OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated August 25, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
S =

F1 =
F2 =
F3 =
F4 =

FP =

X =

A =
B =
C =
$a =
$b =
$c =
$d =
$e =

| | |
|---|---|
| $f | = |
| $g | = |
| $h | = |
| $i | = |
| | |
| aa% | = |
| bb% | = |
| cc% | = |
| dd% | = |
| | |
| aaa | = |
| bbb | = |

Year 1 =
Year 3 =
Year 4 =

| | |
|---|---|
| Date 1 | = |
| Date 2 | = |
| Date 3 | = |
| Date 4 | = |
| | |
| Country X | = |

ISSUE:

Whether the $a loss claimed on the consolidated return of P upon the purported sale of F1's stock to X should be disallowed because the substance of the sale and management agreement was a payment to X for managing the liquidation of the assets of F1 and not a sale of F1's stock.

CONCLUSION:

[redacted]

FACTS:

The transaction involving the purported sale of F1's stock to X has been the subject of several prior FSAs. The facts concerning this transaction were set forth in more detail in those prior FSAs. The pertinent facts will only be briefly summarized herein.

During the year at issue, P was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. S was a member of the P consolidated group. S owned all of the stock of F1, a Country X corporation.

On Date 1, following a corporate restructuring: (1) S also owned all of the stock of F2, and (2) F1 owned all of the stock of F3 (which owned an aa% interest in FP) and bb% of the stock of F4. F2, F3 and F4 are all Country X corporations.

On Date 2, S entered into an agreement with X to sell the stock of F1 for $b. The purported sale was consummated on Date 3.

The owner of X was A, who prior to the Date 1 restructuring had managed the leasing business of the F2 group.

Under the agreement, X will manage the lease portfolio of F2. In exchange, X will receive a management fee equal to cc% of the aggregate moneys outstanding under the F2 leases. As of Date 3 (i.e., the date the purported sale was consummated), this fee amounted to $c. This fee was guaranteed to be paid by S to X in the first year irrespective of the size of the F2 lease book. In other words, even if F2 sold the lease book on the first day following the F1 sale, X would still receive the full management fee.

In addition, X would receive a success fee for arranging for the sale or assignment of F2 leases equal to dd% of the aggregate amount realized by F2 upon such sale or assignment. This fee was computed to be approximately $d.

F2 provided the financing for the FP lease portfolio held by F3 in connection with the purported purchase by X of F1's stock. F2 and F3 entered into a loan agreement whereby F2 provided a loan to F3 in the amount of $e.

On Date 3 (when the purported sale was consummated), the agreement between S and X was amended as follows: (1) X could not sell, transfer, assign or terminate its (a) FP leases financed by the F2 loan and (b) F4 stock, without the consent of F2 for the aaa-month period following the purported sale, (2) X agreed to use its best efforts to pay out the F2 loan as expeditiously as possible, and (3) X would be entitled to receive a success fee in the amount of dd% of the aggregate amount of the F2 loan refinanced by loans from third party lenders for the bbb-month period following the purported sale.

The P consolidated group claimed a long term capital loss of $a on its consolidated return for the year ending Date 4, of which $f was deducted. The remainder ($g) was carried back to the group's Year 1 tax year and fully utilized.

LAW AND ANALYSIS

In determining whether the form of a transaction should be disregarded, it is important to keep in mind that so long as there is a business purpose for a transaction and the transaction has economic substance, a person is free to structure the transaction in such a manner as to minimize taxes. See generally Gregory v. Helvering, 293 U.S. 465, 469 (1935); Frank Lyon Co. v. United States, 435 U.S. 561, 580 (1978); United States v. Cumberland Public Service Co., 338 U.S. 451, 455 (1950); Commissioner v. Tower, 327 U.S. 280, 288 (1946); Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). But see Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Higgins v. Smith, 308 U.S. 473, 476-477 (1940). Thus, it is not enough to show that the structure of the transaction in question was driven by tax considerations. Rather, in order to disregard the form of the transaction, it is necessary to demonstrate that the form does not comport with the substance of the transaction. In the instant case, that means that it must be established that the benefits and burdens of ownership did not pass to X.

As recognized by our respective offices in the numerous memoranda that have been exchanged with respect to this transaction, 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). Similarly, the transfer of mere legal title is insufficient to shift the incidents of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. Commissioner v. Sunnen, 333 U.S. 591 (1948). The test for determining whether a transaction is a sale is whether the benefits and burdens of ownership have passed to the purported purchaser. This is a question of fact that must be ascertained from the intention 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). Some of the factors that have been considered by courts in making this determination include (1) whether legal title passed to the purchaser; (2) how the parties treated the transaction; (3) whether an equity was acquired in the transaction; (4) whether the right of possession is vested in the purchaser;
(5) which party bears the risk of loss; and (6) which party receives the profits from the operation and sale of the property. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-1238 (1981).

As you are undoubtedly aware, substance over form and the related analysis of the benefits and burdens of ownership are highly factual inquiries. In addition, there is no mechanical test setting forth how to balance or weigh the relevant factors. This may vary from case to case depending on the specific facts and circumstances that exist, with no one factor being controlling. Consequently, as we discussed informally, this is a determination about which reasonable minds may differ. We will address the specific points raised in your request in the context of our discussion of further case development, litigation hazards and other considerations, which follows infra.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

You have requested that we reconsider our prior advice to you regarding the purported sale of the F1 stock in which we concluded that [redacted]. As indicated above, substance over form and the related analysis of the benefits and burdens of ownership are highly factual inquiries. Accordingly, there are significant hazards inherent in litigating these issues and without strong and convincing evidence, it is difficult for the Service to prevail. For the reasons set forth below, [redacted]

At the outset, it is noted that you consider this transaction to be abusive because it enabled the P consolidated group to accelerate and directly deduct an $a long term capital loss on its consolidated return for Year 3 that it would not otherwise be able to deduct because the losses are attributable to F2, a Country X corporation, that is ineligible to be included in the P domestic consolidated group for tax purposes. Hence, you state that but for the sale of F1 outside the group, the P consolidated group would only be able to indirectly benefit from the F2 losses by using them to offset subpart F income from the various Country X subsidiaries. Consequently, you argue that the structure of the transaction was tax motivated and was a sale in form only.

In determining whether the form of the transaction in question should be respected, we believe that the purported sale of the F1 stock should be viewed in the context of the overall restructuring undertaken by P. Given the financial environment in Country X as summarized in the expert report prepared by C that you provided to us, there clearly was a business purpose for the restructuring. Thus, as discussed in the previous section of this FSA, it is not enough to show that the structure of the transaction in question was driven by tax considerations, which, incidentally, you have amply supported. Rather, in order to disregard the form of the transaction, it is necessary to demonstrate that the form does not comport with the substance of the transaction.

In support of your position that the transaction should be recharacterized as an agreement by X to manage the liquidation of the assets of F1 rather than a purchase by X of F1's stock, you principally rely on X=s apparent inability to raise sufficient funds to finance the large corporate lease deals offered by FP. To put this argument in context, it is noted that at the time of the purported sale of F1 by S to X, F1 owned all of the stock of F3 and a bb% interest in F4, which managed the FP leases. F3 held $e in FP leases that were financed by F2 and owned an aa% partnership interest in FP. FP financed leasing transactions for corporate motor fleets and shared a common fleet administrator who maintained the vehicles. The other partners in FP were all large banking concerns. You have represented that no profits were made by FP inasmuch as it was merely a conduit through which large corporate lease deals were offered to its partners. Therefore, since X lacked the financial resources to finance the FP leases on its own and did not have access to such funds, you have concluded that X could not benefit from its interests in FP and F4.

The prior FSA indicated that [redacted]

In your request for reconsideration as well as your previous submissions, you indicated that A (on behalf of X) was unsuccessful in obtaining financing for at least half of the FP leases and that the sale and management agreement had to be amended to increase the amount of the loan from F2 to F3 from $h to $e. You also stated that the fleet administrator was experiencing financial problems and that investors were unwilling to invest in the FP leases. Additionally, you refer to documents suggesting that the continued existence of FP was uncertain at the time of the purported sale transaction. Moreover, you rely on documents dated shortly after the transaction in question indicating that X agreed to dispose of its interest in F4 (for an undisclosed amount that you characterize as Anominal@) to demonstrate that A/X had no intention of playing an active role in the management of the FP leases.

On the other hand, you previously referred to a document between F2 and S in which it was stated that the FP leases were probably saleable outside of the corporate structure (i.e., F1). See memorandum dated March 20, 1998, p. 11 (Exhibit AG discussing and quoting Exhibit S). This contradicts your current position that investors were unwilling to invest in FP leases. Moreover, it supports an inference that investors may have been willing to participate in or finance future lease deals put together by FP. Hence, if A/X were willing to contribute management services to FP, X/F3 potentially could have benefitted from its aa% interest in FP. Likewise, if FP did in fact continue in existence after Date 3, X/F3 possibly could have sold its partnership interest in FP. Similarly, if FP liquidated after that date, X would be entitled to a share of the liquidating proceeds. These are indicia that X had the benefits of ownership of F1/F3.

In the same vein, the fact that X may have disposed of its bb% interest in F4 shortly after the purported sale transaction (albeit with F2's consent) does not mean that X did not have the benefits of ownership. On the contrary, to the extent that any consideration was received by X for the F4 interest, even if nominal in amount as you represent, it supports the proposition that X had the benefits of ownership. In this regard, we have no information upon which to determine whether the so-called nominal amount received for the bb% interest in F4 represented adequate consideration. Assuming that it did, this negates any adverse inference to be drawn from your representation that A did not place any value on F1's interest in F4 and that he intended to quickly dispose of that interest. Instead, those facts bear more on the value of F1 and whether X paid a fair price to acquire the stock of that company. The same is true with respect to your argument concerning the value (if any) of F3's aa% interest in FP, due to the uncertainty about FP=s continued existence as of the time of the purported sale transaction.

With respect to the FP leases held by F3, which were the only income generating assets owned by F1, you indicate that the maximum profit that X could earn from the leases was the 1% difference between the income from the leases and the principal and interest owed to F2, which financed the leases. Apparently, F2 received the bulk of the net profit from the income stream from the leases pursuant to the financing agreement that it entered into with X. You argue that S and F2 exercised control over the FP leases held by F3 and that the 1% return is consistent with a management fee rather than an ownership interest. However, it should be recognized that the restrictions placed on X with respect to the FP leases are reasonable in light of the fact that the leases were the security for the $e loan from F2 to F3 and the restrictions were no more onerous than those that would be imposed by an unrelated lender. Similarly, we have no information to suggest that the interest rate charged by F2 was out of line with the rate that an outside lender would have charged X, if such a lender could have been found. Consequently, the fact that X=s profit potential was limited because it had to finance the FP leases does not militate against X having the benefits of ownership and transforming the purported sale transaction into a management agreement.

As further support for your position that the purported sale of the stock of F1 should be treated as an agreement to manage the liquidation of F1's assets, you argue that the purported management agreement pertaining to the F2 leases has no substance because F2 never intended to relinquish the management of its leases to X. In this regard, you point out that X did not provide any of the management services or reports required by the sale and management agreement and that F2 continued to receive the receipts from the leases although the agreement provided that X would collect the lease payments and forward them to F2. See memorandum dated March 20, 1998, p. 13 (Exhibit AG discussing Exhibit H). Thus, you conclude that the $c payment to X was really to manage the FP leases held by F3 rather than to manage the F2 leases. While these facts, if proven, would support your position that the $c payment was not to manage the F2 leases, it does not necessarily follow that the payment was to manage the leases held by F3 and that there was no sale of the F1 stock. Instead, it is just as plausible that the $c payment was an inducement to X to enter into the sale transaction. This is supported by a document that you previously referred to between F2 and S, which provides in pertinent part as follows:

> However, it was recognized that the [F1] operation itself, especially if third party external financing was introduced for a majority of the book, would provide nowhere near sufficient income to support the operation, let alone provide an appropriate return for risk.
>
> In order to sweeten the deal, and provide sufficient revenues to the purchaser, it was agreed that he would also manage [F2's] current leasing portfolio with a mandate and incentive to sell it down (thereby reducing [P=s] risk) as soon as possible.
>
> * * *
>
> There is no question that [P] would not be entering into the management contract if it were not to facilitate the [F1] deal.
>
> * * *
>
> Therefore it should be well understood that the decision to subcontract the management of the [F2] leasing portfolio as a stand alone decision would in all likelihood not be taken. However, the linking of this transaction to the sale of [F1] is crucial to that sale which crystallizes the significant tax losses for [S].

Memorandum dated March 20, 1998, p. 11 (Exhibit AG quoting Exhibit S) (emphasis in original).

Moreover, that same document seems to undercut your position that the substance of the transaction was for A/X to manage the liquidation of the assets of F1. This is because the document mentions as an alternative the option of A Aclosing down@ after one year, but states that A would not be able to liquidate F1 and thus, he would still have continuing obligations, which would be significant. Id. Hence, the implication is that liquidating the assets of F1, at least in the short term, is not a viable option.

The final subject addressed in your request for reconsideration concerns the mortgage taken out on A=s house by X to indemnify F2 against loss on a guarantee of the residual value of vehicles in the amount of $i that F2 was required to give to the purchaser of a lease portfolio owned by F1 that was sold on Date 3, the same date that the purported sale of the

F1 stock to X was consummated. Our prior FSA stated that this action indicated that X had the burden of ownership. In rebuttal, you point out that the purchaser of the F1 leases looked to F2 for the guarantee rather than to X. In addition, you argue that the risk of loss on the guarantee of the residual value of the vehicles was low and thus, X=s obligation had Amarginal economic substance@.

With respect to the first point, although it is unclear from the facts presented, it is logical to assume that the sale of the F1 lease portfolio occurred prior to the purported sale of the F1 stock to X (albeit that both events took place on the same day). Hence, it would make sense for the purchaser to look to the prior lender (F2) for a guarantee of residual value rather than to the new owner of the company that previously held the leases. In other words, if the leases were sold prior to X acquiring F1, then, from the purchaser=s point of view, X would have no connection with those leases. Therefore, X was only on the hook because the guarantee was a contingent liability of F1, which X presumably assumed as part of its acquisition of F1. Otherwise, if X were simply managing the liquidation of the F1 assets remaining as of the time of the purported sale transaction, then there would be no reason for X to agree to provide a cross-indemnification to F2 relating to leases that were disposed of prior to X=s involvement with F1.

With respect to the second point, regarding the economic substance of the cross-indemnification, it is noted that in one of your earlier submissions it is stated that in Year 4, X fell into arrears on its loan repayments to F2 because the residual value at which X could sell the leased vehicles was less than the projected residual value. Memorandum dated March 20, 1998, p. 13 (Exhibit AG discussing Exhibits V, W and X). Although it appears that the shortfall was with respect to the FP leases held by F3 as opposed to the leases to which the $i cross-indemnification related, the decrease in residual values of those vehicles demonstrates that the risk of loss was genuine and borne by X.

[redacted] In part, this is because many of the facts are susceptible to more than one interpretation, as discussed earlier in this FSA. Moreover, we adhere to the view expressed in our prior FSA (and herein) that there was potential for X to benefit from its ownership of F1 (although that potential admittedly appears to be somewhat limited), and X also seems to have borne the risk of loss, for example, loss resulting from the decline in residual values of the vehicles subject to the leases. [redacted]

In your memorandum dated March 20, 1998, p. 14 (Exhibit AG), you indicated that [redacted]

[redacted]

[redacted]

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By: ____________________________
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