

# MARKS & WEINBERG, P.C.

## **CMA Consolidated, Inc. v. Commissioner of Internal Revenue** 2005 WL 209951 (U.S. Tax Ct. Jan. 31. 2005)

In this petition against the Commissioner of the Internal Revenue Service (the IRS), a corporate taxpayer petitioned for a re-determination of income tax deficiencies and additions to tax. Petitioner claimed substantial income deductions, operating losses and bad debt losses arising from many complicated transactions, and the tax court had to determine if those transactions should be respected for tax purposes, and whether petitioner is eligible for the deductions he claimed.

Among the transactions in question were two lease "strip" deals arranged by petitioner that involved tax-indifferent parties. The Tax Court had to determine, among other things, whether the lease strip deals should be respected transactions for tax purposes. If the transactions are found to have no economic substance, they should be ignored, and petitioner will not be able to claim deductions which totaled over \$ 2.7 million and which originated from the lease strip transactions.

Lease strip deals are designed to separate equipment rental income from depreciation and related rental expenses. The rental income is allocated to a tax indifferent or a tax neutral party in order to allow another party to claim a greatly disproportionate share of the related tax benefits. One such tax-neutral party that participated in these lease strip deals



with petitioner was the Iowa Tribe of Oklahoma, who was not subject to Federal income received from these transactions.

The ultimate beneficiary/customer of the lease deals would invest perhaps several million dollars in the transactions, and would eventually be able to claim income deductions many millions of dollars more than its initial investment. Through a series of complex, preconceived, multi-party transactions involving equipment purchases, leases, and related expenses, petitioner stripped out the rental income from these end-user leases and allocated that income to the Iowa Tribe. The Court described these transactions as a "Byzantine Labyrinth."

In determining whether a transaction is legitimate for tax purposes, the court examined several factors but grouped these factors into two main categories. The first category involved the determination of whether the petitioner had a *subjective*, legitimate non-tax purpose for participating in the transaction. In the case at bar, the court found that petitioner entered in the first lease strip deal for a legitimate business purpose, namely, to make a profit. However, the court found no subjective legitimate pre-tax profit motive in the second lease strip deal other than petitioner's intent to claim \$4.2 million in tax benefits.

The second category involved the determination of whether the lease strip deal had an *objective*, economic profit potential aside from the tax benefits. The court analyzed expert opinions on this subject obtained by petitioner and the IRS and focused on whether the underlying rental equipment would have any estimated residual value or whether the fair market value of the residual lease interests was nominal.

The Court found the first lease strip deal to have economic substance. However, with respect to the second lease strip deal, the Court held that: (a) the transaction did not have economic substance, (b) petitioner had no legitimate reason for entering in the deal other



than to claim a large tax deduction and (c) the complex transactions involved in that deal involved many participating entities that were closely related to petitioner or owned by those who regularly cooperated with petitioner such that the participants were not acting at arm's length, and shared a common interest in inflating the values of the leases and residual interests to generate substantial tax benefits for the ultimate customer (in this case, petitioner). Not only was the petitioner not entitled to claim deductions from the second lease strip deal, but it was also subject to tax penalties pursuant to 26 USC § 6662.

Marks & Weinberg, PC is a law firm with significant experience in dealing with virtually every type of equipment and facility lease financing. The lawyers of the firm have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. If you would like more cases or articles on leasing, or have any questions or comments about this Article or other leasing issues, please visit [leaselawyer.com](http://leaselawyer.com) or contact Barry Marks at 205.251.8303 or Ken Weinberg at 205.251.8307.

