

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
BENDER MACHINE, INC.) No. 85A-0632-PS
)

Appearances:

For Appellant: John E. James,
Attorney at Law

For Respondent: Donald C. McKenzie,
Counsel

OPINION

This appeal is made pursuant to section 25666^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Bender Machine, Inc., against proposed assessments of additional franchise tax in the amounts of \$40,740, \$73,047, and \$88,299 for the income years ended June 30, 1978, June 30, 1979, and June 30, 1980, respectively.

^{1/} Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

The issue in this appeal is whether appellant is entitled to claim depreciation deductions for certain computer purchase and leaseback transactions.

During the periods in issue, appellant Bender Machine, Inc., a California corporation, was engaged in the business of repairing and maintaining large machinery. In 1976, 1977, and 1979, appellant and OPM Leasing Services, Inc., of New York ("OPM"), a corporation engaged in the buying, selling, and leasing of new and used computer equipment, entered into "sale/leaseback" transactions. In general, OPM found an end user for a computer, obtained a computer with purchase money financing, leased the computer to the end user, and, after it was installed but before being placed in service, "sold" the computer to appellant and simultaneously "leased" it back. The computers acquired were as follows:

1. In 1976, appellant acquired an 18.59 percent undivided interest in a CDS 175-16 computer for \$740,000, with a \$22,000 cash down payment and a non-negotiable limited recourse installment promissory note for \$718,000 (interest rate of 16.12255 percent through March 1, 1978, and 12 percent thereafter). Appellant also paid \$115,000 in prepaid interest, and claimed a federal investment tax credit (ITC) of \$74,000. Appellant's net cash investment was \$63,000, and its tax saving was \$68,302. The rental period was 10 years and 10 days. An independent appraisal set the residual value of the computer at 20 percent of the computer's purchase price or \$148,000.
2. In 1977, appellant acquired an IBM 370/148 computer for \$707,140, with a cash investment of \$57,428,^{2/} and a non-negotiable limited recourse installment promissory note for \$649,712 (interest rate of 10 percent). The ITC claimed by appellant was \$70,714, and the rental period was eight years and three days.
3. In 1979, appellant acquired an IBM 3033 computer for \$4,035,000, with a cash investment of \$201,750 and a non-negotiable limited recourse installment promissory note for \$3,833,250 (interest rate of 12 percent). The ITC claimed was \$403,500, and the rental period was nine years, six months, and three days. An independent appraisal set the residual value of the computer at 20 percent of the computer's purchase price or \$807,000.^{3/}

A separate remarketing agreement (agreement), entered into by the parties provided that under certain conditions OPM was entitled to a 25-percent fee. In general, the conditions were that, if the leasing company (OPM) did not exercise its purchase option to acquire the equipment at the end of the lease, or did not re-lease the equipment (to the existing lessee or a new lessee), then under

^{2/} Appellant, however, claims its cash investment was \$70,714, after ITC of \$70,714. (App. Br. at 8.)

^{3/} Appellant's computation of \$847,350 appears to be based on a cost of \$4,236,750, which is an additional \$201,750 in cost.

the agreement the agent could dispose of the equipment and collect his fee.^{4/} (Tran., at 10.) In all the appeal years, appellant claimed depreciation and interest expense deductions relating to the equipment. Respondent Franchise Tax Board, however, viewed the transactions as shams having no economic substance apart from the tax benefits, and determined that the transactions should be disregarded for tax purposes.

With respect to whether or not appellant entered into the transactions with the requisite profit motive, the parties have stipulated that: (1) for the 1976 transaction, appellant had the requisite profit motive if the ITC is considered part of the profit motive, and if not, the existence of the requisite profit motive is to be analyzed in connection with the value placed on the remarketing agreement; if the value of the remarketing agreement is less than \$26,000, the profit motive issue is to be decided in favor of appellant, and if the value of the remarketing agreement is more than \$26,000, the profit motive issue is to be decided in favor of respondent;^{5/} (2) for the 1977 transaction, appellant accepts respondent's determination that the computer acquired in this year had a situs in Virginia so that the losses generated from this transaction were allocable to that state, and further agreed that all other issues related to this transaction should be resolved in favor of respondent; and (3) for the 1979 transaction, appellant had the requisite profit motive "only" if the ITC is considered part of the profit motive. (Tran., at 2-3, 9; App. Supp. Memo., Apr. 24, 1987, at 1-2.)

The parties have further agreed that, whether or not the ITC is considered to provide the requisite profit motive, appellant will be allowed to deduct all interest in excess of its rental income stemming from its 1976 and 1979 computer purchases. (Tran., at 3.) As a result, respondent has agreed that the proposed assessments against appellant, for the income years ended in June of 1978, 1979, and 1980, should be adjusted to reflect an allowance for interest expense deductions of \$44,255, \$59,490, and \$377,676, respectively. (Resp. Ltr., May 26, 1987, at 2.)

It is well settled that taxpayers are generally free to structure their affairs as they please even when motivated by tax reduction considerations. (Gregory v. Helvering, 293 U.S. 465 [79 L.Ed. 596] (1935); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 196 (1983), affd. on this issue, 752 F.2d 89 (4th Cir. 1985).) However, a transaction entered into solely for tax benefits, which has no economic, commercial, or legal purpose other than the expected tax benefits, is an economic sham and without effect for federal income tax purposes. (Frank Lyon Co. v. United States, 435 U.S. 561 [55 L.Ed.2d 550] (1978); Rice's Toyota World, Inc. v. Commissioner, supra, 81 T.C. at 196; Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1243 (1981).) Further, a taxpayer's profit motive need not be reasonable, but it must have an actual and honest profit objective (Fox v. Commissioner 80

^{4/} Appellant concedes that any economic profit on the 1976 transaction would have been reduced to zero if appellant had to pay the full 25-percent remarketing fee to the leasing entity to dispose of the property. However, appellant's witness, Richard W. Candland, testified that it was very unlikely that the remarketing fee would be earned at all. (Tran., at 8-10.)

^{5/} It appears that the \$26,000 is the difference between appellant's expected cash return of approximately \$100,000, and ITC for the year of \$74,000. (Appeal Ltr., Tab 4.)

T.C. 972, 1006, (1983), *affd.* without published opinion [742 F.2d 1441] (2d Cir. 1984)), and in this context the requisite element is economic profit, independent of tax savings. (Ramsay v. Commissioner, 83 T.C. 793, 810 (1984); Surloff v. Commissioner, 81 T.C. 210, 233 (1983).) Nonetheless, the accrual of tax benefits to an investor will not necessarily deprive a transaction of economic substance. (Estate of Thomas v. Commissioner, 84 T.C. 412, 432 (1985), citing Frank Lyon Co. v. United States, *supra*, 435 U.S. at 574, 581.)

In the sale and leaseback context, it appears the standard established by the U. S. Tax Court is that: (1) the nonuser recipient of tax benefits must establish that entry into the transaction was motivated by a business purpose apart from the tax benefits, and (2) the transaction must be supported by economic substance. (Rice's Toyota World, Inc. v. Commissioner, *supra*, 81 T.C. at 201-203.) However, even if a business purpose is present, the transaction is not entitled to recognition for federal tax purposes where objective indicia of economic substance indicating a realistic potential for economic profit are not manifested. (Cherin v. Commissioner, 89 T.C. 986 (1987).) In Rice's Toyota World, Inc., the tax court stated that the tests developed under the sham transaction doctrine are applied to determine whether a threshold level of business purpose or economic substance is present. (Rice's Toyota World, Inc. v. Commissioner, *supra*, 81 T.C. at 196.)

We first examine the 1976 transaction in accordance with the parties' stipulation agreement which provides that: if the value of the remarketing agreement is less than \$26,000, the profit motive issue is to be decided in favor of appellant, and if the value of the remarketing agreement is more than \$26,000, the profit motive issue is to be decided in favor of respondent.

As set forth above, the terms of the remarketing agreement provide in general that at the termination of the lease agreement, if the leasing company (OPM) did not exercise its purchase option to acquire the equipment, or did not re-lease the equipment (to the existing lessee or a new lessee), then the agent could dispose of the equipment, and appellant would be obligated to pay a 25-percent remarketing fee to OPM. The record before us indicates that performance of the above remarketing services would entitle OPM to a remarketing fee as high as \$37,000 (25 percent of the equipment's \$148,000 residual value, and assuming zero remarketing costs). Thus, the threshold question is whether or not OPM would fail to exercise the option or re-lease the equipment, and thus earn the fee. The parties, not surprisingly, are on opposite ends of this question: appellant contends it is unlikely that OPM would fail to perform either activity. Respondent, on the other hand, argues that as a reasonable person, the financial agent's incentive would be to charge the fee by finding some other buyer for the computer.

Here, apart from the lease transactions, it does not appear that appellant had a special relationship with OPM, an apparently unrelated entity, nor any knowledge whatsoever of the financial condition or operational methods of OPM, which would permit appellant to conclude with any certainty whether OPM would or would not perform the remarketing services and earn the fee. Respondent, on the other hand, argues what OPM's incentive would be as a reasonable person, but does not provide us with any bases for this conclusion, nor any reason as to how this conclusion was reached. Thus, we cannot state with any certainty whether or not OPM would perform the remarketing activity, and

consequently, we cannot state if the value of the remarketing agreement is more or less than \$26,000. Absent the ability to determine the value of the remarketing agreement, we must now determine if appellant had any realistic potential for economic profit, apart from the tax benefits, for the 1976 and 1979 transactions.

Appellant's first argument is that the legislative history of the federal investment tax credit should lead us to the conclusion that the investment tax credit is part of the economic profit analysis, and thus demonstrates that the 1976 and 1979 transactions were entered into with the requisite profit motive. Appellant here, like the taxpayer in Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054 (1988), contends that the ITC should be viewed as nothing more than a reduction in the cost of a capital asset, which consequently results in an increase in a purchaser's profitability. (Friendship Dairies, Inc. v. Commissioner, supra, 90 T.C. at 1065.) Appellant's analysis is flawed because it appears directed towards a contention that Congress enacted the investment tax credit specifically for the purpose of increasing profitability. While it is correct that a reduction in the cost of a capital asset will increase the expected profit from use of the asset, it is equally clear to us that the real purpose of Congress in enacting the investment tax credit was to stimulate the economy by increasing investment in capital assets.

In Friendship Dairies, Inc. v. Commissioner, supra, the tax court, upon examination of a situation similar to the one before us,^{6/} stated that:

The investment tax credit was the centerpiece of the Revenue Act of 1962, Pub. L. 87-834, 76 Stat. 960, 1962-3 C.B. 111 et seq. Congress enacted the credit as part of a program designed to stimulate the economy and encourage capital investment. The other major element of this program was the Treasury Department's reduction in the depreciable lives of capital assets. H. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 405, 412; S. Rept. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 707, 717-718. At no point does the legislative act distinguish between accelerated depreciation as a tax benefit and the investment tax credit as a non-tax or economic benefit. (Emphasis added.)

(Friendship Dairies, Inc. v. Commissioner, 90 T.C. at 1064-1065.)

In line with the above, it is clear that the ITC cannot be viewed as a substitute for economic profit. (Friendship Dairies, Inc. v. Commissioner, supra, 90 T.C. at 1065, 1066.) We now determine whether appellant had a reasonable expectation of an economic profit, apart from the ITC.

Appellant projected economic profits for the 1976 and 1979 transactions of \$100,003

^{6/} In the case of Friendship Dairies, Inc. v. Commissioner, the seller/leasing company was also OPM.

and \$225,141, respectively, inclusive of ITC of \$74,000 and \$403,500; however, exclusion of the ITC would reduce the 1976 projection to \$26,000, and result in an economic loss of approximately \$178,000 for 1979. The projections also included estimated cash returns for the equipment's residual value: \$148,000 for 1976 and \$847,350 for 1979, but no offset for payment of the remarketing fee to OPM. (Appeal Ltr., Tabs 4 and 14.) We cannot understand how appellant expected payment for the equipment's residual value, without payment of the remarketing fee to OPM; it appears both transactions go hand in hand.

We note that in Friendship Dairies, Inc. v. Commissioner, a case where OPM was engaged in a transaction very similar to the 1976 and 1979 transactions, the taxpayer there, in computing its expected cash return from certain computer equipment, reduced the residual value of the equipment by a remarketing fee payable to OPM. In Friendship Dairies, Inc., the tax court stated that, "in this case, as in most computer purchase and lease cases, the possibility of economic profit [is] dependent upon the expected residual value of the equipment at the end of the lease term." (Friendship Dairies, Inc. v. Commissioner, supra, 90 T.C. at 1063.)

Thus, since appellant's possibility of economic profit is also dependent upon receipt of the expected residual value of the equipment at the end of the lease term, and we believe payment of the remarketing fee to OPM is directly connected to the recovery of the equipment's residual value, we believe netting appellant's expected cash return from the residual value of the equipment by the remarketing fee payable to OPM (\$37,000 for 1976, and \$211,838 for 1979) is appropriate. Thereafter, a recomputation of appellant's 1976 and 1979 economic profit, including the residual value of the equipment, net of the remarketing fee, more properly reflects economic losses of approximately \$11,000 for 1976, and \$390,000 for 1979. After these recomputations, it becomes apparent that appellant's 1976 and 1979 computer purchase and leaseback transactions had no economic substance because there was no reasonable possibility of making a profit without consideration of the ITC, and the ITC cannot be considered in determining the profit potential of a transaction since a taxpayer must demonstrate an independent profit motive apart from the tax benefits arising from the transactions. (See Rice's Toyota World, Inc. v. Commissioner, supra, 81 T.C. at 196; Grodt & McKay Realty, Inc. v. Commissioner, supra, 77 T.C. at 1243.)

Appellant next argues that since the investment tax credit is not available under California law, we must fashion a new form of analysis in determining whether appellant's motives for entering into the transactions were purely for the tax benefits. In summary, appellant argues that since it cannot use the ITC as a reduction of its California franchise tax liability, it is entitled to use the ITC as part of its economic profit analysis for purposes of determining whether the transactions were entered into solely for state tax benefits, with no economic, commercial, or legal purpose other than the expected tax benefits. It is well settled that the taxing authorities are not required to acquiesce in the form of a transaction, if its substance is unreal or a sham, but may look to the actualities of the transaction. (Gregory v. Helvering, supra; Higgins v. Smith, 308 U.S. 473 [84 L.Ed. 406] (1940); 58th Street Plaza Theater, Inc. v. Commissioner, 16 T.C. 469 (1951), affd., 195 F.2d 724, cert. den., 344 U.S. 820 [97 L.Ed. 638] (1952).) Here, the adoption of appellant's argument would result in a

transformation of the ITC into something other than a federal tax benefit for the determination of whether appellant had the required profit motive. Further, even though the transactions here were driven solely by a desire to obtain the federal tax benefits, appellant has not provided us with any evidence or reason which convinces us that a different result should be permitted for state tax purposes.

Therefore, for the reasons stated above, respondent's action in this matter must be modified in accordance with respondent's concessions.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Bender Machine, Inc., against proposed assessments of additional franchise tax in the amounts of \$40,740, \$73,047, and \$88,299 for the income years ended June 30, 1978, June 30, 1979, and June 30, 1980, respectively, be and the same is hereby modified in accordance with the Franchise Tax Board's concessions. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 23rd day of April, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong, and Ms. Scott present.

_____, Chairman

Ernest J. Dronenburg, Jr., Member

Winnie Scott*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9