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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Index (UIL) No.: 465.01-02
Case MIS No.: TAM-109286-99

SEP 15 1999

Taxpayers' Name:
Taxpayers' Address:

Taxpayers' TIN:
Years Involved:
Conference Held:

LEGEND:

Corp X =

Corp Y =

Corp Z =

H =

W =

a =

b =

c =

d =

e =

f =

ISSUE:

Whether the circular Lending Transactions among H and his three S corporations constituted an arrangement that protected Taxpayers against loss so that they were not considered at risk under § 465(b)(4) of the Internal Revenue Code?

209

CONCLUSION:

With regard to the Lending Transactions, the circularity of payments, the nature of the notes with demand and deferral provisions, and the similarity of ownership among the entities, when taken together, are sufficient to demonstrate that the Taxpayers were effectively immunized from any realistic possibility of suffering an economic loss under § 465(b)(4) and, thus, were not at risk for the amounts in issue.

FACTS:

Taxpayers are husband (H) and wife (W) who own part or all of Corp X, Corp Y, and Corp Z. H individually owns 100 percent of both Corp Y and Corp Z. H, W, and their children own Corp X, with H individually owning a 54.95 percent majority interest.

Corp X is an S corporation that has been engaged in the trucking business since its incorporation. At one time, H owned all of the stock of Corp X, but estate planning considerations motivated him to transfer interests in Corp X to W and their children. After building Corp X into a successful company, H became concerned over liability issues involving the trucks and trailers used in the business. Therefore, in order to limit Corp X's liability, H formed two corporations, Corp Y and Corp Z, to own the trucks and trailers used by Corp X. Corp Y owns trailers that are used in over-the-road trucking and leases them to Corp X. Corp Z also owns trailers as well as tractors, leases them to Corp X, and performs maintenance work.

Because of large depreciation deductions on their tractors and trailers, Corp Z and Corp Y immediately began generating losses to pass through to Taxpayers. However, Corp Y's and Corp Z's passthrough losses exceeded H's bases in the corporations, thereby limiting Taxpayers' ability to claim the losses. Therefore, H sought a way of increasing his basis in each corporation in order to claim the losses.

H had always used Corp X assets to capitalize Corp Y and Corp Z and wished to continue doing so. Under the advice of his tax advisors, H considered capitalizing Corp Y and Corp Z with distributions from Corp X. However, because Corp X had accumulated earnings and profits from prior years as a C corporation, H was restricted in the amount of tax-free distributions he could receive from Corp X. In consultation with his tax advisors, H determined that he would resolve the basis problem by lending to Corps Y and Z, thereby creating basis in indebtedness of each corporation to its shareholder. Accordingly, H borrowed the proceeds from Corp X and re-loaned them to each of Corp Y and Corp Z, each of which re-loaned the proceeds back to Corp X ("Lending Transactions"). In this manner, H hoped to create basis in each of Corp X and Corp Y for

indebtedness of the corporations to a shareholder.

In all, three sets of Lending Transactions involved H, Corp X, and Corp Y, and one set involved Corp X, H, and Corp Z. In the first set involving Corp Y, which occurred on a, Corp X loaned $4 million to H in exchange for H's recourse promissory note. H re-loaned the proceeds to Corp Y in exchange for Corp Y's note and increased his basis in Corp Y stock. Finally, Corp Y turned around and re-loaned the same proceeds back to Corp X, from where they originated, in exchange for Corp X's note. In the second set, which occurred on b, Corp X loaned $5 million to H, who re-loaned the proceeds to Corp Y, which re-loaned the proceeds to Corp X. In the third set, on c, Corp X loaned $4.4 million to H, who re-loaned $4.5 million to Corp Y, which re-loaned the proceeds to Corp X. In the single set involving Corp Z, which occurred on d, Corp X loaned $1.9 million to H in exchange for H's recourse promissory note. H re-loaned $2 million to Corp Z in exchange for Corp Z's note and increased his basis in Corp Z stock. Finally, Corp Z turned around and re-loaned the proceeds to Corp X, from which $1.9 million originated, in exchange for Corp X's note.

All of the loans involved in the Lending Transactions were documented with notes that provided for the same rate of interest and provided for principal to be due 375 days after demand. In addition, no collateral was provided as security for any of the loans. Offsetting interest payments were made by the parties to the sets of loans. No principal payments were made.

Thus, when the losses from Corps Y and Z exceeded H' bases in these corporations, H arranged the Lending Transactions to create additional basis against which to continue claiming losses from Corps Y and Z. The Taxpayers together claimed for taxable years e approximately $f in losses that passed through from Corps Y and Z. The revenue agent examining the Taxpayers concluded that these circular loans should not cause Taxpayers to be at risk for the amounts involved in the Lending Transactions, which originated from Corp X's loans to H. Therefore, the losses claimed by Taxpayers were disallowed. We agree with the agent's determination.

LAW and ANALYSIS:

Section 465(a)(1) provides that in the case of an individual engaged in an activity to which § 465 applies, any loss from the activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of § 465(b)) for such activity at the close of the taxable year.

211

Section 465(b)(1) provides that for purposes of § 465, a taxpayer shall be considered at risk for an activity with respect to amounts including (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) the amounts borrowed with respect to such activity. Section 465(b)(2) provides that for purposes of § 465, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he (A) is personally liable for the repayment of the amounts, or (B) has pledged property, other than property used in the activity, as security for the borrowed amount (to the extent of the net fair market value of the taxpayer's interest in the property). No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness that is secured by property described in § 465(b)(1).

Section 465(b)(4) provides that notwithstanding any other provision of § 465, a taxpayer shall not be considered at risk with respect to amount protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

The issue presented for technical advice is whether Taxpayers were protected against loss by "other similar arrangements".

The phrase "other similar arrangements" was analyzed by the Ninth Circuit in considering loss protection in a computer purchasing and leasing transaction under § 465(b)(4) in American Principals Leasing Corp. v. U.S., 904 F.2d 477 (9th Cir. 1990). In American Principals, the taxpayers were held to be not at risk for their obligations in a computer leasing transaction because they were protected from loss by a system of circular book entries. In analyzing the phrase "other similar arrangements", the Court propounded the "realistic possibility" or "economic reality" test. See American Principals Leasing Corp. v. U.S., at 483.

Under this test, it is enough to show that as a practical matter it was unlikely that anyone would ever force the taxpayer to pay actual cash. In its discussion, the Court states:

> [T]he purpose of subsection 465(b)(4) is to suspend at risk treatment where a transaction is structured - by whatever method - to remove any realistic possibility that the taxpayer will suffer an economic loss if the transaction turns out to be unprofitable.... A theoretical possibility that the taxpayer will suffer economic loss is insufficient to avoid the applicability of this subsection [465(b)(4)]. We must be guided by economic reality.... If at some future date the unexpected occurs and the taxpayer will suffer

212

a loss, the taxpayer will at that time become at risk and be able to take the deductions for previous years that were suspended under this subsection.

American Principal Leasing Corp. v. U.S., at 483.

Using this economic reality test, the Court found under the facts involved that no circumstances existed under which one of the parties would break the chain of payments or even demand that its obligee satisfy its obligations in cash (or sell a note to an outside party who would demand cash payment). According to the Court, no party could expect any benefit from doing so.

Thus, the Ninth Circuit's test asks whether there is any realistic possibility that the taxpayer ultimately will be subject to economic loss on the investment at issue. In applying this standard, the substance of the transaction, not its form, guides. The test looks not to any single factor, but whether the combination of factors and characteristics of the transaction rises to the level of an "other similar arrangements" with the effect of protecting taxpayers against risk.

The Tax Court approved this test in Levien v. Commissioner, 103 T.C. 120, 126 (1994), affd. 77 F.3d 497 (11th Cir. 1996), for another computer purchasing and leasing transaction. In addition, the Tax Court has held that the potential insolvency of the party providing the loss protection is not a consideration in determining whether amounts are protected from loss unless and until the insolvency occurs. See Capek v. Commissioner, 86 T.C. 14, 52-53 (1986).

Under the facts of Taxpayers' case, Corp X loaned money to H, who re-loaned the money to either of Corp Y or Corp Z, which re-loaned the money back to Corp X. For each set of Lending Transactions, the proceeds of all of three loans originated with Corp X and ended up with Corp X. For each set of Lending Transactions, the terms of all of the loans among the parties were identical: the same rate of interest, no principal payments until demand, and payment due 375 days after demand.

The circular nature of each set of Lending Transactions, in part, protected H against loss within the meaning of § 465(b)(4). Applying the above economic reality test to the facts involved, we find no circumstances existed under which one of the parties would break the chain of payments or even demand that its obligee satisfy its obligations in cash (or sell a note to an outside party who would demand cash payment). No party could have expected any benefit from doing so, since that would have triggered a demand for payment from each of the other parties resulting in the same circularity of payment as there was of lending. Moreover, the provisions of the loans created an essentially matching flow of interest payments, with no principal

payments. While no rule exists that holds circular payments to per se constitute "an other arrangements" for purposes of § 465(b)(4), they are an element to be considered.

In addition, the common ownership of the S corporations and the deferral provisions of the loans are other elements to be taken into account in determining insulation from risk. In Vander Heide v. Commissioner, T.C. Memo 1998-19, the Court stated that the circularity of the payments, when combined with the common ownership of two parties to a computer purchasing and leasing transaction, provided little incentive for the creditor of the limited partnership involved to pursue the limited partners for their share of the debt in the event of a default. In holding that the petitioner was effectively immunized from any realistic possibility of suffering economic loss, and, therefore, not at risk, the Court cited the similarity of ownership among the entities as an element of its determination. In the instant case, common ownership existed among the parties. H is the shareholder of both Corps Y and Z and the majority shareholder of Corp X, in which W is also a shareholder.

Also in Vander Heide, there were deferral provisions for delaying the rental payments and the payment of principal and interest on the note for the computer equipment purchase. The Court cited the deferral provisions as another element in its determination of whether taxpayers were at risk. In the instant case, the loans involved in the Lending Transactions were demand loans that were not payable until 375 days after demand.

We conclude that the circularity of payments, the demand notes with deferral provisions, and the similarity of ownership among the entities, when taken together, are sufficient to demonstrate that the Taxpayers were effectively immunized from any realistic possibility of suffering an economic loss under § 465(b)(4) and, thus, were not at risk for the amounts in issue. The issue of whether the Lending Transactions created basis for H in either Corp Y or Corp Z for purposes of § 1366(d) was not presented for technical advice because both the Appeals Officer and the Taxpayers' representative believe that the government's position on that issue is clear and unchanged; that is, these transactions do not create either debt or equity basis in the S corporations.

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

214