MARKS & WEINBERG, P.C.

Kimmich, the Commission of Internal Revenue

WL959168 (US Tax Ct., 2000).

If you are a part of depository agreements and circular leasing transactions, you may want to consider whether or not you are sufficiently ñat riskò to claim tax benefits.

X sold equipment to Y which sold equipment to Taxpayer under a purchase agreement in which Taxpayer executed in connection with a buyer acquisition note that was specifically recourse. Taxpayer then leased equipment back to X who subleased the equipment to individual sublessees. All payments were made in reverse order under a depository agreement that facilitated the debiting and crediting of accounts. The depository agreement was not able to be modified, rescinded, or amplified except by a writing signed by all three parties.

Taxpayer claimed and was denied tax deductions by the IRS which claimed that the petitioner was not ñat riskò. The Court noted that Section 465 allows deductions for certain leasing activities solely to the extent that Taxpayer is at risk with respect to such activity. Section 465B defines ñat riskò and notes that the term includes the basis of property contributed to the activity as well as amounts borrowed with respect to the activity to the extent that the Taxpayer is personally liable for the repayment (i.e. to the extent Taxpayers obligations are recourse). A taxpayer is not ñat riskò to the extent that it

is protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Although the petitioner was obligated on a recourse buyer acquisition note, the Court applied an ñeconomic realityò test rather than a ñworse case scenarioò test and held that petitioner was not ñat risk.ò The Court noted that ñall components of the instant transaction were structured and set in motion simultaneously [and that] the instant case involves a binding circular payment arrangement providing for offsetting payments and bookkeeping entries; i.e. the depository agreement.ò Whether an economic reality test or a worse case scenario test is used, the ultimate decision still rests upon the ñsubstance of the transaction in light of all the facts and circumstances.ò The Court noted that it would focus on: (i) the relationship between the parties; (ii) whether the underlying debt is nonrecourse; (iii) the presence of offsetting payments and bookkeeping entries; (iv) the circularity of the transaction; and (v) the presence of any payment guarantees or indemnities. The Court held the petitioner was not at risk, that it was highly unlikely due to the circular nature of the transaction any one of the parties refuse to meet his obligations because if one party failed to pay he could only expect a chain reaction resulting in his Obligor ceasing payment as well and that petitioner was therefore liable for taxes as the IRS claims.

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