Office of Chief Counsel
Internal Revenue Service

memorandum

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CJSantaniello

date: SEP 1

to: JoAnn Prager, Technical Advisor, PFT, Norwalk, Connecticut

from: District Counsel, Connecticut-Rhode Island District, E. Hartford

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subject: **Advisory Opinion - Lease Stripping Cases, Related Entities**

THIS DOCUMENT INCLUDES CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE SERVICE. THIS DOCUMENT ALSO CONTAINS TAX RETURN INFORMATION OF THE INSTANT TAXPAYER SUBJECT TO THE PROVISIONS OF I.R.C. § 6103 AND ITS USE WITHIN THE SERVICE SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW IT.

We are responding to your memorandum dated July 7, 2000, in which you requested our advice regarding the propriety of closing as unchanged the cases involving the entities related to the lease stripping transactions previously examined by the Connecticut-Rhode Island District. For the reasons set forth below, we do not believe that the proposed case closings will have any adverse effects on the pending investor cases. However, because the possibility exists under the Service's alternative I.R.C. § 482 theory for an overpayment of tax by [redacted], "no-change" letters should not be issued to [redacted], [redacted], and [redacted]. Instead, the cases should be closed with reports containing statements that the leasing transactions are still under consideration by the Service and the courts and that the taxpayer may wish to file protective claims for refund for the years in question. As further discussed below, both [redacted] and [redacted], may receive "no-change" letters because neither taxpayer would be entitled to a refund under any of the legal theories asserted by the Service to contest the validity of the investors' tax treatment stemming from the lease stripping transactions.

Facts

In recent years, the Connecticut-Rhode Island District has examined several corporate and partnership returns reflecting income and deductions emanating from lease stripping transactions. These transactions constitute abusive corporate

tax shelters in which one entity, generally a tax neutral Indian Nation, realizes income while another entity, typically a CEP taxpayer, simultaneously claims deductions related to that income. Based on Field Service Advice received from the National Office in the investor cases, the Service has determined that because the transactions are economic shams, the investors are not entitled to the claimed deductions. Alternatively, the Service has also determined that the lease income should be reallocated to the investor under section 482.

The status of the investor cases is as follows: [redacted], which was designated for litigation, defaulted on the notice of deficiency issued in [redacted]. It recently filed a claim for refund and has received a notice of claim disallowance. [redacted], which involves a transaction virtually identical to the [redacted] transaction, is apparently settled pursuant to a closing agreement. The final case, [redacted], a TEFRA partnership, is presently in Appeals. The CEP taxpayer in this latter transaction is [redacted].

Regarding the related entities, you indicate in your memorandum the following proposed closings:

(a) [redacted] - This corporation promoted the [redacted] and [redacted] transactions. It also participated in the [redacted] transaction as the subsequent equipment purchaser of the equipment. Its employees were also partners in [redacted] the entity that absorbed the income from the transaction.

The Service proposes to accept [redacted] Forms 1120 as filed, as there are no possible deficiency arising from its promotion of the lease stripping these transactions. In return for its services, the entity received substantial fees that were included in its gross income. There is, however, the possibility of deficiencies based on [redacted]'s investments in other lease stripping transactions to shelter its significant fee income from its promotional activities. Because these investments were not examined in sufficient detail to sustain any adjustments relating to those investments, no adjustments are warranted without further factual development.

(b) [redacted] - This partnership absorbed the income for the leasing transactions in the [redacted] and [redacted] promotions. Its [redacted]% limited partner is [redacted], another partnership. The remaining partners are employees of [redacted].

The Service does not currently intend to "unwind" the transaction in either the [redacted] or [redacted] investments. Because this partnership is a pass-through entity, a no-change will not result in any tax consequences to this partnership, although it could potentially result in reductions in income to its partners if the Service prevails on a section 482 theory. Specifically, if the income reported on the partnership's Forms 1065 is reallocated to the investors, a corresponding reduction in the income reported by the partnership should be made. As noted below, although a corresponding adjustment will not have any tax consequences to [redacted] [redacted]% limited partner (the Indian Nation), it could create overpayments for [redacted] remaining partners or [redacted] general partner [redacted]).

To date, no final decision has been made on how the pass-through income should be treated. The Service proposes to issue a report without adjustment containing a statement that "Leasing transactions which are reflected in part on this return are still under consideration by the Internal Revenue Service. You may wish to consider filing a protective claim for refund."

(c) [redacted] - This partnership received flow-through income from [redacted]. Its partners are [redacted] (the [redacted]% general partner) and an Indian Nation, the [redacted]% limited partner. As noted above, this partnership is a pass-through entity. Thus, a no-change will not result in any tax consequences to this entity, although it could potentially result in reductions in income to its general partner. To date, no final decision has been made on how the pass-through income should be treated. The Service proposes to issue a report without adjustment containing a statement that "Leasing transactions which are reflected in part on this return are still under consideration by the Internal Revenue Service. You may wish to consider filing a protective claim for refund."

(d) [redacted] - As noted above, this entity is the [redacted]% general partner in [redacted]. Its [redacted]% shareholder is [redacted]. The Service proposes to accept the corporation's Forms 1120 as filed. You have requested our advice regarding whether a statement should be included in any report to the taxpayer regarding [redacted]'s income from the lease stripping transactions that were questioned but not adjusted.

(e) [redacted] - This entity was the original owner of the equipment that was sold to and leased back from [redacted] in the [redacted], [redacted], and [redacted] transactions. As a result of each sale, [redacted] avoided a substantial alternative minimum tax in the year of sale. The Service proposes to accept [redacted]'s Forms 1120 as filed, as we are unaware of any theory upon which to challenge the validity of the sales. Although the Service could recast the transactions by characterizing the investors as actual purchasers, [redacted] would remain the seller under that theory. Consequently, the possibility of a deficiency or an overpayment does not exist. You have requested that we advise whether a statement should be included in any report issued to [redacted] regarding its involvement in the sale-leaseback transactions.

The earliest statute of limitations for the above taxpayers is [redacted].

Discussion

I.R.M 4421(1) provides "generally, in all examined no-change tax cases in which the taxpayer or representatives was contacted, the taxpayer will be notified that the reported tax liability or income is accepted as without change." Based on the facts presented, the Service does not accept the lease income reported on the Forms 1065 filed by [redacted] and [redacted], as evidenced by its alternative assertion of section 482 in the notices of deficiency issued to the investors. Accordingly, no-change letters should not be mailed to the partnership. We do, however, suggest that because the Service has alternativly raised section 482, which could result in the reallocation of the accelerated lease income from [redacted] to the investors, a statement be included in the report issued to [redacted] regarding the possible reduction in its income.

I.R.M. 4224.1 refers generally to related cases. Related cases generally involve adjustments of items of income or deductions reported in a return, the consistent treatment of which requires corresponding adjustments in determining the income tax liability of another taxpayer. Adjustments of this type occur in the case of taxpayers in which the Commissioner has applied I.R.C. § 482. As noted above, the Service has determined, as an alternative to its primary position that the lease stripping transactions are economic shams, that the income reported by the partnership should be reallocated under section 482 to the corporate investor. Consequently, the corresponding adjustment would be a reduction in the income reported on the partnership's Form 1065. However, no tax effect would result

from the corresponding adjustment because of the tax neutral status of the Indian Nation. Accordingly, as the income tax liability of the Indian Nation would not be affected, I.R.M. 4224.1 would not apply.

Moreover, in Collins Electrical Company, Inc. v. Commissioner, 67 T.C. 911 (1977), the Tax Court held that the Commissioner is not precluded from asserting an adjustment under I.R.C. § 482 where the correlative adjustment affecting the related taxpayer is barred by the statute of limitations. Although the Court suggested that the Commissioner may have a duty to assert related adjustments where necessary to avoid double taxation, it held that the satisfaction of this obligation was not a prerequisite to the assertion of the primary adjustment.

In the lease stripping cases at issue, however, there is the possibility of a double taxation if the Court were to sustain the Service's alternative I.R.C. § 482 argument. As noted above, because [redacted] is a pass-through entity, a reduction in its gross income under that theory would flow through to its partners. Although such reallocation would not result in any tax consequences to the tax Neutral Indian Nation (the [redacted]% limited partner of [redacted]), it could result in overpayments by [redacted]'s other partners and [redacted] (the general partner of [redacted]).

As suggested above, no-change letters should not be mailed to [redacted] or [redacted]. The Service should, instead, issue a report without adjustment containing a statement that "The lease income reported by the partnership is subject to reallocation under section 482, which would result in a reduction of such income at the partnership level. You may wish to consider filing a protective claim for refund."

[redacted] and [redacted] may receive no-change letters because there is no possibility of double taxation and such no-change would not conflict with the Service's determination regarding the lease stripping income and deductions.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

Since there is no further action required by this office, we are closing our file in this matter. Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

BRADFORD A. JOHNSON
Acting District Counsel

By: _____
CARMINO J. SANTANIELLO
Attorney

cc: Cynthia Vassilowitch, New Haven Appeals
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