T. C. Memo. 1992-669

A taxpayer is not considered ‘at risk’ under Section 465(b)(4) if the transaction structure eliminates any realistic possibility of economic loss.

Summary

In T. C. Memo. 1992-669, the Tax Court addressed whether a taxpayer was ‘at risk’ under Section 465 for losses claimed from a computer leasing investment. The court found that the taxpayer’s investment was structured to prevent any economic loss, with payments offsetting each other through circular transactions and guarantees. Consequently, the losses were disallowed, and the transaction was deemed tax-motivated under Section 6621(c), resulting in additional interest on underpayments. This case emphasizes the importance of economic reality in determining at-risk amounts and highlights the scrutiny applied to tax-motivated transactions involving offsetting payments and guarantees.

Facts

In 1983, the taxpayer purchased a 2. 665560% interest in computer equipment for $543,750, paying with cash and notes. The equipment was subsequently leased back to the original sellers, with rental payments designed to exactly offset the taxpayer’s note payments. The transactions involved multiple entities, with rental payments guaranteed by an affiliate. The taxpayer claimed significant losses on their 1983 and 1984 tax returns, which the IRS challenged under Section 465, arguing the taxpayer was not at risk due to the structured protection against loss.

Procedural History

The IRS issued a notice of deficiency, disallowing the losses and asserting additional interest. The taxpayer petitioned the Tax Court, which heard the case fully stipulated. The court’s decision focused on whether the taxpayer was ‘at risk’ under Section 465 and whether additional interest should apply under Section 6621(c).

Issue(s)

1. Whether the taxpayer was ‘at risk’ under Section 465(b)(4) for the losses claimed from the computer leasing activity.
2. Whether the transaction qualifies as tax-motivated under Section 6621(c), subjecting the taxpayer to additional interest.

Holding

1. No, because the transaction was structured to remove any realistic possibility of the taxpayer suffering an economic loss.
2. Yes, because the disallowed losses under Section 465(a) render the transaction tax-motivated under Section 6621(c)(3)(A)(ii).

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Court’s Reasoning

The court applied Section 465(b)(4), which excludes amounts protected against loss from at-risk calculations. It focused on whether there was a realistic possibility of economic loss, scrutinizing the transaction’s structure for circularity, offsetting payments, nonrecourse financing, and guarantees. The court found the transaction similar to previous cases where taxpayers were not at risk due to these factors. The rental payments were offset by the taxpayer’s note payments, and guarantees from an affiliate further insulated the taxpayer from loss. The court rejected the taxpayer’s argument for a ‘worst case scenario’ test, emphasizing that economic reality should guide the analysis. The court concluded that the taxpayer was not at risk, and the transaction was tax-motivated, justifying additional interest under Section 6621(c).

Practical Implications

This decision reinforces the importance of economic substance in tax transactions, particularly in sale-leaseback arrangements. Taxpayers and practitioners must carefully structure transactions to ensure a realistic possibility of economic loss, as offsetting payments and guarantees can lead to disallowed losses under Section 465. The case also underscores the potential for additional interest under Section 6621(c) for tax-motivated transactions. Practitioners should advise clients on the risks of such structures and consider the broader implications for tax planning, especially in complex leasing arrangements. Subsequent cases have continued to apply this reasoning, emphasizing the need for genuine economic risk in tax investments.

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