DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR JODY TANCER
ASSOCIATE AREA COUNSEL (BROOKLYN)
LMSB (CC:LM:FSH:BRK)

FROM: ASSOCIATE CHIEF COUNSEL (PASSTHROUGHS AND SPECIAL INDUSTRIES) CC:PSI

SUBJECT: Lease Strip Transaction/Inflated Basis - Transferee Liability

This memorandum responds to your request for nontaxpayer specific Chief Counsel Advice. Chief Counsel Advice is not binding on Examination or Appeals. This document is not to be used or cited as precedent.

ISSUES

1. Does the transaction under the facts described below lack economic substance?

2. Can the shareholders of A, a corporation, be held liable as transferees for A's tax liability resulting from A's gain on the sale of appreciated assets?

CONCLUSIONS

1. Yes. On these facts, there is no objective economic substance or business purpose for the formation of the sale and lease backs and subsequent sale of the right to receive lease payments.

2. The distribution rendered A insolvent. Under the relevant state law, the distribution would be fraudulent as to other creditors in a fact specific case. If so, the shareholders may be transferees under the laws of such state. In addition, the shareholders may be transferees under the trust fund doctrine as they received a distribution from their corporation rendered the corporation insolvent.

FACTS

We understand that the following hypothetical situation is representative of the type of factual situations that are being confronted by the Leasing ISP Team. Our response is limited to these facts. We caution that when you confront these or similar issues with respect to a specific taxpayer, you should consider whether a field service request or a technical advice request is needed.

Corporation 1 (“C1") purchases equipment from unrelated corporations for approximately $40M. The equipment is then leased to unrelated end-users. One month later, Partnership 1 (“P1") purchases the equipment subject to the leases, from C1 for $40M.   P1 issues a full recourse promissory note for the entire purchase price. On the same day, P1 leases the equipment back to C1. C1's lease payment obligations roughly equal P1's purchase price obligations under the note it issued to C1.

On the same day, P1 sells the equipment, subject to the preexisting leases and obligations, to D Corp for the same $40M. D Corp pays for the equipment with a series of notes equaling $40M. D Corp immediately leases the equipment back to P1. P1's payments under the lease equal D Corp’s purchase price obligations under the notes it issued to P1.

Approximately one month later, P1 sells its right to receive the equipment lease payments from C1 to a domestic bank for $35M in cash; this is roughly equivalent to the present value of the stream of payments due under the lease. This money is paid directly to C1 in payment of the bulk of the promissory note issued by P1 to C1 when P1 purchased the equipment. P1 has a 98 percent partner that is tax indifferent, i.e., not subject to United States taxation. This partner is allocated 98 percent of the accelerated income.

Two weeks later, but within the same calendar year, C1, in a purported transaction under I.R.C. § 351, transfers $1M to its wholly owned subsidiary, S1, and receives 2000 shares of S1’s common stock. On the same day, pursuant to the same purported section 351 transaction, P1 transfers to S1 the $40M in notes receivable issued to it by D Corp, and S1 agrees to pay an amount equal to P1's lease payment obligations due to D Corp, and also transferred 200 shares of its preferred stock to P1. The fair market value of these shares was $200K. P1 claims a basis in the S1 shares of $40M. S1 takes deductions related to the lease payment obligations.

Two days later, but still within the same calendar year, D Corp. sells the equipment and its rights under the master leases to an unrelated company for $40M. D Corp. uses this amount to prepay in full the note now held by S1.

In the following year, in order to take advantage of P1's inflated basis in the S1 stock created by the above-described purported section 351 transaction, a group of promoters forms a second partnership, P2, by contributing $20K. P2 forms Company A Acquisition Corporation (ACQ) and contributes the $20K to ACQ in exchange for 100 percent of the company's stock. ACQ takes out a bridge loan for $80M. ACQ then purchases the shares of Company A (A) for $80M in cash. A, which has seven shareholders, has assets with a value of $80M and a basis of $60M. ACQ then merges into A with A surviving.

On the same day, in a purported section 351 transaction, P1 transfers 100 of its shares of S1's preferred stock (with a fair market value of $100K and a purported basis of $20M) to A for 40 shares of newly issued A common stock. At the same time, P1 transfers its remaining 100 shares of S1's preferred stock (also with a fair market value of $100K and a purported basis of $20M) to Company B (B) for 40 shares of B's newly issued common stock.

A then sells its (built-in gain) assets to an unrelated corporation for $83M. A realizes a capital gain of $23M on the sale of its assets. $80M is used to pay off the bridge loan that financed ACQ's acquisition of the A stock. The remaining $3M pays off fees and other liabilities.

One month later, B buys the100 shares of the S1 stock from A for $90K. A claims a $19,910M capital loss ($20M basis - $90K). The loss helps to offset the gain realized from the sale of the assets.

A few months later S1 redeems its 200 shares of stock from B for $200K. B claims a capital loss of $19,890M ($20M basis in the 100 shares received from P1 + $90K basis in the 100 shares purchased from A - $200K). Accordingly, at the end of this complex series of transactions, C1 is once again the 100 percent owner of S1.

LAW AND ANALYSIS

1. Lack of Economic Substance

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

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363. See also Notice 95-53, 1995-2 C.B. 334.

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, 435 U.S. 561, 583-584 (1978); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990).

Recently, the Service was successful in showing that a series of prearranged 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. ACM Partnership, 157 F.3d 231.

In ACM Partnership, the Commissioner argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance, and lacking in economic reality. The 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. The court also stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved primarily by tax reduction. It held that the transaction lacked economic substance and, therefore, that the taxpayer was not entitled to the claimed deductions. The opinion 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. See Rev. Rul 99-14, 1999-13 I.R.B. 3 (because lease-in/lease-out transactions have no economic substance, a U.S. taxpayer could not take deductions for rent or interest paid or incurred in connection with the transaction); see also, Compaq v. Commissioner, 113 T.C. 214 (1999); UPS of Am. v. Commissioner, T.C. Memo. 1999-268; Winn-Dixie v. Commissioner, 113 T.C. No. 29 (1999).

While the profit potential or economic risk, relative to the expected tax benefit, necessary to meet the objective economic substance test has not been quantified, a reasonable prospect or possibility for profit is required. See Horn, 968 F.2d at 1237-38 n. 10, 13; Rice's Toyota World, Inc., 81 T.C. at 202. Nominal or de minimis profit potential does not imbue a transaction with economic substance. Knetsch v. United States, 364 U.S. 361 (1960); Hines v. United States, 912 F.2d 736 (4th Cir. 1990), rev'g 89-9 USTC (CCH) ¶ 9523 (E.D.N.C. 1989); Krumhorn v. Commissioner, 103 T.C. 29, 55 (1994); Sheldon v. Commissioner, 94 T.C. 738, 767-68 (1990); Estate of Thomas v. Commissioner, 84 T.C. 412, 438 (1985).

On these facts, there is no objective economic substance or business purpose for the formation of the sale and leasebacks and subsequent sale of the right to receive lease payments. In a taxpayer specific case, however, factual development will have to support this position. If factual development supports that the primary purpose of the transaction was the creation of tax benefits and that the sale-leasebacks have no economic substance, then P1 has no basis in the assets and obligations it purportedly transferred to S1 in exchange for stock.

If the facts show the following, then the argument that the transaction lacks economic substance is strengthened:

- Whether the transaction, which could reasonably be expected to be tax-neutral over its normal life expectancy, was artificially divided into an income leg and a loss leg;

- Whether the entity that is either tax-exempt or not subject to U.S. taxation, if it exists, effectively exits from the transaction, leaving the loss generated by this transaction to be recognized by a U.S. taxpayer to utilize against other income;

- Whether the U.S. taxpayer is at no time exposed to any significant risk of economic loss as a result of the transaction and at no time had a significant opportunity to earn an economic profit as a result of the transaction; and

- Whether the U.S. taxpayer does not provide any detailed explanation of its tax-independent motivation for entering into the transaction.

It should also be determined whether the parties followed a pre-determined plan in carrying out the above-described steps. Such a plan could establish that they 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 addition, you should develop facts that show the relationships between the parties and demonstrate whether there are prearrangements between them so as to establish that there is no economic substance to the transaction.

We also recommend that you attempt to obtain information regarding the following:

- Any information or correspondence that the participants controlled or crafted the role of the other participants. It is possible that the other participants in the transaction required and maintained written assurances and that such information or correspondence would establish that the transaction was prearranged and controlled. If this can be affirmatively established, e.g., from interviews or documents concerning the transaction, it may be used to establish actual, effective control. See Hall v. Commissioner, supra; see also Unger v. United States, 61-1 U.S.T.C. ¶ 9163, p. 79,309-10 (N.D. Tex. 1960) (because the taxpayer's lease-in/lease-out transaction lacked economic substance, a relevant factor in evaluating a sale-leaseback transaction's economic substance was whether the buyer/lessor had experience in leasing or dealing with assets of the type at issue.).

- Who hired and compensated the appraiser(s) who computed the residual value of the equipment.

- How was the transaction reported for financial statement purposes.

- What was C1's projected pre-tax economic profit and its cost of investing in the transactions.

Dependent upon the analysis set forth above, if the lease stripping portion of the transaction lacks economic substance, then P1 would not be able to claim a basis in the assets that it transfers in a purported section 351 transaction to S1.

2. Transferee Liability

P2 transfers 20K to ACQ in exchange for 100 percent of ACQ's common stock. ACQ, a transitory company, borrows 80M from an unrelated bank, in order to buy 100 percent of the A stock from its original shareholders. ACQ transfers the 80M to the A shareholders in exchange for their stock, then merges into A, with A surviving. A thus assumes the 80M liability to the unrelated bank. Shortly thereafter, A sells its assets to an unrelated party for 83M and uses the 83M to pay off the bank loan and to satisfy other liabilities. Thus, A was left with minimal remaining assets. These events render A insolvent, in that it had insufficient assets to satisfy the tax liability generated by the sale of its appreciated assets.
The 80M transfer to the original A shareholders in exchange for their stock can be characterized in two ways. On the one hand, it can be characterized as a redemption distribution (and hence a transfer to the original shareholders) since the payments had their source in A (because they were derived from an 80M obligation taken on and satisfied by A). See, Custom Chrome v. Commissioner, 217 F.3d 1117 (9th Cir. 2000).

Alternatively, the transfer may be characterized as a liquidation (i.e. a de facto liquidation) distribution (and hence a transfer) by A to its original shareholders, since A has no assets, business activity or ability to satisfy its liabilities after it used the proceeds from the sale of its assets to pay off the loan and other obligations. See, Treas. Reg. § 1.332-2(c); Redina v. Commissioner, T.C. Memo. 1996-392.

More specifically, as the shareholders and not A may be held liable for the tax, we must next consider whether transferee liability can be asserted. Section 6901(a) provides a procedure through which the Service may collect from a transferee of assets unpaid taxes owed by the transferor of the assets if a basis exists under applicable state law or equity for holding the transferee liable. Bresson v. Commissioner, 111 T.C. 172 (1998); and Hagaman v. Commissioner, 100 T.C. 180, 183 (1993). A transferee's liability may be established either at law or in equity. Estate of Stein v. Commissioner, 37 T.C. 945 (1962). Section 6901 does not create the liability of a transferee, but is a secondary method for enforcement of the existing liability of the transferor. Mysse v. Commissioner, 57 T.C. 680 (1972). Although section 6901 provides a method by which to collect the tax, state law determines the existence and extent of the liability of a transferee. Gumm v. Commissioner, 93 T.C. 475, 479 (1989); Nicholson v. Commissioner, T.C. Memo.

1984-299; Adams v. Commissioner, 70 T.C. 373 (1978), aff'd in part dismissed in part, 688 F.2d 815 (2d Cir. 1982); and Pierce v. Commissioner, 61 T.C. 424, 432 (1974).

In the case of a shareholder, liability may arise in equity, based on court decisions applying the trust fund doctrine, or at law, based on state statutes (such as the Uniform Fraudulent Transfer Act), or on both. C.D. Construction Corp. v. Commissioner, 451 F.2d 470 (4th Cir. 1971); Ginsberg v. Commissioner, 305 F.2d 664 (2d Cir. 1962) (applying the law of fraudulent transfers).

In general, shareholders who receive a liquidating distribution from a corporation that subsequently winds up its affairs and dissolves without paying a federal income tax liability have been held to be transferees under the trust fund doctrine. Dillman v. Commissioner, 64 T.C. 797 (1975); Commercial Finance Co. v. Commissioner, T.C. Memo. 1968-229; Foster v. Commissioner, T.C. Memo. 1967-224. The trust fund doctrine is an equitable principle that contemplates that assets of a dissolved corporation are held in "trust" for the benefit of the creditors of the corporation. In re MortgageAmerica Corp., 714 F.2d 1266 (5th Cir. 1983); and Albert v. Commissioner, 56 T.C. 447 (1971).

The trust fund doctrine makes a shareholder liable as a transferee following any distribution after which the transferor is insolvent. Drew, N.B. v. United States, 367 F.2d 828 (Ct. Cl. 1966). The distribution may include a redemption of stock. See Botz v. Helvering, 134 F.2d 538 (8th Cir. 1943) (holding shareholders who redeemed their stock under an employee stock repurchase agreement were transferees). The most common instance of transferee liability based on the trust fund doctrine is that asserted against the shareholders of a corporation which has been liquidated by transferring assets to its shareholders. In that situation, the shareholders are jointly and severally liable, to the extent of the assets received, for unpaid taxes of the corporation. Cold Metal Process Co. v. Commissioner, 25 T.C. 1333 (1956), rev'd on other grounds, 247 F.2d 864 (6th Cir. 1957). The courts look to the substance of a transaction in determining whether it was a liquidating distribution, even though executed under the guise of a sale. D'Agostino v. Commissioner, T.C. Memo. 1973-202.

In order to impose liability under the trust fund doctrine, the transfer must be made after the tax liability accrued, the tax must still be unpaid, and the transferor must be liable for the tax. Pasadena ENT Clinic. P.S. v. Commissioner, T.C. Memo. 1996-448. This is true even though the transferor's tax liability was not finally determined at the time of the transfer. Papineau v. Commissioner, 28 T.C. 54, 58 (1957). In the case of federal taxes, the liability becomes due as of the due date of the return. Hagaman, 100 T.C. at 188; Pert v. Commissioner, T.C. Memo. 1997-150. In addition, the transferor must be insolvent at the time of the transfer or rendered insolvent by the transfer. Kreps v. Commissioner, 351 F.2d 1 (2d Cir. 1965).

In the instant case, the original seven shareholders received a distribution of 80M for their stock. This distribution rendered A insolvent. You must look to the relevant state law to determine whether the distribution would be fraudulent as to other creditors in a fact specific case. If so, the shareholders may be transferees under the laws of the state. In addition, the shareholders may be transferees under the trust fund doctrine since they received a distribution from their corporation that rendered the corporation insolvent.

Please call if you have any further questions.

By: ________________________________
HARVE M. LEWIS
Chief, Branch 9
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)