determining whether a transaction has sufficient economic substance to be respected for tax purposes is the relationship between the fair market value of property involved in a transaction and its purchase price. In fact, some courts have maintained that an inflated purchase price is the single most important factor in determining that the actual motive for a transaction is tax avoidance. See J.T. Bromwell v. Commissioner, T.C. Memo 1993-438; Independent Elec. Supply, Inc. v. Commissioner, 781 F.2d 724 (9th Cir. 1986), affg. T.C. Memo 1984-472.

In Estate of Franklin v. Commissioner, supra, a limited partnership purchased a motel for $1,224,000. The purchase price was to be paid over a 10-year period through small monthly principal and interest payments together with a large balloon payment of the difference at the end of that period. The purchase obligation was nonrecourse, and apart from $ 75,000 paid as prepaid interest, no cash exchanged hands because the parties had entered into a leaseback, which payments approximated the stated monthly payments provided for under the purchase agreement. Since the lease was on a net basis, the sellers remained responsible for all of the operating expenses, and they remained responsible for the first and second mortgages until the balloon payment was made. In concluding that the partnership was not entitled to the depreciation deductions generated by the property, the court stated that the fatal defect in the arrangement was the fact that the taxpayers failed to establish that the purchase price was at least approximately equivalent to the fair market value of the property.

In the present case, Corp A contends that it acquired the rights to lease the equipment in exchange for assuming Corp B's lease payments for the equipment. If Corp A's contention is accepted, it assumed obligations of amount 1, which has a present value of $j, for the rights to property valued by the IRS at $s. Similarly, by treating Transaction 1 in the manner that it did, Corp A is contending that it acquired Corp C's promissory note with a present value of $j for $l. Corp A then, on the same day it acquired the note, exchanged the Corp C note for Corp D's note also with a present value of $j. It is a strong indicator that the transaction lacks economic substance where property is sold for $j that was purchased the same day for $l. It is apparent, therefore, that the cost assigned to the rights to lease the equipment by Corp A is in no way indicative of the $s re-lease value of the equipment. This excessive valuation is further indication of the lack of any potential significant economic consequences other than the creation of tax benefits.

Finally, while some courts have refused to call a transaction a sham if the taxpayer had, apart from the tax benefits, either (1) a business purpose for entering into the transaction or (2) a reasonable opportunity for economic profit, other courts require taxpayers to meet both requirements to avoid sham treatment. See Casebeer v. Commissioner, supra; Prager v. Commissioner, T.C. Memo 1993-452. In the present case, regardless of the proper test, we do not believe Corp A can demonstrate either a business purpose or a reasonable opportunity for economic profit in connection with Transaction 1. Corp A had no prior experience in leasing transactions and was not expanding its operations to generally include the leasing of equipment. Further, it is apparent that Transaction 1 was not entered into for profit, apart from its tax benefits. Corp A's acquisition of the Corp C note (and subsequent sale of the note to Corp D) will not result in a profit because the payments it was entitled to receive on the Corp C note (and, following the sale, the Corp D note) are fully offset by the leasehold obligations it assumed from Corp B. The only other component of the transaction, in which Corp A acquired the rights to the equipment following expiration of the User Leases, can hardly be considered one with profit potential given that the equipment had a re-lease value of $s and was acquired by Corp A for $l. Corp A also made a payment to Corp D further diminishing its opportunity for profit apart from the transaction's tax benefits.

Therefore, in conclusion, it is our position that the form of Transaction 1 should be ignored. Instead, Transaction 1 should be viewed as one in which Corp A purchased from Corp B for $l the rights to the equipment from the date of the expiration of the User leases to the date of the expiration of the Master Lease. For purposes of determining Corp A's tax liability in Year 2, all other components of the transaction should be ignored and not given significance. Thus, Corp A does not have a capital gain in Year 2 for the transfer of the Corp C note to Corp D.

The determination and application of economic substance is always a highly factual matter. With respect to the facts in this case, our analysis invests heavily in the IRS appraisal value of the re-lease potential to Corp A of the equipment involved in Transaction 1. The taxpayer's re-lease appraisal of the equipment in Transaction 1 is substantially higher than that of the IRS appraisal. The only possible non-tax profit potential Corp A could derive from the transactions is the re-leasing of the equipment for an amount greater than the amount of cash expended by Corp A for those rights. The IRS appraisal indicates that there is no profit associated with Transaction 1.

Basis analysis

Even assuming the form of Transaction 1, as described above, is respected for tax purposes and not ignored for lack of economic significance, it nevertheless continues to be our position that Corp A did not realize a capital gain in the amount of $f in Year 2 when it transferred to Corp D the promissory note acquired from Corp C.

Section 1001(a) of the Internal Revenue Code provides that a taxpayer's gain from the sale of property shall be the excess of the taxpayer's amount realized over the adjusted basis provided in § 1011 for determining gain, and that the taxpayer's loss shall be the excess of the taxpayer's adjusted basis provided in § 1011 over the amount realized.

Section 1001(b) provides that a seller's amount realized from the sale of property is the sum of any money received plus the fair market value of the property (other than money) received.

Section 1011(a) provides, for purposes of this analysis, that the adjusted basis for determining the gain or loss from the sale or other disposition of property shall be the basis of such property as determined under § 1012.

Section 1012 provides, in general, that the basis of property shall be the cost of such property. Section 1.1012-1(a) of the Income Tax Regulations provides that the cost of property is the amount paid for property in cash or other property. Part of the cost of property, and thus an amount also included in the basis of such property, is any liability incurred to make the acquisition or any liability of the seller assumed by the taxpayer as consideration for the property. Crane v. Commissioner, 331 U.S. 1 (1947); Stackhouse v. U.S., 441 F.2d 465, 467 (5th Cir. 1970); Bertoli v. Commissioner, 103 T.C. 501 (1994).

Case law has established that where a mix of properties is acquired, the total cost of such properties must be allocated among the properties in the ratio that the fair market value of each particular property bears to the fair market value of all properties acquired. Banc One Corp v. Commissioner, 84 T.C. 476 (1985), aff'd, 815 F2d 75 (6th Cir. 1987); Laird v. United States, 556 F.2d 1224 (5th Cir. 1977); F&D Rentals, Inc. v. Commissioner, 44 T.C. 335 (1965); Rev. Rul. 55-675, 1955-2 C.B. 567. For this purpose, if one of the properties acquired has a readily ascertainable value and other property does not, the value of the property without ascertainable value should be the difference between the purchase price and the value of the property with the ascertainable value. Banc One Corp, supra.

The issue in the present case is the cost, and thus the basis, of the Corp C promissory note acquired by Corp A. In Transaction 1, the Corp C note and the rights to use the equipment were acquired in exchange for cash and the assumption of lease obligations. In our view, the assumption of the lease obligation must be taken into account in determining the cost of acquiring the Corp C promissory note.

In Commissioner v. Oxford Paper Company, 194 F.2d 190 (1952), the lessee, desiring to rid itself of a lease, assigned its lease to the taxpayer. The lessee also paid the taxpayer $100,000 in cash and transferred to it stock in another corporation worth $6,000, land, a building, machinery and equipment. One of the questions the court had to decide was the amount of the basis of the building acquired by the taxpayer when it assumed the lease obligations. The court stated as follows:

> It seems to this court that the correct analysis of the entire transaction is that the property the taxpayer received was acquired by way of purchase for which it paid the obligations it assumed under the lease less the
> $100,000 cash received. [Citations omitted]. Since cost, computed in accordance with [section 1012], with certain exceptions not here relevant, is the proper basis for depreciation deductions, the taxpayer must show what part of the assumed obligations, which were its cost [citations omitted] is allocable to the [building]. This it has not done on the present record and, since the assumed obligation consisted of what was shown to
> be a low rent, it may turn out that the [building] cost little, if anything. But,
> whatever amount is properly allocable to the [building] is the basis for depreciation, not the [building]'s fair market value at the time of acquisition. Id. at 192.

Similarly, Rev. Rul. 55-675, examined this issue of the manner in which basis is computed when property is acquired in connection with the assumption of leasehold obligations. As in Oxford Paper Company, Rev. Rul. 55-675 involved a lessee ridding itself of an unwanted lease by assigning that lease to a sublessee and transferring property to the sublessee in consideration for assuming the lease. In discussing the basis of the property acquired, the Rev. Rul. held that the basis of the property is its cost, and the leasehold obligations assumed, provided they are not so contingent and indefinite that they cannot be valued, must be taken into account in determining such cost.

In Transaction 1, Corp A acquired the Corp C promissory note and the rights to the equipment following the expiration of the User Leases in exchange for $l and assumption of the amount 1 payments due under the Master Lease. As noted above, an IRS appraisal concluded that the value of Corp A's rights to the equipment from the date of the expiration of the User Leases to the date of the expiration of the Master Lease was $s. Corp A, therefore, assumed an obligation with a present value of $j for the rights to the equipment, which was worth only $s. Consequently, it is apparent that a large portion of the assumed lease payments was in consideration for the acquisition of the Corp C promissory note and, contrary to Corp A's computation, should be taken into account in computing the basis of the Corp C note.

It is our position that the difference between the re-lease value of the equipment as appraised by IRS and the amount of the leasehold obligations assumed by Corp A represents liabilities assumed in consideration for property acquired by Corp A. This difference, $x, must be taken into account in determining the purchase price of the property acquired by Corp A. Thus, the purchase price of the property, $u, which is the sum of the $l amount Corp A paid to Corp C and the $x portion of the lease payments assumed in consideration for the property, must be allocated in proportion to the relative fair market value of the acquired property.

We know the fair market value of the Corp C note is $j. Therefore, $j of the $u purchase price should be allocated to the basis of the Corp C note. The remaining purchase price must then be allocated to the basis of Corp A's rights to use the equipment. Consequently, Corp A would not have a capital gain on the exchange of the Corp C note because its amount realized for the Corp C note is equal to the basis of the Corp C note.

Sale vs. lease

If the Master Leases were re-characterized as sales, Corp A, in Transaction 1, would be considered to have acquired the equipment and the Corp C note in exchange for $v, its $l payment plus the $j assumption of the Corp B's liability incurred to purchase the equipment. In accordance with the analysis set forth above, the $v would be allocated between the acquired property in proportion to the relative fair market values of the property. Corp A's basis in the Corp C note would be equal to the amount realized on the exchange of that note for Corp D's note and no capital gain would arise. If the Master Leases are considered capital leases, we believe there is a strong argument in asserting that Corp A has no capital gains resulting from the transactions.

Whether a transaction is a sale or a lease is a question of fact, which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). The judicial test for determining if a transaction is a sale, as opposed to a lease or a financing arrangement, is whether the benefits and burdens of ownership have passed to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229 (1987). The Tax Court analyzes the following factors to determine if the benefits and burdens of ownership pass in a transaction: (1) whether legal title passed; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the sale contract obligated the seller to execute and deliver a deed and obligated the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the property's operation, retention and sale. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981). Although the potential for gain and the amount of risk have been deemed the pivotal factors, the overall concentration should lie on the economic substance of the transaction. Mapco, Inc. v. United States, 556 F.2d 1107, 1111 (Ct. Cl. 1977).

Rev. Rul 55-540, 1955-2 C.B. 39, also addresses whether a transaction is a sale or a true lease for federal income tax purposes. The ruling states that, in the absence of compelling persuasive factors to the contrary, a transaction should be treated as a purchase and sale rather than as a lease or rental agreement if one or more of the following conditions are present:

(a) Portions of the periodic payments are made specifically applicable to an equity interest to be acquired by the lessee;

(b) The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make;

(c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to purchase title to the property;

(d) The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property; or

(e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.

Rev. Rul. 55-540 also provides that there is a presumption that a transaction is a sale and not a lease if the total of the rental payments, and any option price payable, approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement.

Of particular importance in the above factors seems to be the value of the property once the lessee no longer has use of the property and whether the lessee could have purchased the property for the amount it is paying in rent. In the present case, again we point to the IRS appraisal and note that the amount Corp A contends it paid for the use of the equipment far exceeds the value of that equipment. The factors listed above suggest that such a transaction is not an operating lease but a capital lease.

Transaction 2

Economic substance analysis

For the reasons discussed above, we believe the form of Transaction 2 should be ignored for federal income tax purposes. Transaction 2, like Transaction 1, was entered into primarily for the purpose of obtaining tax benefits. If Corp A's treatment of Transaction 2 is accepted, Corp A will have received $q for property for which it paid only $o.

It is our position, therefore, that the form of Transaction 2 should be ignored. Instead, the transaction should be viewed as one in which Corp A paid $w for the right to lease the equipment for the period following the expiration of the User

Leases until the expiration of the Master Lease. The rest of the transaction should not be given effect for federal income tax purposes.

Basis analysis

Even if the lack of economic significance argument is not asserted, it continues to be our position that Corp A does not have a capital gain of $r in Year 2 as a result of Transaction 2. Similar to the discussion relating to Transaction 1, whether Corp A has a capital gain for its receipt of payment on the Corp E promissory notes depends on the adjusted basis of the notes prior to Corp E's payment. Corp A takes the position that it had an adjusted basis in the notes of $o, the amount Corp A contends it paid to acquire the notes, and thus had a capital gain of $r.

Under Corp A's computation, the $r of capital gain recognized by Corp A is the difference between the $q Corp E paid Corp A and Corp A's $o adjusted basis in the notes. Corp A, however, in computing its adjusted basis in the Corp E notes, failed to account for the fact that not only did Corp A make a payment to acquire the Corp E notes from Corp B, it also assumed certain obligations of Corp B. Clearly, a significant part of the assumption of those obligations was in payment for the Corp E notes, which far exceeded in value the $o amount that Corp A contends it paid for those notes. In fact, Corp A's own valuation of its rights to use the equipment following the expiration of the User Leases is far less than the cost it assigned to its rights to use the equipment. Thus, as in Transaction 1, Corp A received multiple properties (the Corp E promissory notes and Corp B's rights under the Master Lease) in exchange for cash and assumption of certain Corp B liabilities.

As discussed above, where a mix of properties is acquired, the total cost of such properties must be allocated among the properties based upon their relative fair market values. Further, where one of the properties acquired has a readily ascertainable value and other property does not, the value of the property without ascertainable value should be the difference between the purchase price and the value of the property with the ascertainable value. Banc One Corp, supra.

In determining Corp A's basis in the acquired property, the purchase price of the property, including the portion of the lease payments assumed in consideration for the property, must be allocated in proportion to its relative fair market value of the acquired property. Because we know the value of the Corp E notes to be $q, $q should be Corp A's basis in the Corp E notes. The remaining cost is then allocated to the basis of Corp A's rights to use the equipment. Corp A, therefore, does not have a capital gain on the payment of the Corp E notes because its amount realized for the Corp E notes is equal to its basis in the Corp E notes.

Sale vs. lease

For the reasons discussed above, we believe that the Master Leases in Transaction 2 should be considered capital leases. If the Master Leases in Transaction 2 were considered capital leases, in addition to the $o payment made by Corp A, all of the assumed liabilities would be taken into account in determining the cost and thus the basis of the acquired property. The cost of the acquired property would be allocated between the property in proportion to its relative fair market values. If the Master Leases are considered capital leases, we believe there is a strong argument in asserting that Corp A has no capital gains resulting from this transaction.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Please call Horace Howells at (202) 622-3050 if you have any further questions.

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