Levy v. Commissioner, 91 T. C. 838 (1988)

A multiple-party equipment leasing transaction can have economic substance and not be a sham if it has a business purpose and potential for profit.

Summary

The Levys and Lee & Leon Oil Co. purchased IBM computer equipment in a multi-party leaseback transaction, aiming to diversify their investments. The IRS challenged the transaction as a sham lacking economic substance, but the Tax Court upheld it, finding a legitimate business purpose and potential for profit. The court determined that the investors were at risk and engaged in the transaction with a profit motive, affirming their entitlement to tax benefits from the equipment ownership.

Facts

In 1980, the Levys and Lee & Leon Oil Co. sought to diversify their investments due to the cyclical nature of the oil industry. They purchased IBM computer equipment from AARK Enterprises, which had recently acquired it from DPF, Inc. The equipment was then leased back to DPF, which subleased it to Bristol-Myers Co. The purchase involved a cash downpayment and promissory notes, with a 10-year lease agreement and rent participation potential.

Procedural History

The IRS issued deficiency notices for the tax years 1980 and 1981, disallowing deductions related to the equipment purchase. The taxpayers filed petitions with the U. S. Tax Court, which consolidated the cases. After trial, the court issued its opinion on November 2, 1988, upholding the transaction's legitimacy.

Issue(s)

1. Whether the transaction was a sham devoid of economic substance?
2. Whether ownership of the equipment transferred to the petitioners?
3. Whether the petitioners were at risk under section 465 with respect to the transaction's debt obligations?
4. Whether the petitioners' investment constituted an activity entered into for profit under section 183?

Holding

1. No, because the transaction had a business purpose and economic substance, evidenced by the potential for profit and adherence to commercial realities.
2. Yes, because the petitioners acquired significant benefits and burdens of ownership, including the potential to realize profit or loss on the equipment.
3. Yes, because the petitioners were personally liable for the debt obligations and

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not protected against loss.
4. Yes, because the petitioners engaged in the transaction with an actual and honest objective of earning a profit.

Court’s Reasoning

The court found that the transaction was not a sham because it had a business purpose (diversification) and economic substance. The purchase price was fair, and the transaction structure was commercially reasonable. The court emphasized the significance of arm’s-length negotiations, the equipment’s fair market value, and the reasonable projections of income and residual value. The court also noted that the benefits and burdens of ownership passed to the petitioners, as they had a significant equity interest and potential for profit or loss. Under section 465, the court determined that the petitioners were at risk because they were personally liable for the debt without protection against loss. Finally, the court found a profit motive under section 183, as the petitioners conducted the transaction in a businesslike manner with reasonable expectations of profit.

Practical Implications

This decision reinforces that multi-party equipment leasing transactions can be legitimate investments if structured with a business purpose and potential for profit. Legal practitioners should ensure that such transactions are not merely tax-driven but reflect economic realities. The ruling impacts how similar transactions should be analyzed, emphasizing the importance of fair market value, reasonable projections, and the transfer of ownership benefits and burdens. Businesses considering such investments should be aware that the IRS may scrutinize these transactions, and careful documentation and adherence to commercial norms are crucial. Subsequent cases have referenced *Levy* in analyzing the economic substance of similar transactions.

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