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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel
Large and Mid-Size Business

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CC:ITA

SUBJECT: Lease in / Lease out (LILO) Transaction

This Field Service Advice responds to your memorandum, dated December 12, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Corp A =
Corp B =
Country C =
Equipment D =
E Years =
F Years =
$G =
$H =
Year J =
$K =
Year L =
Year M =
Year N =
$P =
Year Q =
$R =

$S	=
$T	=
Year U	=
$V	=
$W	=
Bank X	=
Country Y	=
$Z	=
Bank AA	=
$BB	=
$CC	=
$DD	=
EE System	=
List FF	=

Years GG =

Firm HH	=
JJ Years	=
$KK	=
Date LL	=
$MM	=
Date NN	=
Date OO	=
$PP	=
$QQ	=
Date RR	=
Date SS	=
Date TT	=
$UU	=
$VV	=
WW%	=
Date XX	=
Date YY	=

ISSUES

1) Whether Corp A is entitled to the deductions claimed under I.R.C. § 162 and § 467 for lease payments and other expenses incurred in the Lease in / Lease out (LILO) transaction described.

2) Whether Corp A is entitled to deduct the interest "paid" on the nonrecourse loan incurred for the Headlease prepayment.

3) Whether Corp A must report the rental income and interest income accrued in the LILO transaction.

CONCLUSION

1) Corp A is not entitled to the deductions claimed under sections 162 and 467 for payments and other expenses incurred in the LILO transaction, because the transaction is an economic sham.

2) Corp A may not deduct the interest paid or accrued on the nonrecourse loan incurred for the Headlease prepayment, because the LILO transaction is an economic sham, and the interest deduction is an integral part of the transaction.

3) Corp A need not report the rental or interest income accrued on rent owed in the LILO transaction, because the transaction is a sham.   However, Corp A should recognize the Original Issue Discount (OID) income that accrues on the Treasury Strips.

FACTS

A Trustee of a domestic grantor Trust acting on behalf of Corp A, a United States corporation, entered into a LILO transaction with Corp B, a limited liability corporation wholly owned by the Country C. First, Corp B leased Equipment D to the Trustee under a Headlease for a primary term of E Years and a renewal term of F Years, exercisable at the Trustee's discretion. The Trustee immediately leased the same equipment back to Corp B under a Sublease having a term of E Years.

The Headlease states that the Trustee must make an initial prepayment of $G and a postpayment of $H in the Year J. If the Headlease is renewed, the Trustee must make a renewal option payment of $K in the Year L. The Sublease requires Corp B to make annual rental payments between the Year M through the Year N totaling $P. In the Year Q, Corp B has the option to purchase the Headlease residual from the Trustee for $R. If Corp B does not exercise its purchase option, it will have to make additional rental payments of $S in the Year U and $T in the Year J.

To fund the Headlease prepayment, the Corp A contributed $V to the Trustee and the Trustee obtained a fixed rate nonrecourse $W loan from Bank X, a Country Y bank. The loan provides for annual debt service payments that fully amortizes the loan between Year M and Year N. The amount and timing of the debt service payments exactly mirror the amount and timing of the Sublease payments due during the same period.

Upon receiving the Headlease prepayment, Corp B deposited $Z into a deposit account with Bank AA, Bank X’s parent. The deposit with Bank AA earns interest at the same rate as the loan from Bank X to the Trustee. Corp B directed Bank AA to pay Bank X annual amounts equal to Corp B's annual rent obligation under the Sublease. These amounts are used to satisfy the Trustee's loan to Bank X. The parties treat these amounts as having been paid from Corp B to the Trustee as Sublease rental payments, and then from the Trustee to Bank X as debt service payments.

Corp B must invest $BB in highly-rated zero coupon United States Treasury Strips to be held in the Trust. The Treasury Strips mature to $CC in Year Q, which approximates the exercise price of Corp B's Year Q purchase option. If Corp B exercises the purchase option, the Headlease ends, no further payments are due under the Headlease or Sublease and the balance of the Treasury strips revert to Corp A. If Corp B fails to exercise the purchase option, Corp B must make the Year U and Year J Sublease rent payments, but will receive the Headlease postpayment. Furthermore, Corp B will receive the balance of the Treasury Strips ($CC), but Corp B will have to post collateral valued at $DD to protect the Trustee's interest during the remaining Sublease term.

If Corp B does not exercise its purchase option and the Trustee renews the Headlease, the Trustee may elect to use Equipment D itself for the remaining term of the Headlease or lease Equipment D to another entity for the remaining term of the Headlease. However, the facts suggest that it is unlikely that the Trustee will be able to use Equipment D itself or rent it to another party. Equipment D is part of a national EE System that exists without competition in the County C. Equipment D is comprised of a number of items shown on List FF and was purchased and placed in service by Corp B during the Years GG. Firm HH determined that Equipment D had a remaining useful life of approximately JJ Years and a fair market value of $KK as of the date of the LILO transaction, Date LL . Corp B’s use Equipment D continues unchanged. Corp B pays for all maintenance and insurance for the Equipment D.

The Headlease allocates the $MM ($G plus $H) over its primary term. Between Date NN and Date OO, the Headlease allocates $PP to each year. The Headlease allocates $QQ to Date RR for that year. Between Date SS and Date TT, the Headlease allocates $UU to each year. Headlease also allocates the $K renewal option payment on a pro rata basis to each year of the renewal term. The amount of rent allocated to each year is claimed by Corp A as a rental expense for that period. Corp A also claims interest deductions for the loan from Bank X.

Corp A claims to have incurred $VV in transaction costs and a return of WW% on its investment. The Service believes that the claimed return on investment is inflated. The tax years currently at issue are those ending on Date XX and Date YY.

LAW AND ANALYSIS

Section 162(a)(3) allows as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rent.

Section 467 determines the timing of rental accruals for certain large leases.

Section 163 allows as a deduction all interest paid or incurred within a taxable year on indebtedness.

However, a transaction that lacks substance is not recognized for Federal income tax purposes. See ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995). Denial of recognition means that such a transaction cannot be the basis for a deductible expense. Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 278 (1999).
See Wexler, 31 F.3d at 122.

Rev. Rul. 99-14 Analysis

The Service position on the economic substance of certain LILO transactions was set forth in Rev. Rul. 99-14, 1999-13 I.R.B. 3. In the revenue ruling, a United States corporation (X), entered into a LILO transaction with a foreign municipality (FM). FM had owned and used the subject property, which had a remaining useful life of 50 years and a fair market value of $100 million.

On January 1, 1999, X leased the property from FM under a headlease with a term of 34 years and immediately leased the property back to FM under a sublease of 20 years. The sublease also included a “put renewal” term of 10 years.

The headlease required X to make two rental payments - an $ 89 million prepayment at the beginning of first year of the headlease and a payment at the end of year 34 that has a discounted present value of $8 million. For federal income tax purposes, X and FM agreed to allocate the prepayment ratably to the first six years of the headlease and the future value of the final payment ratably over the remaining 28 years of the headlease.

The sublease required FM to make fixed, annual rental payments over both the primary term and, if exercised, the renewal term. The payments during the renewal term are substantially higher that those for the primary term, but are still projected to be only 90 percent of the fair rental value for the property at that time.

At the end of the primary term of the sublease, FM has the option to purchase the headlease residual for a fixed amount that is projected to be equal to its fair market value. If FM exercises this option, the transaction is terminated and X is not required to make the final payment. If FM does not exercise this option, X may elect to 1) use the property itself during the remaining term of the headlease, 2) lease the property to another party for the remaining term of the headlease, or 3) compel FM to lease the property for the 10-year put renewal term of the sublease.

If X exercises the put renewal option, it can also require FM to purchase a letter of credit guaranteeing the rents during the renewal term. If FM does not obtain the letter of credit, it must exercise the option to purchase the residual of the headlease.

In order partially to fund the $89 million prepayment, X borrowed $54 million from one bank (BK1) and $6 million from another (BK2). Both loans are nonrecourse, have fixed interest rates, and provide for annual debt service payments that fully amortize the loans over the 20-year primary term of the sublease. The amount and timing of the debt service payments mirror the amount and timing of the rental payments due during the primary term of the sublease.

Upon receipt of the prepayment, FM deposits $54 million with an affiliate of BK1 and $6 million with an affiliate of BK2. The deposits earn interest at the same rates as the respective loans from BK1 and BK2. FM directs the affiliates to pay the interest to BK1 and BK2. The parties treat these payments as payments from the affiliates to FM as interest, from FM to X as rental payments, and from X to BK1 and BK2 as debt service. Further, FM pledged the $54 million dollar deposit as security for its rental payments.

X requires FM to invest $15 million of the prepayment in highly-rated debt securities that will mature in an amount sufficient to fund the fixed amount due under the purchase option and to pledge these securities to X.

On its federal income tax returns, X claims deductions for interest on the loans and rents under the headlease. X includes in gross income the rents received under the sublease and, if and when exercised, the payment from the purchase option. By accounting for reach element of the transaction separately, X purports to generate substantial net deductions in the early years of the transaction followed by income on or after the primary term of the sublease. X also anticipates a positive pre-tax economic return from the transaction. However, this pre-tax return is insignificant in relation to the net after-tax return.

Rev. Rul. 99-14 holds that the LILO transaction it describes lacks economic substance, indicating that a transaction will be respected for tax purposes if it has -

> economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached.

Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978); James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990).

In assessing the economic substance of a transaction, the revenue ruling notes a key factor is whether the transaction has any practical economic effect other than the creation of tax losses. Courts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer's beneficial interest except to reduce tax. The presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes. In reaching these conclusions, the revenue ruling relied upon Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, 157 F.3d at 248; and Sheldon v. Commissioner, 94 T.C. 738, 768 (1990).

In determining whether a transaction has sufficient economic substance to be respected for tax purposes, courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. For example, in Knetsch, the taxpayer purchased an annuity bond using nonrecourse financing. However, the taxpayer repeatedly borrowed against increases in the cash value of the bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon, the Tax Court denied the taxpayer the purported tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequences of holding the Treasury bills were largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 at 769.

In ACM Partnership, the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had a large tax effect resulting from the application of the installment sale rules to the sale. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership, 157 F.3d at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

The revenue ruling finds that, viewed as a whole, the objective facts of the LILO transaction it describes indicate that the transaction lacks the potential for any significant economic consequences other than the creation of tax benefits.
First, during the basic lease term of the sublease, X's obligation to make the property available under the sublease is completely offset by X’s right to use the property under the headlease. In addition, X’s obligation to make debt service payments on the loans is completely offset by X’s right to receive sublease rentals. The same circumstances are found in the present case. In fact, the LILO described in the present case presents

an even stronger case for the government, because the Headlease and the Sublease are coextensive.

Moreover, the revenue ruling notes that X's exposure to the risk that FM will not make the rent payments is further limited by the arrangements with the affiliates of BK1 and BK2. The defeasance arrangements almost eliminate all risk. As a result, neither bank requires an independent source of funds. Thus, during the primary term, the offsetting and circular nature of the obligations eliminate economic consequences.

Similarly in the present case, Corp A's exposure to the risk that Corp B will not make the rent payments is limited as a result of the arrangements with Bank X, and Bank AA. Corp A's economic risk as to the $W loan is almost eliminated by the deposit arrangement with Bank X's parent, Bank AA. As a result, neither Bank X nor its parent, Bank AA required an independent source of funds. The majority of the remaining money flows from the banks through the hands of the parties to the transaction and back to the banks. Like the revenue ruling there is a close relationship here between the lender and the defeasance depository bank. The circular nature of the cash flow appears to eliminate any significant economic consequences of the transaction. Corp A is expending relatively small amounts of equity and transaction expenses to generate substantial tax deductions.

The revenue ruling also considered the economic risks regarding residual of the headlease after the basic lease term. It found that the fixed payment option to purchase the residual and put renewal option operated to "collar" the value of the headlease residual. In addition, the revenue ruling also finds that there is little economic consequence from the nominal exposure to FM's credit. Lastly, the revenue ruling notes that the facts indicated that the purchase option would be exercised.

The LILO in the present case involves even less economic risks than were involved in the LILO involved in the revenue ruling, because the Headlease and the Sublease are coextensive. In the revenue ruling, the key to the risks in the transaction is the headlease residual; here, that residual is nonexistent. Further, there is no real credit risk given the nature of equipment, which is an integral part of a national system, and the ultimate involvement of Country C.

It is also apparent that, very much like the revenue ruling, the LILO is structured so that the purchase option will be exercised by Corp B. The Treasury Strips mature in Year Q and approximate the exercise price of Corp B's Year Q purchase option. The rent payments Corp B must make in the final two years of lease if the purchase option is not exercised, are more than five times the purchase option and also exceed the amount Corp B will receive as a postpayment. In addition, if Corp B does not exercise the purchase option, it risks losing the use of the equipment during the renewal period.

Corp A can pay to renew the lease only if Corp B does not exercise its purchase option. During the renewal period, Corp A could use Equipment D itself or leasing it to another entity. The renewal period parallels the residual period of the headlease in the revenue ruling, but it is far less likely to occur since it would not only require that Corp B not exercise the purchase option but also that Corp A pay to renew the lease. The potential renewal period presents the only real economic risk in this LILO transaction. Again the facts suggest that it is unlikely that the Corp A will be able to use Equipment D itself or rent it to another party. That is, the leased equipment is part of a national system, with no competitor, and has been used by Entity B for years. The short length of the renewal period and the nature of the Equipment also limits the potential renters.

Finally, the revenue ruling found that X's pretax return was too insignificant when compared to its after tax yield, to support a finding that the transaction has significant economic consequences. Here, according to the Agent, the pre-tax return is apparently either nonexistent or, at most, insignificant.

Rev. Rul. 99-14 holds that neither the rent nor interest arising from the LILO transaction are deductible. We believe the revenue ruling is controlling under these facts and that the LILO transaction involving Corp A lacks economic substance. As a result, no expenses arising out of the transaction are deductible.

Frank Lyon Analysis

As indicated above, Rev. Rul. 99-14 quoted the standard for economic substance set forth by the Supreme Court in Frank Lyon Co., 435 U.S. at 583-84. Frank Lyon set forth standards for determining when a sales leaseback may be ignored as a sham holding that "so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes." Frank Lyon Co. v. United States, 435 U.S. at 584. In upholding the sales leaseback in Frank Lyon, the Court rejected the Government's attempt to characterize it as a sham.

A sales leaseback differs from a LILO in that it involves a sale, which is a disposition recognized for tax purposes; in fact, sales leasebacks have long been recognized as legitimate tax structures. In contrast, it is unclear that any LILO transaction, particularly one with coextensive lease terms, has any real economic substance.

In Frank Lyon, Frank Lyon, the individual, was the Frank Lyon Company's majority shareholder and board chairman; he also served on the board of Worthen Bank. The Company invested $500,000 of its own funds to acquire a new office building from the Bank and lease it back to the Bank for an initial term of 25 years. The Company financed the remainder of the building with a fully recourse loan of $7,140,000 obtained from an unrelated insurance company. The rent for the first 25 years equaled the principal and interest payments that would amortize this loan. The Company also leased the land under the building from the Bank for 76 years.

The Bank had the right to renew its lease of the building for eight additional 5-year intervals at a fixed rent making its total potential leasehold 65 years long. The Bank had the option to purchase the building at 15 years and at other points in the lease for the Company's investment plus compound interest at 6 percent. The Bank also had the option to purchase the building at fair market under certain conditions involving a transfer of the Company's interest.

Under applicable federal and state law, the Bank was precluded from financing an office building of its magnitude for its own use. However, the state and federal regulators approved the sale leaseback so long as the Bank had an option to purchase the property after 15 years at a fixed price and another party owned the building.

The Government argued that the sale leaseback should be disregarded as a sham, in that the Frank Lyon Company was only acting as a conduit to forward rent payments to pay the mortgage and was doing so for a guaranteed return.

The Government relied on <u>Helvering v. F. & R. Lazarus & Co.</u>, 308 U.S. 252 (1939), where the Supreme Court held that, "taxation... [is] concerned with substance and realities, and formal written documents are not rigidly binding." 308 U.S. at 255. In <u>Lazarus</u>, the taxpayer, a department store, had transferred legal title to three buildings to a bank and then leased them back. The Court found that the transaction was in reality a loan and allowed the taxpayer depreciation on the buildings even though legal title was held by the bank.

However, the Court in <u>Frank Lyon</u> distinguished <u>Lazarus</u> because it involved two rather than three parties. The third party was necessary to the transaction in <u>Frank Lyon</u> because of the restrictions on borrowing imposed on the Bank. The Court noted that other investors could have been substituted for the Company with much the same result and the ultimate solution was not dictated by Mr. Lyon's relationship to the Bank. The Court found it significant that the Bank could not legally own and finance its own building

The Court also emphasized that there was no simple device to peel away the form of the transaction and reveal another substance. In this regard, it was important that the Company assumed recourse liability in the debt. Because of this, the Company, an ongoing enterprise, had been exposed to real and substantial risk and reduced its own borrowing ability. The Court also noted the Company's liability on the ground lease which could extend beyond the building lease.

In addition, the Court also pointed out that the government was likely to lose little revenue, if any, as a result of the shape given the transaction. That is, "[n]o deduction was created that is not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently." <u>Frank Lyon</u>, 435 U.S. at 580.

The government had argued that the purchase options allowed the Bank to accumulate equity in the property over time. However, the Court rejected this contention resting its conclusion on the factual finding of the district court that the option prices represented fair estimates of market value on applicable dates. The Court also noted that, the

Company would be free to do with the building as it chooses if the lease were not extended. The Court concluded that "so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes." Frank Lyon Co. v. United States, 435 U.S. at 584.

The present case does not demonstrate the economic substance required by Frank Lyon and is clearly distinguishable from that case. Initially, there is no legal barrier preventing the foreign entity from owning the equipment itself. In addition, because the lessee is a tax-exempt foreign entity, the expenses claimed would not be otherwise claimed by a United States taxpayer. See also Sacks v. Commissioner, 69 F.3d 982, 988 (9th Cir. 1995), holding sales leaseback was not a sham in part because the tax benefits would have existed for someone, and were shifted to the taxpayer rather than created out of thin air.

Further, the decision in Frank Lyon rested strongly upon the risks, including recourse debt, incurred by the Company. Such risks gave the Company the significant attributes of a lessor. No similar risks were incurred in the present case. Here, the loans are subject to defeasence and the risks as well as the potential gains from the transaction have been carefully collared to limit both potential loss and profit by the taxpayer.

Part of this restriction of risk is also the assurance that Corp A or the Trustee will never come into the possession of the property or will very likely never even be its "lessor" beyond Year Q, when the purchase option occurs. That this will never happen is also underscored by the possible limited use of the property, that is, no one but the foreign government entity may have any commercially reasonable use for it. See Rev. Proc. 76-30, 1976-2 C.B. 752, modifying Rev. Proc 75-21, 1975-1 C.B. 715. Limited use property was not involved in Frank Lyon.

Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985), is a pivotal case in defining sham transactions under the rationale of Frank Lyon. Significant to the present case, the Fourth Circuit affirmed that the Tax Court in finding an equipment sale leaseback a sham. Under the test formulated, a transaction is a sham if (1) it is not motivated by any economic purpose outside of tax considerations, and (2) it is without economic substance because no real potential for profit exists.

Under applicable case law, the business-purpose inquiry tends to be an inquiry into the investor's subjective purpose for entering into the transactions at issue. Rice's Toyota World, 752 F.2d at 92; Packard v. Commissioner, 85 T.C. 397, 417 (1985). In a sales leaseback transaction, those claiming tax benefits must show that they entered into the transactions motivated by a business purpose sufficient to justify the form of the transaction. Levy v. Commissioner, 91 T.C. 838, 854 (1988); Prager v. Commissioner, T.C. Memo. 1993-452. The economic substance inquiry tends to be an analysis of the objective factors indicating whether the transactions had a reasonable opportunity of producing a profit, exclusive of tax benefits. Rice's Toyota World, 752 F.2d at 94; Levy, 91 T.C. at 854.

In interpreting Rice's Toyota World, the Tax Court has been willing to find a sham if either of the two requirements are met rather than both. See, e.g., Mukerjii v. Commissioner, 87 T.C. 926, 959 (1986); Prager v. Commissioner, T.C. Memo. 1993-452. In addition, a number courts including the , whose precedent appears to govern the present case, have treated the two requirements as one. See, e.g., Sacks v. Commissioner, 69 F.3d 982, 988 (9th Cir. 1995); Gilman v. Commissioner, 933 F.2d 143, 148 (2d Cir. 1991), cert. denied 502 U.S. 1031 (1992); Smith v. Commissioner, 937 F.2d 1089, 1096 (6th Cir. 1991); Karr v. Commissioner, 924 F.2d 1018, 1022-23 (11th Cir. 1991), cert. denied 502 U.S. 1082 (1992). Simply stated the unitary test is whether the transaction has "any practical economic effects other than the creation of income tax losses." See Gilman, 933 F.2d at 148, also referring to the "flexible nature of the analysis."

Whether the formal two part test of Rice's Toyota World or the simpler one is used, a minimal profit should not be conclusive in finding economic substance or practical economic effects. Minimal or no profit has been held to be acceptable in highly risky circumstances, where a chance for large profits also existed. See Bryant v. Commissioner, 928 F.2d 745 (6th Cir. 1991); Jacobson v. Commissioner, 915 F.2d 832 (2d Cir. 1990). However a minimal profit should conversely be less acceptable when a ceiling on profits from a transaction is all but certain. More simply, that the taxpayer is willing to accept minimal returns in a transaction with no more profit potential demonstrates that the transaction was tax motivated. Thus, a minimal profit in an equipment leasing transaction will not prevent the finding of a sham if tax considerations predominate. See Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990); Prager v. Commissioner, T.C. Memo. 1993-452.

Special concerns regarding the deduction of interest.

There is no question that an interest deduction that is part of a sham transaction may be disallowed even if arises on bona fide debt. See Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967). However, there are also circumstances where a loan that is part of a sham transaction may be recognized. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985). Therefore, we

must focus on whether the loans in the present case are an integral part of the sham transaction, which we believe they are.

As discussed above, Rice's Toyota World is a pivotal case in defining sham transactions in that it established the two part test which has subsequently been relied upon in many decisions. It also contained another holding that a taxpayer may deduct interest paid on genuine indebtedness incurred to invest in a sham transaction.

In Rice's Toyota World, the taxpayer purchased a used computer from a leasing company by issuing a recourse note and two nonrecourse notes to the seller. The taxpayer claimed accelerated depreciation deductions, based on its ownership of the computer, and interest deductions for the payments on the notes. The taxpayer paid off the recourse indebtedness, which was $250,000, in three years along with $30,000 of interest.

The Fourth Circuit affirmed the Tax Court's finding that the transaction was a sham. However, the Fourth Circuit reversed the Tax Court's finding that the interest on the recourse indebtedness was not deductible. The Tax Court, after finding a sham transaction, thought the entire transaction could be disregarded, including the interest deductions.

The Fourth Circuit, however opined that "a sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded." Rice's Toyota World, 752 F.2d at 96, citing Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1243 (1981), which had been relied upon by the Tax Court. The Fourth Circuit concludes that both the recourse indebtedness and the interest paid upon it were genuine. 752 F.2d at 96. Thus, section "163 does not limit the deductibility of...interest expense depending upon the item purchased by the taxpayer." Id.

The Tax Court explicitly adopted the section 163 holding of Rice's Toyota World in Rose v. Commissioner, 88 T.C. 386, 423 (1987), aff'd, 868 F.2d 851 (6th Cir. 1989), and allowed a deduction for interest paid on a recourse note given to invest in and as part of a transaction found to lack "economic substance."

In addition, in Lieber v. Commissioner, T.C. Memo. 1993-424, the Service challenged the taxpayers' deduction of interest on nonrecourse indebtedness incurred to enter a computer sale leaseback transaction. The Tax Court found that the taxpayers lacked a profit objective in regard to the transaction and disallowed the other deductions. However, the court went on to find the indebtedness incurred to purchase the computer genuine and ultimately allowed the interest paid. In reaching this conclusion, the court questioned the continuing viability of Goldstein, after the Second Circuit's decision in Jacobson v. Commissioner, 915 F.2d 832 (2d Cir. 1990), which followed Rice's Toyota World.

As explained below, the continuing viability of Goldstein is no longer at issue. Goldstein is the primary precedent that disallows interest deductions in circumstance where there is no question that genuine loans were obtained. In Goldstein, the taxpayer had won the Irish Sweepstakes. To shelter her windfall, she borrowed money from banks to purchase Treasury securities that would yield a lower rate of interest than she would be paying to the banks. The transaction only benefitted her because of the tax savings on prepaid interest on the loans.

The Second Circuit found that the loans were genuine and recourse, but affirmed the disallowance of the interest expense. The decision emphasizes the Tax Court's finding that the taxpayer's sole purpose for entering the transactions was to obtain an interest deduction. 364 F.2d at 740-42. Following Knetsch, Goldstein holds that borrowing for that purpose should not be recognized under section 163. Id.

After Rice’s Toyota World and following Goldstein, a number of cases have disallowed interest deductions where they are an integral part of a transaction found to lack economic substance. For example, Wexler v. United States, 31 F.3d 117, 125-126 (3d Cir. 1994), cert. denied, 115 S. Ct. 1251 (1995), affirmed the disallowance of an interest deduction in a "repo" transaction. A "repo" transaction is a complex "repurchase agreement" involving securities, where the tax benefits arise from an up front interest deduction. Wexler distinguished Rice's Toyota World, because "the interest payments on the recourse note were separable from...the principle tax benefits of the transaction" and the interest expense was not "in itself, the purpose of Rice's transaction." 31 F.3d at 125-26. In contrast, the indebtedness in Wexler could not be "separated from the underlying repo scheme." Id. Similarly Sheldon, relied upon in the revenue ruling, disallowed interest deductions in a repo scheme.

Recent Tax Court decisions have likewise recognized the distinction between borrowings that are separable from and those that are an integral part of a sham transaction. In Arrowhead Mountain Getaway, Ltd. v. Commissioner, T.C. Memo. 1995-54, 69 T.C.M. (CCH) 1805, aff’d, 80 AFTR 2d (RIA) 5664 (9th Cir. 1997), the Tax Court, citing Wexler, Rice's Toyota World, Lieber, noted that some cases do indicate that a sham transaction may have separable, economic substantive elements for which a deduction is permitted. The Tax Court, however, distinguished its case, because its,

> "loans," instead of being separable from the sham transactions, were an integral part of the transactions...and were the driving force of the tax-avoidance scheme, rather than merely tangential aspects of the dealings among the parties. As a result, the "loans" are themselves shams and must be disregarded for tax purposes.

Arrowhead Mountain, 69 T.C.M. (CCH) at 1820.

In addition, in Seykota v. Commissioner, T.C. Memo. 1991-541, 62 T.C.M. (CCH) 1116, the Tax Court on motion from the Service, reconsidered its allowance of interest expense in a "cash and carry" gold transaction which also depends on an up front interest deduction for its tax benefits. The Tax Court changed its previous determination and disallowed the interest. It distinguished Rice's Toyota World based on the fact that the interest was recovered by the taxpayer in the form of gains. Thus the Court looked to the "function of the interest payments" and subsequently cited Goldstein. 62 T.C.M. at 1118.

Lee v. Commissioner, T.C. Memo. 1997-172, 73 T.C.M. (CCH) 2545, aff’d 155 F.3d 584 (2d Cir. 1998), involved the same transaction as Seykota. In disallowing the interest deduction, the Tax Court assert that Goldstein “continues to apply to the narrower situation where a taxpayer enters into a borrowing transaction for no purpose other than to claim the deductions generated by that transaction itself.”
73 T.C.M (CCH) at 2549.

In affirming the disallowance of the interest deduction in Lee, the Second Circuit held Jacobson did not and could not overrule Goldstein. In coming to this conclusion, the Second Circuit reasoned that:

> To adopt petitioner's reading would be to permit every shelter, no matter how transparently sham, to qualify for an interest expense deduction as long as the money used to finance the not-for-profit transactions involved were borrowed from a lender – any commercial bank would do -- that demanded repayment. That result, soundly criticized by the Third Circuit in...Wexler...is contrary to the longstanding jurisprudence of sham shelters from Knetsch on down.

155 F.3d at 587.

This language from Lee was paraphrased by Tax Court in Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999), as part of its rationale for disallowing interest incurred in a leveraged corporate-owned life insurance (COLI) program, which was found to lack economic substance. The Tax Court also held that "the overall transaction of which the debt is a part must have economic substance before interest can be deducted." Id,

Under the COLI program, the taxpayer purchased life insurance on its employees and systemically borrowed against the cash value of the policies to fund the premiums. The annual premiums, fees and policy loan interest would exceed the projected death benefits and net cash value of the policies. The program was designed to generate large interest deductions on taxpayer's policy loans.

The language of the holding of Winn-Dixie is broader than that found in prior Tax Court cases and would appear to encompass the present case in that the loans here were part of the LILO transaction and could not be separated from it. Further, Lee and Goldstein are apparently controlling precedent in this case.

Income from Rent and Interest

It has been suggested that Corp A may have to report rent and interest accrued in the LILO even though the expenses attributable it are disallowed. However, when deductions are disallowed because a transaction lacks economic substance, income attributable to the transaction is eliminated as well. Sheldon, 94 T.C. at 762; Leema Enterprises v. Commissioner, T.C. 1999-18. See ACM Partnership, 157 F.3d at 261. The Sheldon case held that certain repurchase transactions were shams and therefore the taxpayer should not be required to include income on the Treasury bills financed by those agreements. Similarly, in the Leema Enterprises case, the court did not require the taxpayer to recognize the income from gains from straddles that lacked economic substance, when it had held that the deductions from the losses on the straddles should be disallowed.

On the other hand, we believe that these cases do not preclude requiring Corp A to recognize interest income from the purchase of Treasury Strips. This would not be inconsistent with Sheldon and Leema Enterprises because the loans for which we denied deductions were not used to finance the purchase of the Treasury Strips. The funds used to purchase the Treasury Strips were funds actually paid by the taxpayer. The OID would be $CC minus $BB.

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