OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:RFP:ATL

FROM: ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES

SUBJECT: LEASING TRANSACTION

This Chief Counsel Advice responds to your memorandum dated May 5, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Participants and advisers:
Taxpayer, or Owner Participant =

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Seller =
Trustee, Buyer, or Lessor =
Lender =

Lessee =

TL-N-6686-00

Appraisers =
Bank A City A Branch =
Bank A City B Branch =
Banker =

Countries, Currencies
Currency A =
Currency B =
Currency C =
C or Government of C =

Property, line of business
X =

Equipment =

Ancillary Equipment =

Numbers
D =
E =
T =

Dates
Date 1 =
Date 2 =
Date 3A =
Date 3B =
Date 3C =
Date 3D =
Date 3E =
Date 3F =
Date 3G (or Sale Date) =
Date 4 (or End of Interim Lease Term) =
Date 4A =
Date 4B =
Date 5 =
Date 6 =
Date 11 =
Date 11A =
Date 11B =
Date 17 (or End of Basic Lease Term) =
Date 18 =

Date 25	=	
Date 29	=	
Interim Lease Term	=	
Basic Lease Term	=	

Percents

A	=	
B	=	

Monetary amounts

Appraised Value	=	
Sale Price	=	
Loan Amount	=	
Taxpayer's Contribution	=	
Currency A Amount	=	
Currency A Loan Balance	=	
Purchase Option Price	=	
Walkaway Payment Amount	=	
Debt Issue Proceeds	=	
Interim Loan Payment	=	
Final Loan Payment Amount	=	
Date 17 Loan Balance	=	
Final Currency A Interest Amount	=	
Taxpayer's Walkaway Option Net Amount	=	
Purchase Option Net Price	=	
Estimated Equipment Value on Date 17	=	
Lessee's Hypothetical Initial Investment	=	
Lessee's Hypothetical Net Benefit	=	
Taxpayer's Purchase Option Pre-tax Loss	=	
Taxpayer's Purchase Option IRR Loss	=	
Taxpayer's Replacement Option Pre-tax Loss	=	
Taxpayer's Replacement Option After Tax Gain	=	
Taxpayer's Walk Away Option Pre-tax Loss	=	
Taxpayer's Walk Away Option After Tax Loss	=	
Taxpayer's Purchase Option Profit	=	
Replacement Lease Cash Flow	=	
Replacement Lease Equipment Residual	=	
Replacement Lease Total Return	=	
Owner-Participant's Fees	=	

<u>ISSUES</u>

1. Whether the transactions described below lack economic substance?

2. Alternatively, whether the transactions described below should be be recharacterized as a financing?

CONCLUSIONS

1. The facts set forth below suggest that the transactions lack economic substance and should not be respected.
2. Alternatively, the transactions described below should be recharacterized as a financing.

FACTS

The following facts are relevant to the Taxpayer's transaction affecting tax years 1992, 1993, and 1994. By the form of Taxpayer's transaction, Taxpayer purported to buy (through Trustee), subject to Lender's security interest, Equipment and then lease the Equipment back to Lessee, an affiliate of Seller.

Lessee, an agency of the Government of C, is a governmental public utility whose obligations are direct obligations of Government C. Lessee's core business is X. Lessee has no direct competitor within C. Seller, a wholly owned subsidiary of Lessee, purchased Equipment and also Ancillary Equipment. For purposes of this memorandum only the Equipment was subject to this transaction. The Equipment was delivered to Seller between Date 1 and Date 2.

According to the Appraisers' fair market value study of Equipment for Owner Participant dated Date 3C, the Equipment has an estimated remaining useful life of T years and a total cost of approximately Appraised Value. The Equipment is among the world's most advanced.

The entire transaction is essentially set forth in a Participation Agreement dated Date 3D, entered into between Lessee, Trustee/Lessor (acting as trustee for Taxpayer), and Lender. Other documents carry into effect the undertakings of the Participation Agreement.

The Participation Agreement contemplates that Lender will make a nonrecourse secured loan equal to A% of the cost of purchasing the Equipment and Taxpayer will make an "equity" contribution to Trustee equal to the remaining B%. Once Trustee purchases the Equipment, the Participation Agreement requires the Trustee to lease all of the Equipment back to Lessee and to execute Loan Certificates to Lender equal to the Lender's commitment. The transaction thus consists of two principal components: (1) the sale of the Equipment by Seller to Trustee, as trustee for Taxpayer; and (2) the leaseback of Equipment to Lessee from Trustee, as Lessor. Additional components, necessary to Lessee, which we believe deals in currencies B and C, are certain "swap agreements" between Lessee and Lender concerning the conversion of amounts under the transaction from one currency into another. The Participation Agreement defines the rights and responsibilities of the parties, such as warranties and security interests.

Trust agreement. On Date 3D, Taxpayer and Trustee entered into the Trust Agreement authorizing Trustee to execute and deliver various agreements, instruments, certificates and documents. The Trust Agreement also authorizes Trustee to purchase the Equipment from Seller, accept the Bill of Sale, execute and deliver a Lease Supplement, execute and deliver the Loan Certificates, and cause the Equipment to be leased to Lessee. The Trustee will make payments under the various agreements only from the Trust Estate. Taxpayer agrees that it will look solely to the income and proceeds from the Trust Estate for any payments, and Trustee will not be liable for any amounts payable under the Trust Agreement. All amounts to be paid to Taxpayer shall be paid by transferring such amounts with a bank wire transfer to the banking institution of Taxpayer. Taxpayer agrees to assume liability for and to indemnify Trustee acting in its capacity as Owner Trustee.

Purchase agreement. Seller agreed to sell the Equipment to Trustee for Sale Price (approximately 5% more than Appraised Value). To fund the purchase of the Equipment, Trustee and Lender entered, on Date 3D, into a Loan and Security Agreement (described further below) under which Trustee borrowed Loan Amount from Lender, which was sufficient to fund A% of the cost of Equipment. Owner Participant contributed Taxpayer's Contribution to fund the B% balance of the cost.

On Sale Date, a Bill of Sale, an Invoice, and a Receipt for Payment of Equipment Cost were executed to acknowledge receipt of the payment by Seller and the transfer of all right, title and interest in the Equipment to Trustee. Under the Notice of Delivery Date, the scheduled delivery date for the Equipment was Sale Date. Title passed from Seller to Trustee.

The cash flow was completed as follows:

1. Owner Participant transfers Taxpayer's Contribution into the Trustee's account at Bank A City A Branch.

2. Lender transfers Loan Amount from Bank A City B Branch to Trustee's account at Bank A City A Branch.

3. Owner Participant had Trustee transfer the Sale Price from Trustee's account into Seller's account at Bank A City A Branch.

4. Seller then transfers the Sale Price from its account to the Lessee's account at Bank A City A Branch.

5. Lessee has Loan Amount transferred from its account above into Lender's account at Bank A City B Branch. (Step 5 is part of an initial swap payment made between Lessee and Lender pursuant to which Lessee transfers Loan Amount to Lender and receives back Currency A Amount (about 2% less)). Lessee retains an amount equal to Taxpayer's Contribution.[1]

Lease agreement. On Date 3D, the Trustee, as Lessor, and Lessee executed the Lease Agreement pursuant to which the Lessee would lease the Equipment for an Interim Lease Term followed by a Basic Lease Term for a combined lease term of D years.[2] The Lease Agreement is a net lease under which Lessee is responsible, at its own cost, for the operation, maintenance, registration and insurance of the Equipment. Lessee will pay for all servicing, repair, overhauling, and testing. Lessee is responsible for affixing to each item of Equipment, a nameplate identifying Trustee's "ownership" interest, and Lender's security interest. Lessee retains possession of the Equipment at all times.

Significantly, at the end of the Basic Term, section 14(a) of the Lease Agreement requires Lessee to exercise one of the three following options:

(1) *Purchase Option.* If Lessee elects to purchase the Ancillary Equipment associated with the Equipment, it may elect to purchase all, but not less than all, of the Equipment at the end of the Basic Lease Term for a cash price of Purchase Option Price, which equals 107.28131% of the Sale Price.[3]

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[1] There is no information about what Lessee did with this Currency B amount and no indication that Lessee converted this amount into Currency A.

[2] D is approximately 35% of T, the useful life of Equipment.

[3] [redacted]

(2) *Replacement Lease Option*. Lessee may elect to procure a "Successor Lessee" to lease the Equipment from the Lessor subject to conditions set forth in the Participation Agreement. Under section 21 of the Participation Agreement, the Lessee will: (i) require any Successor Lessee to enter into a replacement lease and related replacement Tax Indemnity Agreement and such other necessary documents; (ii) attempt to secure a taxable entity as the Successor Lessee; however, if a taxable entity cannot be secured, "any other person" is permitted to become the Successor Lessee if such person meets all requirements set forth for qualifying an entity as the Successor Lessee; and (iii) ensure that the Successor Lessee is not related to Lessee. The Successor Lessee must agree to either use the Equipment in its own operating business in the United States or outside the United States; use the Equipment by entering into one or more service contracts within the meaning of section 7701(e) of the Code to provide services to one or more other persons operating Equipment related businesses inside or outside the United States; enter into one or more subleases with sublessees that are taxable entities for use of the Equipment either outside or inside the United States or enter into subleases with Tax Exempt entities for a term less than three years. The term of any Replacement Lease will commence upon expiration of the Basic Lease Term and end on Date 29 (a lease term when combined with the Basic Lease Term totals E years or approximately 68% of the Equipment's useful life). The terms and conditions of the Successor Lease will be identical in all material respects to those contained in the Lease, with some exceptions not relevant here. The Successor Lease Basic Rent is set forth in Schedule II to the Participation Agreement and, for the first 6 years, exceeds the rent due for any year during the Basic Lease Term. Further, under this Replacement Lease Option, the Lessee may need to compensate the Successor Lessee with a lump sum payment or other inducement for entering into the Replacement Lease.[4]

Under this option, the Participation Agreement also permits the Trustee to elect to reject the "Successor Lessee" and relieve the Lessee of its obligations. The Lessee would be required to return the Equipment to the Trustee provided the Trustee makes proper arrangements with the Lender for payment of the Loan Certificates.

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[4] Lender's loan must be prepaid at the end of the Basic Lease Term if, as a result of Lender's and Taxpayer's actions, the interest rate on the loan is not reset for the period after the Basic Lease Term. Were this to happen, Lessee might be unable to secure a Successor Lessee, since the payment to induce the Successor Lessee would not be less than the outstanding loan balance. In that event, the Lessee is given the opportunity to exercise the purchase option. Loan Agreement section 2.10(a), 2.11(d); Participation Agreement section 21(a) (flush language).

(3) *Walkaway Option*. The Lessee could return the Equipment to the Lessor upon expiration of the Basic Lease Term (Date 17) and pay an amount equal to the "Termination Value" (107.28430548% x Sale Price) less 20% of the Sale Price. This amount would equal Walkaway Payment Amount. The Lessee must return the Equipment at its own expense and free and clear of any liens.

If the Lessee does not elect the Purchase Option, it will be deemed to have elected the Walkaway Option. Otherwise, the Lessee has the option of exercising any of the above three options at the end of the Lease.

Under section 14(a) of the Participation Agreement, the Owner Participant's right to assign, convey, or otherwise transfer any of its rights, title or interest in the Equipment, the Trust Agreement, the Tax Indemnification Agreement, the Trust Estate and certain other documents is subject to the prior written consent of the Lessee and the Lender "to be given or withheld in the sole discretion of each such party" and is subject to certain enumerated conditions.[5] If the transferee of such rights, title or interest in the Trust Estate meets certain financial and other requirements, the prior written consent of the Lessee and Lender is not necessary.

Under section 15 of the Lease agreement (Voluntary Termination of the Lease), Lessee, on or after the 5th anniversary of the "Delivery Date" (Sale Date), has the right to propose a date of termination of the Lease if the Equipment has become obsolete or surplus to the Lessee's requirements. The date of termination coincides with a "Basic Rent Payment Date."

Beginning on Date 4B, Lease payments in Currency B (assigned by Trustee to Lender) are due semiannually on the same date, and in the same amount, as Lender is obligated to make Currency B Swap Agreement payments to Lessee and on the same day Trustee is obligated to make Currency B Loan Agreement payments to Lender. No Lease payment is due on Date 4 (the end of the Interim Lease Period). Over the life of the Lease, the Lease payment amounts apply variously to rent in arrears, or advance rent, or a combination.

Section 16 of the Lease Agreement includes in "Events of Default" failure to make any payment(s), bankruptcy proceedings, or any default event pursuant to a certain attendant lease. If any such event occurs, the Lessor may declare the Lease to be in default and proceed with various actions, including demanding the return of the Equipment by the Lessee, selling or otherwise disposing of the Equipment, or any

[5] See also Lease, section 19, limiting the Lessor's right to assign its rights and responsibilities under the lease.

other right or remedy which may be available to the Lessor. See section 17 of Lease.

Tax Indemnification Agreement. On Date 3D, Lessee and Owner Participant signed a Tax Indemnification Agreement that assumed that for certain tax purposes the Lease will be treated as a "true lease" and the Owner Participant will be treated as the owner and lessor of the Equipment; that Owner Participant will be entitled to a depreciation deduction with respect to the Equipment under section 168(h) of the Code, an amortization deduction, and interest expense deduction; and, that Owner Participant will not be required to include in gross income any amount other than "Basic" rent and, if applicable, any gain realized on the "Purchase Option Price." In addition, Lessee warrants that it will not claim to be the owner of any part of the Equipment on any U.S. federal, state or local income tax return, and also that it will not claim depreciation deductions or interest expense, nor will it treat the Lease as a conditional sales agreement.

Under section 4 of the Tax Indemnification Agreement, if any depreciation, interest and/or amortization deduction of the Owner Participant is disallowed, or must be recaptured, and this results in a loss of tax benefits or a corresponding increase in the federal income taxes payable by Owner Participant, Lessee will pay to Owner Participant an amount equal to the sum of such federal, state and local income taxes and any interest, penalties or other additions. Lessee shall not have any liability to Owner Participant for indemnification for any tax loss if the tax loss results from certain conditions listed in section 5, including failure of the Lease to constitute a "true lease" for federal income tax purposes.

Loan agreement. Also on Date 3D, Trustee and Lender entered into a Loan and Security Agreement to provide for the issuance of Loan Amount in Loan Certificates maturing on Date 25. The loan proceeds are to be used by the Trustee to fund part of the Equipment's cost. Lender agreed that it will look solely to the "Loan Estate" for all payments including principal, interest, and premium (if any) and any other amounts due under the Loan Certificates. A Pledge Agreement was entered into on the same date whereby Trustee pledges a security interest to Lender of all right, title and interest of Trustee in the "Loan Estate," including the Equipment, the Lease, payments under the Lease, and rights under other documents or payments in specified circumstances. Under an Assignment of Rentals Agreement, as long as the lien of the Loan Agreement is in effect, all rent and any other payments payable to the Trust Estate will be paid directly to Lender, and Lender is granted a first priority interest in such amounts. Thus, both the documents and conversations with the Field indicate that this financing is nonrecourse to the Trustee and nonrecourse to the Owner Participant.

The interest rate for the Loan Certificates is set at 8.61%. Since the Basic Lease Term ends on Date 17 and the Loan Agreement runs through Date 25, the applicable interest rate will be reset to the “Reset Rate” on the “Reset Date” (Date 17). The “Reset Rate” will be determined by either (a) a fixed rate of interest determined by the Lender in the Lender’s own business judgment (taking into account various factors) or (b) the lowest fixed rate that allows Banker to find one or more entities to purchase all or a portion of the Loan Certificates.

Article IV, section 4.01 of the Loan Agreement sets forth certain “Loan Events of Default” including failure to make any payment(s), bankruptcy proceedings, or any Event of Default. Upon the occurrence of a “Loan Event of Default,” Lender may declare the outstanding Loan Certificates to be due and payable along with any outstanding interest or other amounts due; take possession and use, operate, manage and control the Loan Estate; sell and dispose of the Loan Estate; or proceed with any legal action.

Beginning on Date 4, Trustee must make Loan payments semiannually in Currency B to Lender. Beginning on Date 4B, the Loan payments are made on the same date and in the same amount as Lessee is obligated to make Currency B Lease payments to Trustee (which lease payments are assigned by Trustee to Lender as security for making Loan payments). Thus, on Date 4, a Loan payment (Interim Loan Payment) is due from Trustee to Lender without any matching Lease payment due from Lessee to Trustee, so Trustee must advance funds from the Trust Estate (provided by Owner Participant) to make this “initial” payment. The first payment does not pay all of the interest due, causing an increase in the Loan’s principal amount. The second payment pays the remainder of the interest due to that payment date, reducing the principal to its original amount. Thereafter, the annual payments combined pay interest only until Date 11. After Date 11, the two semiannual payments (combined) include both principal and interest. This also results in a larger portion of interest being assessed up front with the majority of the principal reduction coming during the 2nd lease stream if the Replacement Lessee Option is chosen.

<u>Interest Rate and Currency Exchange Agreement (Swap Agreement)</u> The Lessee and the Lender entered into Swap Agreements on Date 3E. The purpose of this agreement is to protect Lessee from any currency exchange risk resulting from the obligation to pay rent in Currency B. In order to accommodate Lessee, the Lender issued debt in the principal amount of Debt Issue Proceeds in Currency A in the Currency A capital market on Date 3A, a part of which was used to fund a part of this transaction.

There are two schedules of payments, Exhibits O and P of the Field’s submission, between Lessee and Lender during the life of the Swap Agreement, which runs from Sale Date through Date 17. The semiannual schedule for payments from Lender to Lessee in Currency B enables Lessee to have Currency B with which to pay rent and coincides in time and amount with recurring payment obligations under the Loan Agreement and, beginning Date 4B, with the schedule of payments under the Lease Agreement. The schedule for payments from Lessee to Lender in Currency A is annual (except a payment is required on Date 17), and pays Lender for the provision of Currency B under the other schedule.[6]

The Swap Agreement will terminate on the date of termination of the Lease, whether that date is a voluntary termination date under section 15 of the Lease that coincides with a rent payment date on or after the 5th anniversary of Sale Date, or whether that date is Date 17.

<u>Schedule of payments under the Lease, Loan, and Swap agreements after Sale Date</u>

On Date 4, as noted, Trustee must pay Interim Loan Payment to Lender under the Loan Agreement (without having received any rent from Lessee under the Lease, so the payment must be funded by the Taxpayer), and Lender must pay Lessee the same amount under the Swap Agreement, resulting in a "net" transfer from Owner Participant to Lessee.

On Date 17, also as noted, Trustee must pay Final Loan Payment Amount to Lender (without having received any rent from Lessee under the Lease, so the payment must be funded by the Taxpayer), and Lender must pay Lessee the same amount under the Swap Agreement, resulting in a "net" transfer from Owner Participant to Lessee. This is the same date as the Purchase Option would be exercised, if selected, or the replacement lease would begin, if selected. Thus, for the first and last payment dates, Trustee makes Loan payments to Lender which in turn makes Swap payments to Lessee for the same amounts, without a reciprocating payment being made from Lessee to Trustee.

The structure of the "recurring" payments (beginning Date 4B) under the Lease and Loan schedules, and from Lender to Lessee under the Swap schedule, are all

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[6] The initial swap payments, described as Step 5 of the flow of funds for the purchase of Equipment under which Lessee pays Lender in Currency B and Lender pays Lessee in Currency A, do not show up in the schedule of swap payments at Exhibits O and P of the Field's submission, but are recounted elsewhere. Those two Exhibits deal only with the "recurring" and "final" swap payments. Lessee's schedule of payments to Lender does not coincide with payment dates under the Loan and Lease Agreements and the other swap schedule.

denominated in Currency B. These three schedules are all set up so that the Currency B amounts being paid parties to the Swap, Lease and Loan schedules offset each other, resulting in a zero cash flow between the parties.[7] On each Lease payment date, Lender pays Lessee, under the Swap Agreement, an amount of Currency B equal to the rent due. Lessee, on the same date, pays Trustee, which has assigned the payment to Lender under the Loan Certificates, rent due in the same amount of Currency B. Trustee, on the same date, pays Lender under the Loan Agreement the same amount of Currency B by virtue of the assigned rent. The payments from Lessee to Lender in Currency A under the other swap agreement schedule, however, are annual and do not coincide with a Lease or Loan payment date (except for Date 17).

On Termination of the Swap Agreement (which coincides with termination of the Lease Agreement), Lessee will pay Lender the notional amount of Currency A Loan Balance and, if the scheduled termination date is a “Currency A Payment Date”, the amount specified in the “Currency A Payment Date” schedule. On such termination date, Lender would pay Lessee the “Notional Amount of Currency B” (per the “Notional Amount of Currency B” schedule) and, if the scheduled termination date is a “Currency B Payment Date” the amount specified in the “Currency B Payment Date” schedule. If termination is on Date 17, Lender’s swap payment to Lessee corresponds to Trustee’s payment of the Date 17 Loan Balance to Lender plus the Final Loan Payment Amount Trustee pays to Lender under the Loan Agreement, as described below. Immediately following the above payments, Lender will enter into an “Equipment Financing Contract” with Lessee for Currency A Loan Balance with a “final maturity” of Date 18 (approximately 17 months after Date 17) and an interest rate of 8.575%.

Since a number of payments are scheduled for Date 17, including the payments under the three options open to Lessee at the end of the Basic Lease Term, the net effect of the first and last Loan payments should be considered when considering the Lessee’s payments under its options at the end of the Basic Lease Term. If Lessee selects the Purchase Price Option and pays Owner Participant the

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[7] These “payments“ presumably may be recorded by offsetting entries on Lender’s books for the transfer to Lessee (under the Swap Agreement) and the receipt of assigned rents from Lessee that satisfies Trustee’s payment obligation under the Loan Agreement). The Assignment of Rentals Agreement states that “… all Assigned Rent payable by Lessee to Assignor [Trust] under the [Equipment] lease…shall be paid directly to Assignee [Lender] in immediately available funds consisting of lawful currency of [Currency B].” Also, in the Trust Agreement, section 4.01 states “So long as the Lien of any Loan Agreement … shall be in effect, all Rent … shall be payable directly to the Lender.”

Purchase Option Price, Owner Participant receives back these two "loan" payments on Date 17. If Lessee elects the Replacement Lessee Option instead, the first lease payment on the second Lease rental stream is made by Successor Lessee to the Trustee for Final Loan Payment Amount on Date 17, which is the same amount and thus will offset the Final Loan Payment Amount paid by Trustee to Lender on that date. Therefore, regardless of whether the Purchase Option or Replacement Lessee Option is chosen, Owner Participant is reimbursed for the full Final Loan Payment Amount to Lender on Date 17. Finally, in the unlikely event that the Walkaway Option is exercised by Lessee, Trustee would receive the Walkaway Payment Amount and, after repaying the Date 17 Loan Balance, "nets" Taxpayer's Walkaway Option Net Amount. This amount is sufficient to cover the Trustee's payment of the Interim Loan Payment and the Final Loan Payment as well as more than half the Taxpayer's Contribution (in constant dollars). Trustee would then have the Equipment to sell and thus increase the amount of return on the Taxpayer's Contribution.

Additional information and analysis supplied by Field

The annual amounts paid out by Lessee to Lender are denominated in Currency B for both the "recurring" and "final" payments (Schedule 2 to Swap Agreement). In analyzing the annual swap payments, the Currency A Amount for each payment equates to the interest amount on the principal of Currency A Loan Balance with an interest rate of 8.575% (which is the interest rate of the "Currency B" swap payments). The "final" payment, on Date 17, is the sum of the Currency A Loan Balance (closely approximating the Loan Amount, as expressed in Currency B) plus the Final Currency A Interest Amount.

Lessee's request for equity investors contained the caution that equity investors should only assume one base lease term including the Interim Lease Term. Taxpayer's transaction-related memorandum dated Date 3B (relating to the bid for the equity portion of the Lease) states that the term of the Lease should be viewed as lasting until Date 29 with an "Early Buyout Option" ("EBO") expected to be exercised after the Basic Lease Term.

Taxpayer's "Annual Credit Review", dated Date 5, provides that all Equipment leases contain three options at the base lease termination date and that it is expected that the Lessee will buy the Equipment on Date 17. A second "Annual Credit Review", dated Date 6, also indicates that the Lessee is expected to exercise the Purchase Option. Both "Annual Credit Reviews" also show that Owner Participant is only at risk for their Taxpayer's Contribution portion and is not at risk for the remaining portion, the Loan Amount.

An analysis was submitted to show how the Lessee would be affected by each of the three options at the end of Lease. If Lessee exercises the Purchase Option, it must pay the Purchase Option Price on Date 17. As noted above, Trustee pays Lender the Final Loan Payment Amount and Lender pays Lessee the same amount under the Swap Agreement. As there is no rent payment required on this date from Lessee to Owner Participant, the Purchase Option Price actually includes the Final Loan Payment Amount, which effectively reduces the net amount paid by the Lessee to Purchase Option Net Price. A memorandum of Date 3F, which accompanied the Appraisal report, states that the Estimated Equipment Value on Date 17, will be 95.5% of the Sale Price. It also states that "Based on the [Purchase Option Price] and the expected fair market value of the [Equipment], from an economic standpoint, it is reasonable to conclude that the Lessee is more likely to provide a Replacement Lessee than it is to exercise the [Purchase Option] at the expiration of the Lease Term." When the swap payment of Final Loan Payment Amount is netted against the Purchase Option Price, Lessee pays Purchase Option Net Price, which is slightly less than the Estimated Equipment Value on Date 17.

In response to a "Treaty Partner" request, a memorandum of Date 11A was received providing information that was requested. Page 2 states that Lessee, "…can choose to pay a sum set in the leasing agreement to the investor in order to reacquire ownership of the equipment. In order to meet part of these undertakings to investors, Lessee has invested in zero coupon bonds. The investments in zero coupon bonds are reported as an asset … ." Further information has been requested.

A cash flow analysis submitted shows that with respect to the Trustee's purchase of the Equipment, the Lessee received the Taxpayer's Contribution from Owner Participant as well as the net loan proceeds from Lender (the Currency B Loan Amount). If the Lessee were to invest the funds into zero coupon bonds, it would be able to obtain an amount sufficient to cover the "periodic" payments of rentals as well as the "Purchase Option Price." Thus, Lessee does not have to make an outlay of other funds for the full term of the Lease. In fact, an analysis submitted regarding the Net Present Value (NPV) of the future "swap" payments and the Purchase Option Price amount at the end of the Basic Lease Term shows that the Lessee would need to invest Lessee's Hypothetical Initial Investment in present value dollars on the day before the Sale Date, which is less than the Initial Cash and Swap Payments, in order to cover the future "swap" and purchase option price payments. Since Lessee initially received an amount in excess of the amount it needed to invest, it would be able to invest the amount required and still enjoy a benefit of Lessee's Hypothetical Net Benefit.

An analysis was also submitted determining the "Internal Rate of Return (IRR)" on the cash flow both before and after the tax benefits. The IRR shows the interest rate required in order to "break even" for the amount(s) invested based on the "Net Present Value". When the IRR is less than the "Contract Interest Rate" the Owner Participant will not receive future cash flows (in net present value amounts) that exceed its investment. If the Lessee exercises the Purchase Option, which results in one stream of lease rental payments, the IRR on the "pre-tax" cash flow is 4.3279%, and thus the Owner Participant would incur a loss equal to Taxpayer's Purchase Option Pre-tax Loss in present value dollars on its initial investment. If the tax benefits are included with the cash flow, the Owner Participant would still have a loss of Taxpayer's Purchase Option IRR Loss in present value dollars with an IRR of 8.1625%.

If the Lessee were to exercise the Replacement Lessee Option and the Lease continued through the Replacement Lease term, the Owner Participant would incur a "pre-tax" loss on its initial investment of Taxpayer's Replacement Option Pre-tax Loss in present value dollars with an IRR of 5.4049%. The "after tax" cash flow would show a gain of Taxpayer's Replacement Option After Tax Gain in present value dollars with an IRR of 8.9812%.

If the Lessee were to exercise the Walk Away Option, the Owner Participant would also incur a "pre-tax" loss of Taxpayer's Walk Away Option Pre-tax Loss in present value dollars and an "after tax" cash flow loss of Taxpayer's Walk Away Option After Tax Loss in present value dollars. The IRR would be 4.3279% and 8.1625%, respectively, for the "pre-tax" and "after tax" cash flows.

As stated above, the IRR is the "break even" point for the amount of Investment using the Net Present Value of the future cash flows. In other words, the "contract interest rate" would have to be the same as the IRR rate in order for the Owner Participant to neither gain nor lose on its investment. If the "Contract Interest Rate" were less than the IRR, then the Owner Participant would enjoy a benefit based on the amount invested. If the "Contract Interest Rate" exceeds the IRR, the Owner Participant would incur a loss on its investment in present value terms.

Accordingly, regardless of which option is chosen by Lessee, under the analysis submitted, in all three cases, the Owner Participant would incur a "pre-tax" cash flow loss on a present value basis. On an "after tax" basis, the Owner Participant would incur a small loss on the Purchase Option and Walk Away Option, and a small gain on the Replacement Lessee Option.

Concerning the intent of the parties, Taxpayer prepared a memorandum dated Date 4A in response to questions about the "Credit Approval Report" for Lessee pertaining to the purchase from the manufacturer of part of the Equipment, which became the subject of the transaction. This memorandum makes certain general statements about "leveraged lease transactions" and their impact for federal income tax purposes. One paragraph states: "It is a critical element of tax-based leasing transactions that the purchase price of the asset being leased be an amount no greater that the asset's fair market value. Apart from pure collateral coverage concerns, this fair market value purchase price concept is an essential factor in the Lessor receiving true lease treatment of the transaction for U.S. federal income tax purposes." Also, it was stated that: "Consistent with the methodology employed in all leveraged lease transactions; [Lessee] has been granted the right to purchase the equipment at the end of the base lease term … for a fixed amount at least equal to the amount needed to retire the outstanding debt and provide Owner Participant with a full recovery of its investment and its return on that investment to the date purchased … . For tax reasons, we also grant [Lessee] the option to return all of the Equipment and pay an amount equal to Termination Value less 20%, …"

The Owner Participant reported the transaction involving the Equipment as a true lease for federal income tax purposes. The lease payments received by Trustee are reported as "Rental Income" by Owner Participant since Trustee is the trustee of a grantor trust for Owner Participant. Owner Participant offsets this rental income by claiming a depreciation expense for the Equipment over 125% of the sum of the Interim Lease Term and the Basic Lease Term, as well as certain amortization expenses related to this transaction. Since Owner Participant considers itself as making loan payments to Lender, it also deducts interest expense related to the Loan payments. An analysis submitted of the first lease rental stream shows that the Owner Participant would experience negative taxable income resulting in tax savings. For the second lease rental stream, the Owner Participant would begin to experience taxable income resulting in a positive income tax. However, this result would not materialize if Lessee exercises its Purchase Option at the end of the Basic Lease Term.

LAW AND ANALYSIS

You have asked whether these transactions should be respected for federal income tax purposes. In the analysis set forth below, we have attempted to determine whether the transaction has any substance beyond the attempt to acquire tax benefits and, to the extent there may be some substance independent of tax considerations, what the proper tax character of the transaction is.

1. Economic Substance

In order to be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, supra.

In determining if a transaction has economic substance, both the objective economic substance of the transaction and the subjective business motivation of the taxpayer must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363. Consequently, in considering whether a sale-leaseback case has economic substance, the Tax Court in Levy v. Commissioner, 91 T.C. 838, 856 (1988), found the following factors to be "particularly significant":

> The presence or absence of arm's-length price negotiations, Helba v. Commissioner, 87 T.C. 983, 1005-1007 (1986), affd. 860 F.2d 1075 (3d Cir. 1988); see also Karme v. Commissioner, 73 T.C. 1163, 1186 (1980), affd. 673 F.2d 1062 (9th Cir. 1982); the relationship between the sales price and fair market value, Zirker v. Commissioner, 87 T.C. 970, 976 (1986); Helba v. Commissioner, supra at 1005-1007, 1009-1011; the structure of the financing, Helba v. Commissioner, supra at 1007-1011; the degree of adherence to contractual terms, Helba v. Commissioner, supra at 1011; and the reasonableness of the income

and residual value projections, Rice’s Toyota World, Inc. v. Commissioner, 81 T.C. 184, 204-207.

Accordingly, an equipment sale-leaseback will be considered a sham if it (1) was not motivated by any economic purpose outside of tax considerations, and (2) was without any real potential for profit. See Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985).

One feature of a transaction that courts recognize may effectively eliminate any real economic significance of the transaction is offsetting legal obligations, or circular cash flows. For instance, in Knetsch v. United States, 364 U.S. 361 (1960), the taxpayer repeatedly borrowed against increases in the cash value of a bond. Since the bond and the taxpayer’s borrowings constituted offsetting obligations, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham because it would produce no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

Subsequently, the Court of Appeals for the Second Circuit applied an economic substance analysis in Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), affg. 44 T.C. 284 (1965). In that case, the taxpayer won the Irish Sweepstakes. In an attempt to shelter her winnings from tax, she borrowed from two banks and invested the loan proceeds in Treasury notes. The loans required her to pay interest at 4 percent, while some Treasury notes yielded one-half percent and others yielded 1-1/2 percent. Her financial advisers estimated that these transactions would produce a pretax loss of $18,500 but a substantial after-tax gain. The court disallowed the interest deductions because it found that the taxpayer’s purpose in entering into the loan transactions “’was not to derive economic gain or to improve here [sic] beneficial interest; but was solely an attempt to obtain an interest deduction as an offset to her sweepstakes winnings.” Id. at 738. The court stated further that the loan arrangements did not “have purpose, substance, or utility apart from their anticipated tax consequences”, and that the transactions had no “realistic expectation of economic profit”. Id. at 740.

Goldstein is significant because unlike many purported tax shelters, the tax-motivated transactions in that case were not fictitious. Goldstein v. Commissioner, supra at 737-738. They were real and conducted at arm’s length. The taxpayer’s indebtedness was enforceable with full recourse and her investments were exposed to market risk. Yet, the strategy was not consistent with rational economic behavior in the absence of the expected tax benefits.

Other courts have applied the teaching of Goldstein in varied settings. For example, in Sheldon v. Commissioner , 94 T.C. 738 (1990), the Tax Court denied the taxpayer the 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 consequence of holding the Treasury bills was 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 T.C. at 769.

Even in cases in which a circular flow of funds was not the predominant feature, courts have indicated that 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). Conversely, a minimal profit should be less acceptable when a ceiling on profits from a transaction is all but certain. Thus, if tax considerations predominate, the courts will find that an equipment leasing transaction is a sham even if it holds out the promise of minimal profit. See Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990); Prager v. Commissioner, T.C. Memo. 1993-452. The fact that the taxpayer is willing to accept minimal returns in a transaction with little additional profit potential is evidence that the transaction was tax motivated.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), 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 economic substance. The Third Circuit Court of Appeals 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. In addition, the court specifically affirmed the Tax Court's adjustment of future income to net present value to determine the profit potential of a transaction under the judicially created economic substance doctrine. The court rejected arguments that there is no statutory basis for using present values, and cited several cases sustaining the use of present value computations to determine the true profit potential of a transaction.

In this case, at the time the initial cash flow took place, the form of the transaction was that the Owner Participant, essentially through the Trustee, "borrowed" funds from a foreign Lender and, together with its own funds, invested an amount with the Trustee in order to purchase the Equipment. The funds then flowed from the Trustee to the Seller (which is related to the Lessee) of the Equipment in exchange for the right, title and interest in the Equipment. Physical possession of the Equipment was never taken by the Trustee but instead remained with the Lessee. Concerning that initial cash flow, the portion of the funds received by the Trust from the Lender (i.e., the Loan Amount) actually was transferred back to the Lender from the Lessee on the same business day in connection with the Swap Agreement entered into between the Lender and Lessee.

These steps in the transaction give the appearance that the Owner Participant borrowed the money from the foreign Lender and is responsible for the outstanding loan. However, the Owner Participant has no risk on any of the Loan Amount because it will not be personally liable to the Lender for any amounts payable under the Loan Certificates, or for any other amounts payable or any liability under the Loan and Security Agreement. This is because the Lender agreed that it will look solely to the "Loan Estate" for all payments of principal, premium (if any) and interest on the Loan. Therefore, the Loan was nonrecourse to the Owner Participant. Accordingly, the only amounts that could be considered "at risk" in this case to the Owner Participant is its Taxpayer's Contribution to the Trust of B% of the cost of the Equipment; the fees paid by the Owner Participant; and the Interim Loan Payment, which will not be offset by any Lease payment from the Lessee until the end of the Basic Lease Term. In substance, therefore, the burden of repaying Lender to remove Lender's security interest in the Equipment falls on the Lessee, not on the Trustee or the Owner Participant, the "owner" according to the form of the transaction.

In our view, the fact that the relationship between the Trust, the Lender and the Lessee resulted in a Swap Agreement concerning the amount of the Loan is of lesser importance.[8] Instead, we think the primary inquiry in this case should concern whether the transaction has economic substance to the Owner Participant, as the party claiming the tax benefits of ownership in the Equipment.

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[8] We note that the same flow of funds might have occurred if this transaction replaced Lender's existing security agreement in the Equipment, although nothing in the facts indicates that the Seller's interest in the Equipment was subject to any pre-existing secured interest on the Sale Date.

Concerning the economic substance of the transaction to the Owner Participant, we think it significant that during the Basic Lease Term, the Lease rental payments flowing from the Lessee to the Trust, the Loan payments flowing from the Trust to the Lender, and the swap payments flowing from the Lender to the Lessee not only represent a “circular” flow of funds during the Basic Lease Term (with the exception of the first and last loan payments) but result in a “net” transfer of zero funds between them. In other words, since cash flow essentially equals debt service, the Owner Participant has been claiming tax benefits during this period without having a commensurate “profit” or positive cash flow from the Lease.

Moreover, although the Owner Participant would enjoy a profit in “constant” dollars based on the amounts it would receive at the back-end of the Basic Lease Term regardless of which of the three options the Lessee exercises at that time, ACM Partnership and the cases cited therein do provide support for adjusting such future income to net present value. This adjustment has been recognized in order to compute the profit potential of a transaction for purposes of determining whether the transaction has economic substance apart from tax benefits. Accordingly, upon using certain present value computations to determine the true profit potential to the Owner Participant of its investment, the analysis provided showed that the Taxpayer would actually incur the Taxpayer’s Purchase Option Pre-tax Loss on exercise of the Purchase Option; the Taxpayer’s Replacement Option Pre-tax Loss on exercise of the Replacement Lease Option; and Taxpayer’s Walk Away Option Pre-tax Loss on exercise of the Walk Away Option respectively.

These losses, however, are minimized when factoring in the “tax benefits” of the transaction to the Owner Participant. When considering tax benefits, the Owner Participant would have a gain in present value terms only if the Replacement Lease Option is exercised. This suggests that it does not seem likely that the Owner Participant would enter into this transaction without taking the time value of money into account. It also suggests that the agreements and documents were structured to give the appearance, in form, that this transaction was a sale-leaseback in order to allow the Owner Participant to claim ownership of the Equipment and thereby utilize tax benefits associated with it. Therefore, when taking the time value of money into account, the Owner Participant does not appear to have an expectation of profit independent of tax benefits. This analysis supports finding that the transaction lacks economic substance.[9]

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[9] Because the Owner Participant’s “profit” from rentals and the residuals increases during the replacement lease term, a realistic possibility exists that a court could view this transaction as, in substance, a valid E-year lease with a “buy-out” purchase option in year D. Here, a court could find that the Owner Participant actually does have the real risk and reward of an owner since, at the end of the replacement

The Field also argues that the only motivation for this transaction is the desire of the Owner Participant to "purchase" tax benefits from a foreign, and thus, tax-exempt entity. At the time this transaction was initiated, a party related to the Lessee already owned the Equipment, which was being used by the Lessee. Since both are tax-exempt entities backed by the Government of C, a sale-leaseback transaction was unnecessary unless the tax benefits associated with ownership of the Equipment could be monetized through such a transaction with a taxable entity. Consequently, this transaction could reasonably be viewed as a "sale" of tax benefits by an entity, which cannot use them (but, nevertheless, retains use of the Equipment) to a taxable entity which can. By entering into this transaction, the Lessee receives a "Net Present Value" benefit equal to the difference between the amount it receives during the initial cash flow and the amount it must repay in "rental" during the life of the Lease. The net amount is the Lessee's Hypothetical Net Benefit and represents the Lessee's profit. In exchange for its investment in the amount of the Taxpayer's Contribution, the Owner Participant receives a substantially greater amount of tax benefits by claiming depreciation and amortization each year over the life of the transaction. Accordingly, there is support for arguing that tax motivation predominates the intent of the Owner Participant for entering into this transaction. It could thus be reasonably characterized as a mere sale of tax benefits.

Support also exists for the assertion that the transaction has no economic substance with respect to the Owner Participant because it has little opportunity to realize, on a net present value basis, any genuine profit on its investment independent of tax benefits. In addition, the facts and circumstances of the transaction indicate a reasonable possibility that it was motivated primarily by tax considerations.

On the other hand, to the extent the transaction is determined to have economic substance, we believe the Owner Participant does not have the benefits and burdens of ownership to the Equipment. Accordingly, under the terms and conditions of the documents, and in view of the "collar" on risk and return to the Owner Participant, as discussed more fully below, we agree with the alternative position that the transaction is a financing arrangement.

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lease, it may hold Equipment with a substantial residual value and useful life remaining. Instead of concluding that the transaction lacks economic substance, a court could conclude that this has the substance of a true long-term lease with back-ended rental payments. After that conclusion, it would become necessary to determine the "term" of the lease for purposes of determining the proper recovery period for depreciating the Equipment. See § 168(g)(3), (i)(3). That issue is beyond the scope of the current inquiry.

2. Sale-leaseback versus Financing Arrangement

Whether a sale-leaseback is respected for federal income tax purposes is not determined by the labels of the parties.[10] In Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939), the Supreme Court stated that, "taxation... [is] concerned with substance and realities, and formal written documents are not rigidly binding." 308 U.S. at 255. In Lazarus, the taxpayer conveyed property to a bank as trustee and then leased the property back for a term of ninety-nine years. The Court concluded that the transaction, though structured in the form of a sale-leaseback, was in substance a loan secured by the property. It held that the taxpayer was the party who bears the burden of exhaustion of capital investment in the property and thus, is entitled to deduct depreciation regardless of the fact that the taxpayer had by agreement designated another party as the legal owner. Lazarus stands for the proposition that, in the sale-leaseback area, the substance of the transaction rather than its form is controlling for federal tax purposes.

In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court set forth standards for determining when a sale-leaseback may not 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." Id. at 584. In Frank Lyon, the Frank Lyon Company's (Company) majority shareholder and board chairman also served on the board of Worthen Bank (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 full 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

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[10] The incoming memorandum from the Field asserts that the transaction should not be respected as a true lease because it does not meet the requirements of Rev. Proc. 75-21, 1975-1 C.B. 715, since modified and superseded by Rev. Proc. 2001-28, 19 I.R.B. 1156 (May 7, 2001). Both revenue procedures set forth the guidelines that the Service will use for advance ruling purposes in determining whether certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes. However, by its terms, these guidelines do not define, as a matter of law, whether a transaction is, or is not, a lease for Federal income tax purposes and are not intended to be used for audit purposes. Accordingly, although the guidelines are illustrative of principles used to determine if a transaction is true lease, this memorandum will instead focus on case law, and Service position as set forth in revenue rulings, for its analysis.

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 11 years and at other points in the lease for the Company's investment with compound interest at 6 percent plus repayment of the loan balance. The Bank also had the option to purchase the building at fair market value 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 that magnitude for its own use. However, the state and federal regulators approved the sale and leaseback so long as the Bank had an option to purchase the property after 15 years at a fixed price where another party owned the building.

The Government argued that the sale leaseback should be disregarded as a sham, because the Company was only acting as a conduit to forward rent payments to pay the mortgage and was doing so for a guaranteed return. In rejecting the sham argument, the Court distinguished Lazarus because it involved two rather than three parties. The third party (the lender) was necessary to the transaction in Frank Lyon because of the restrictions on borrowing imposed on the Bank. The Court found it significant that the Bank could not legally own and finance its own building. The Court emphasized that the Company had assumed recourse liability in the debt, and thus it had exposure to real and substantial risk. Moreover, the Court rejected the contention that the purchase options allowed the Bank to accumulate equity in the property over time because the Bank was free to walk away without further obligation without exercising any lease extension and, alternatively, 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 chose if the lease were not extended, but would remain liable for the ground rent. The Court concluded, at 583-84, that:

> Where...there is a genuine multi-party transaction with 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, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, 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. What those attributes are in any particular case will necessarily depend upon its facts.

Accordingly, the decision in Frank Lyon rested strongly upon the risks incurred by the Company, including the recourse debt, the ground rent, and the possibility the lease would not be extended (significantly, without any compensation to the Company), and the rewards of the use of the property if the Bank did not extend the lease. Such risks gave the Company the significant attributes of a lessor. No similar risks were incurred in the present case. Here, the loans are nonrecourse to the Trustee/Owner Participant. While it is true that Frank Lyon suggests rental payments in a lease may match up to the amount of principal and interest necessary to amortize a loan, that case involved the construction of a building that, implicitly at least, could be used by any lessee. That the payments match up, therefore, is not significant unless it reinforces the view that the lessor's risks and rewards indicate the lessor is not the owner of the property. Significantly, therefore, the below analysis will show that the risks and the potential gains from the transaction to the Owner Participant have been carefully collared to limit both potential loss and profit to the Owner Participant. For example, unlike the taxpayer in Frank Lyon, the Taxpayer here is indirectly compensated by the Lessee if the Lease is extended through the Replacement Lease Option.

Moreover, in Frank Lyon the Bank was precluded by federal and state regulations from financing and constructing the building itself. No such restrictions are present in this case since a party related to Lessee actually did purchase and possess the Equipment prior to the effective date of the transaction here.[11] Accordingly, although the legal principles of Frank Lyon (that is, focusing on the substance of the transaction) are appropriate to an analysis of this transaction, that case is factually distinguishable from the present case.

Despite the government's inability to demonstrate, on the facts in Frank Lyon, that the Company was simply financing the Bank's building purchase, many courts have addressed whether a sale-leaseback was, in substance, a financing, that is, whether the purported owner/lessor simply loaned money to the purported seller/lessee. A particularly instructive example is Pacific Gamble Robinson and Affiliated Companies v. Commissioner, 54 TCM 915 (1987). There, petitioner (PGR) sold its Yakima Apple Facility to Third Birkenhead Properties Inc. for $500,000; $490,000 of which was financed with a nonrecourse note payable to Minnesota Mutual Life Insurance Company. At the same time, the facility was leased back to PGR for a 25-year primary term and six 5-year renewal terms. During the primary lease term, the rental payments equaled the payments due from

[11] In response to a "Treaty Partner" request, the Lessor's financial statements are quoted as indicating that its "investments have mainly been financed through so-called cross-border leasing." The quoted material continues by noting that the Lessor can choose to reacquire the property at sums set forth in the leases. We also infer that it is probable that Lessor could have arranged financing for its Equipment, without the involvement of the Owner-Participant (and the cross-border lease) through Lender.

Third Birkenhead to Minnesota Mutual on the note. Third Birkenhead had the right to require PGR to buy the facility at the end of the basic lease term under a pre-determined price schedule for a stated purchase price nearly equal to the then outstanding balance owed on the note. This lease provision was amended to require PGR to offer to buy the facility at the end of the primary term for the greater of its then fair market value or the outstanding balance owed on the note. It was unlikely that the fair market value of the facility would exceed the outstanding balance on the note. New notes were later issued that provided that the lenders would look solely to the facility and to the sums due from PGR under the lease for repayment on the notes. Under the new notes, PGR agreed to pay the installments as and when they became due.

The Tax Court disregarded the form of the transaction as a sale-leaseback as inconsistent with its economic substance. It held that PGR was in substance the “owner” of the facility for federal tax purposes. The court cited several factors to support its holding: (1) As a matter of economic reality, PGR (the “lessee”), not the lessor, was principally liable on the debt; (2) PGR, not the lessor, retained the primary benefits and burdens of ownership associated with the facility; and (3) the lessor had no reasonable opportunity for economic profit from the transaction absent tax benefits.

Similarly, in situations involving the characterization of sale-leaseback transactions, the Service consistently has held that the substance of a transaction is controlling for federal tax purposes. For instance, Rev. Rul. 72-543, 1972-2 C.B. 87, concluded that a transaction in the form of a "sale-leaseback" is in fact a financing where under the terms of the leaseback, the taxpayer-lessee never actually parted with the benefits and burdens of ownership to the property for federal income tax purposes. In that ruling, the taxpayer, a shipping company financed reconstruction of a vessel by "selling" title to the vessel to the subsidiary of a bank for the vessel's then fair market value. The subsidiary borrowed the cost of the acquisition and reconstruction from a group of lenders under a "charterparty," an agreement whereby the subsidiary leases the vessel to the taxpayer for use in its transportation business. At the same time, the subsidiary assigned all of its rights, title and interest to the monies due under the charterparty to the lenders. Under the agreement, the subsidiary chartered the vessel to the taxpayer for a 21-year term at a rental rate sufficient to pay the total costs of acquiring and reconstructing the vessel plus interest over the 21-year period. The 21-year term exceeded the vessel's useful life. The taxpayer was at risk for the vessel at all times during this term and had to maintain insurance. The charter gave the taxpayer the right to buy the vessel on the 9th anniversary of delivery for a predetermined price equal to the unamortized principal amount of the loan on that date.

Rev. Rul. 72-543 concluded that the taxpayer held the benefits and burdens of ownership to the vessel since (i) it was obliged to repay the costs of acquisition and reconstruction plus interest in the form of rentals; (ii) it had to pay the vessel's operating and insurance costs; (iii) it had an option to purchase the vessel for the unamortized principal amount of the loan at a specific anniversary date; and (iv) the parties intended for legal title to pass to taxpayer. Although cast in the form of a sale-leaseback, the ruling held that the transaction, when viewed in its entirety, was a financing arrangement with ownership of the vessel in the taxpayer.

Thus, whether a transaction is a sale, a lease, or a financing arrangement is a question of fact, which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). The judicial test for determining if a transaction is a sale, as opposed to a lease or a financing arrangement, is whether the benefits and burdens of ownership have passed to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229 (1987). For this purpose, the "refinements of title" are not dispositive. Corliss v. Bowers, 281 U.S. 376, 378 (1930). In fact, even if the vesting of title in someone other than taxpayer created a prima facie case that the taxpayer was not the owner of certain equipment for depreciation purposes, the Tax Court, in Coleman v. Commissioner, 87 T.C. 178, 202 n. 18 (1986), aff'd, 833 F.2d 303 (3d Cir. 1987), acknowledged that the location of title did not mean that it was holding that taxpayer was not the owner. Instead, the location of title meant only that the taxpayer had the burden of producing "strong proof" that the other benefits and burdens of ownership were held by the taxpayer. 87 T.C. at 203-04. The court's opinion in Coleman analyzed the benefits and burdens of ownership of the equipment and concluded that the taxpayers failed to demonstrate that it held the incidents of ownership to the equipment.

The Tax Court analyzes the following factors to determine if the benefits and burdens of ownership pass in a transaction: (1) whether legal title passed; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the sale contract obligated the seller to execute and deliver a deed and obligated the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the property's operation, retention and sale. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981). Although the potential for gain and amount of risk have been deemed the pivotal factors, the overall concentration should lie on the economic substance of the transaction. Mapco, Inc. v. United States, 556 F.2d 1107, 1111 (Ct. Cl. 1977).

The Tax Court has also considered the following factors as being relevant to determining whether a sale has occurred (that is, whether to respect a sale-leaseback): (1) the existence of a useful life of the property in excess of the leaseback term; (2) the existence of a purchase option at fair market value; (3) renewal rental at the end of the leaseback term set at fair market rent; and (4) the reasonable possibility that the purported owner of the property can recoup his investment in the property from the income producing potential and residual value of the property. Torres v. Commissioner, 88 T.C. 702, 721 (1987) citing Estate of Thomas v. Commissioner, 84 T.C. 412, 436 (1985); Mukerji v. Commissioner, 87 T.C. 926 (1986). The Tax Court in Torres has found the taxpayer's equity interest as a percent of the purchase price to be significant, and it further noted that a sale-leaseback involving a net lease has certain specific characteristics, 88 T.C. at 721:

> [B]ecause net leases are common in commercial settings, it is less relevant that petitioner was not responsible for the payment of property taxes or that petitioner bears less of a risk of loss or damage to the property because the lessee is required to maintain insurance on the property. Similarly, a lessor is normally not vested with the right to possession during the term of the lease and, therefore, the relevant consideration in this regard is whether the useful life of the property extends beyond the term of the lease so as to give the purchaser a meaningful possessory right to the property. Also, in a leaseback transaction it is normal for the lessee to receive profits from the operation of the property while the lessor's receipt of payments is less dependent upon the operation of the property.

Since no one factor is dispositive of the issue of whether a sale has occurred, the facts and circumstances determine the importance of each factor. For example, whether the buyer has acquired an equity interest in the property may be considered substantive evidence of a sale. See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976). However, a taxpayer who acquires no equity interest in the property has no depreciable interest in the property, but instead will be viewed as having attempted to acquire mere tax benefits. Houchins v. Commissioner, 79 T.C. 570, 602 (1982). In this context, equity consists of a positive differential between the fair market value of the property and the balance of any loans owed on the property. Equity may also be viewed as the amount of the purchaser's funds at risk in the property. Thus, a true owner has potential for gain or loss from increase or decrease in the market value of the property. In contrast, a mortgagee's economic return, consisting of interest payments and return of principal, is generally fixed at the time of the initial transaction, irrespective of fluctuations in market value of the property.

Given these overlapping lists of factors, we proceed first to examine the factors set out in Grodt & McKay that the Tax Court analyzes to determine if the benefits and burdens of ownership pass in a transaction. We then analyze the factors set out in Torres that the Tax Court analyzes to determine whether a sale has occurred.

A. Benefits and Burdens of Ownership (Grodt & McKay)

1. Whether legal title passed. The Purchase Agreement provides that Seller sells, assign, transfers and sets over to the Trustee all of Seller's right, title, and interest in the Equipment. Under the Lease, if the Lessee elects to exercise the Purchase Price Option, all of the Trustee's, as Lessor, right, title, and interest in the Equipment shall be transferred to the Lessee and the Lessee shall prepare, and the Lessor execute, a bill of sale evidencing such transfer. Even though title did pass from Seller to Trustee, the facts also suggest the likelihood that the Lessee will exercise this option to regain all right, title and interest to the Equipment at the end of the Basic Lease Term. If Lessee does so, this feature indicates that title is only held temporarily by the Trustee as security, which makes the transaction look more like a secured financing than a sale-leaseback. See Rev. Rul. 72-543, above.

2. Whether the parties treated the transaction as a sale of Equipment. We note that the documents and agreements were prepared in the form of a sale. Moreover, as the only United States taxpayer, Owner Participant reported this transaction for federal income tax purposes as a sale, and claimed United States tax ownership of the asset(s). It deducted depreciation over 125% of the sum of the Interim Lease Term and the Basic Lease Term[12] and amortization expenses on its federal income tax return. (However, the Owner Participant did treat the transaction on its books as a financing.) The other parties to the transaction agreed not to claim ownership for United States tax purposes, which would be inconsistent with treating the transaction as a sale. This factor appears to favor sale-leaseback treatment.

3. Whether the Owner Participant acquired an equity interest in the Equipment. The documents are drafted to indicate that it made a B percent equity contribution to the purchase of the Equipment. If "equity" is defined as the difference between the Equipment's fair market value and the amount of the Loan, and assuming Sale Price represents fair market value, arguably the Owner Participant has an equity interest equal to B percent of the Equipment. Equity, however, also is the amount of the taxpayer's investment or funds at risk in the property, as opposed to the financier's risk that funds loaned (with a security interest in the property) will not be repaid. Therefore, an owner's equity interest in property is distinguished from a

[12] Cf. Sections 168(g)(3); 168(i)(3).

mortgagee's security interest in property by the potential for appreciation or depreciation in the value of the property, the potential to profit from use of the property at the expiration of the lease term, and the nature of its risk of loss. Thus, whether that B percent represents "true" equity or the interest of a secured lender is the primary inquiry in this case.

Here, the funds that the Owner Participant has at risk are more in the nature of principal on a secured financing than an equity interest in the Equipment since, as a result of the nature of the three options held by the Lessee at the end of the Basic Lease Term, it appears that the Owner Participant has capped its right to potential appreciation in the Equipment at the difference between the Purchase Option Price and the amount necessary to repay the Lender. If the value of the Equipment at the end of the Basic Lease Term exceeds this differential, Lessee, acting rationally in its economic interest, will exercise this option and re-acquire title to the Equipment.

4. Whether the sale contract obligated the seller to execute and deliver a deed and obligated the purchaser to make payments. Here, the Seller did transfer to Trustee all of the Seller's right, title and interest in the Equipment. Also, according to the documents, the Owner Participant must make semi-annual payments to the Lender. However, since the Field's analysis shows that the most economically realistic option for the Lessee to exercise at the end of the Basic Lease Term is the Purchase Option, which will return title to the Equipment to the Lessee, it appears that the documents created a circular delivery of the deed. That is, it appears that Owner Participant only has a "loan" of the deed or bill of sale during the Basic Lease Term, after which the title to the Equipment returns to Lessee. Such circular delivery, or "loan," of the deed is more consistent with treating the Owner-Participant as holding a security interest in Equipment.

This view is supported by the flow of funds concerning the Owner Participant, which is (with the exception of the initial, first and last payments) able to offset the remaining Loan payments with rental income it receives from the Lessee. In each instance, the amount of the rental income equals the amount of the Loan payment. For both the first and last Loan payments required to be made by the Owner Participant, it will receive such amounts back at the end of the Basic Lease Term. The last payment to be made by the Owner Participant is returned to it on the very day paid, either in the form of the Purchase Option Price, as the most likely option to be exercised, or the initial lease payment under the Successor Lessee option. If Lessee exercises the Purchase Option, the Lessee is essentially "loaning" title of the Equipment to the Trustee for the Owner Participant for the Basic Lease Term, and the Owner Participant is, in substance, only making one Loan payment (the initial payment) which it will receive back at the end of the Basic Lease term. In substance the deed transfer may only be temporary since it is more than reasonable to contemplate the return of the Equipment to the Lessee.

5. Whether the purchaser is vested with the right of possession. The right of possession factor favors a financing since there is no indication that the parties ever manifested an intent for the Trust or the Owner Participant to actually "possess" the Equipment. Generally a sale-leaseback contemplates that the buyer-lessor wants possession of the property at the end of the lease term. In a financing, however, the mortgagee typically does not want use or possession of the property. Here, at the time it acquired "possession" through the execution of the "sale" documents, the Owner Participant through the Trustee had no right to sell the Equipment to anyone other than the Lessee or even hold it out for lease to the highest bidder prior to its leaseback to the Lessee. In fact, Lessee already had possession of the Equipment at the time the transaction was entered into. All of Trustee's activities thus were circumscribed so as to keep the Equipment under the possession and control of the Lessee at all times. The Lessee also controls whether the Trustee/Owner Participant will possess the Equipment at the end of the Basic Lease Term by unilaterally determining which option it will exercise. Arguably, such limitations on possession are inconsistent with the benefits and burdens of ownership. It is not within Owner Participant's control to determine if it will ever obtain possession of the Equipment.

In addition, the Lease prevents the Trustee, acting for the Owner Participant, from taking possession of the Equipment unless necessary to protect its rights, as in the event of default. These conditions are essentially the same as the conditions in which a secured creditor would take possession of the secured property. However, while the documents appear to make possession by the taxpayer a possibility, this possibility is unlikely since the Lessee has the backing of the Government of C, which makes default very unlikely. Consequently, when this transaction is taken as a whole, Owner Participant has not shown any intent to possess the Equipment.

6. Whether the purchaser pays property taxes after the transaction. We believe that this factor is insignificant in this case because the terms of the Lease indicates that it is a net lease under which the Lessee is responsible for all the administrative and operating costs associated with the asset. The Lessee is responsible for all property taxes wherever they may be. Under the Participation Agreement, the Lessee is responsible for all applicable customs duties and stamp taxes and all other taxes in respect of the Equipment. However, this factor is neutral since this is common to net leases. See Torres, supra, at 721.

7. Whether the purchaser bears the risk economic loss or physical damage
First, we note that the documents include Stipulated Loss Values and Early Termination Payments that must be paid if the Lessee exercises its option to end

the Basic Lease Term at any particular point in time. These values are computed to include the amount necessary to repay the Lender; provide a guaranteed return to the Owner Participant of its initial investment, fees, and initial loan payment; and provide an agreed upon profit to be realized by the Owner Participant. Even if the Lessee exercises its Walk Away Option, the Owner Participant will receive back the Equipment and enough funds from the Lessee (that is, the Termination Value less 20% of the Equipment's cost) to cover the Loan repayment to the Lender. In such circumstance, a "floor" is effectively imposed on the amount of risk to the Owner Participant. For instance, the fair market value of the Equipment would have to decline to less than 20 percent of its original cost (that is, the difference in amount between the Purchase Option Price amount and the Walk Away Option amount) before it would be economically rational for the Lessee to exercise the Walk Away Option and end its participation in the transaction. If the Equipment were to decline less than this amount, it would make more economic sense for the Lessee to purchase the Equipment than to forego ownership of the Equipment and make the Termination payment. Since the Lessee is required to maintain the Equipment to the highest possible standard, and since the Equipment will still be relatively young in its useful life at the end of the Basic Lease Term, a decline in its fair market value of this magnitude is remote.[13] Accordingly, the ceiling on the Owner Participant's opportunity for appreciation and the floor on its risk of loss indicate that the interest of the Owner Participant is that of a mortgagee, or secured lender, not that of an equity owner.

Concerning which party has the risk of physical loss on the Equipment, the Lease requires Lessee to maintain insurance on the Equipment and to replace or repair

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[13] Similarly, since the Lessee must reimburse or compensate any Successor Lessee for the difference between the rentals required under the schedules provided in the Participation Agreement and Lease and the actual rentals such Successor Lessee is willing to pay, the economic rationale to the Lessee for exercising the Replacement Lease Option is similarly limited. That is, to the extent the amount of rent a lessor is able to command for leasing property is directly related to the fair market value of that property, a precipitous decline in value should lead to a corresponding decline in rent. Consequently, if the Equipment declines in value to the point referred to in the text, the Lessee might have to make a significant payment to induce a Successor Lessee into the transaction. The decline in value of the Equipment, however, would have little effect on the Owner Participant. Under the Successor Lease, the Owner Participant would receive a stream of rental payments unaffected by the decline in value of the property. Further, as none of the Owner Participant's funds originally advanced and still outstanding will be returned when the Successor Lease begins, the pre-established stream of lease payments bears more resemblance to the repayment obligation due a secured lender than the rent obligation due a lessor of devalued property.

the asset in the event of damage or destruction. These undertakings insulate the Lessor from an obligation that might be implied, in the event of physical loss of the property, to lease Lessee replacement property. As noted above regarding the risk of loss of value of the Equipment, it appears the back-end Purchase Option Price amount, the Termination Payment amount and the rental stream for any Replacement Lease apparently were determined by reference to the amount necessary to repay the Loan and guarantee that the Owner Participant would receive a certain rate of return on the transaction. Furthermore, during the Basic Lease Term, the possible lease termination payments were computed by taking the outstanding loan balance at each particular date and adding to it the amount of required return on the Owner Participant's equity investment, fee and loan payment(s). These provisions essentially insulate the Owner Participant from any risk of physical loss of the property. Further, these conditions essentially shift the risks to the Lessee. The Lessee's risks of loss are those of an owner/mortgagor, while the Owner Participant's fixed return and entitlement to payment without regard to damage to the collateral are consistent with the risks of a mortgagee.

8. Whether the purchaser receives the profit from the property's operation. Courts have consistently found that the potential for profit or loss on the sale or re-lease of the property is a crucial benefit or burden of owning property. Gefen v. Commissioner, 87 T.C. 1471, 1492 (1986). At all times after the transaction is initiated, the Lessee operates the Equipment and receives the profit, if any, therefrom. This is consistent with a lessee's right to operate property under a valid lease. In this case, however, as previously discussed, the amount the Lessee must pay under the Purchase Option, the Walk Away Option, or the Replacement Lease Option, when compared to increased or decreased values of Equipment, results in either a ceiling on the Owner Participant's potential for profit or a floor under its potential for loss. This factor indicates that the transaction has the character of a financial arrangement.

B. Whether a Sale has Occurred (4 Torres' Factors)

A sale-leaseback will be respected if it meets the four factors set forth above from Torres v. Commissioner, 88 T.C. 702, 721 (1987) citing Estate of Thomas v. Commissioner, 84 T.C. 412, 436 (1985); and Mukerji v. Commissioner, 87 T.C. 926 (1986).

1. The existence fo a useful life of property in excess of the leaseback term. According to the Appraisal, the Equipment has a useful life of approximately T years, which exceeds the aggregate of the Basic Lease Term and Interim Lease Term of D years. Even if the term of any Replacement Lease is aggregated with the Lease to Lessee, the combined lease term is E years, which is substantially less than the Equipment's useful life. In accordance with the Lease, the Lessee will

cause each item of Equipment to be serviced, repaired, maintained, overhauled and tested during the term of the Lease, which should allow the Equipment to reach or exceed the estimated useful life. However, since the Lessee is expected to exercise the Purchase Option at the end of the Basic Lease Term, the additional useful life may not benefit the Owner Participant. Because control of whether to exercise this option rests with Lessee, and because this option is the most likely to be exercised by Lessee, we are less inclined to find this factor supports treatment as sale-leaseback.

2. <u>The existence of a purchase option at fair market value</u>. Here, the Appraisal provides that the fair market value at the end of the Basic Lease Term is estimated to be 95.5% of the cost of the Equipment. Under the Lease, the Purchase Option Price is set at 107.28131% of the cost of the Equipment. This would seem to indicate that the Purchase Option Price exceeds fair market value. However, when analyzing the Lessee's options at the conclusion of the Basic Lease Term and the Lease, Loan and Swap Agreements, the Trustee, acting for the Owner Participant, is required to pay Lender the Final Loan Payment Amount, which Lender swaps to Lessee. This amount reverts back to the Owner Participant from the Lessee as part of the total Purchase Option Price (or first lease payment under the Successor Lease Option) and thus reduces the "net" amount of the Purchase Option Price to the Purchase Option Net Price. As noted, the Purchase Option Net Price is slightly less than the Estimated Equipment Value on Date 17, resulting in a (slightly) "discounted" purchase.[14] However, this amount also may have been computed with regard to repaying the outstanding amount of the Loan, which would call into question the methodology used in the Appraisal. Nevertheless, because the appreciation potential of the Equipment is capped by this amount, this factor arguably favors treatment as a financing arrangement.

3. <u>Renewal rental at the end of the leaseback term set at fair market rent</u>. In this case, the requirement that the Lessee make an "inducement" payment to any Successor Lessee should that party hesitate to enter into the Replacement Lease indicates that the rental rates for a Replacement Lease were not set at the then fair market value. Generally, a true fair market value rental renewal rate for property would reflect negotiations between the Lessor and any subsequent lessee so that if rental rates drop, the lessee would receive the advantage of a lower rate. The lessor would have the attendant risk of a decline in such rates. Here, however, the Lessee's obligation to compensate the Successor Lessee for the differential between the rate the Successor Lessee may want to pay and the required rental rates set forth in the attachments to the Participation Agreement and Lease

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[14] The Lessee's Purchase Option Net Price would be somewhat lower if further adjusted for Interim Loan Payment to Lender, swapped to Lessee.

indicates that such negotiations between Trustee and prospective successor lessees are unnecessary. Instead, the rental schedules in the documents appear to have been determined more by reference to the need to repay the amount loaned by Lender, Taxpayer's Contribution and Interim Loan Payment, and to guarantee the Taxpayer's return on investment.

Moreover, assuming rental rates increase, under the documents, the Trustee has the right to reject the Successor Lessee chosen by Lessee and recover the Equipment. This feature would seem to indicate that the Trustee has some appreciation potential in that it can find its own lessee to rent the Equipment at a higher rental rate. In our view, however, this feature is illusory. For instance, if Equipment appreciates in value, the Lessee could simply exercise the Purchase Option, recover title to the Equipment, and either use it, or re-lease it at the higher rental rate reflected by the Equipment's then fair market value. This factor actually indicates that the risks of a decline, or the rewards of an increase, in the then fair market rental value of the Equipment have shifted to the Lessee. This shift is inconsistent with the risks and rewards to a lessor associated with the requirement that any renewal or re-lease of property be set at fair market value. Therefore, this factor supports treatment of the transaction as a financing arrangement.

4. <u>The reasonable possibility that the purported owner of the property can recoup its investment in the property based on the income-generating potential and residual value of the property</u>. Under the structure of the transaction, the Owner Participant actually receives no net income stream during the Basic Lease term (with the exception of a final payment made pursuant to exercise of the Purchase Option) since all rental payments made by the Lessee equal all payments made by the Trust for principal and interest (with the exception of the first and last loan payments for which there is no offsetting rental payments made by the Lessee). Consequently, since the rental stream essentially equals the debt service, there is no income-generating potential to the Owner Participant during the Basic Lease term. Accordingly, the Owner Participant can only look to either the lump sum payment received upon exercise of the Purchase Option or the Walk Away Option, or to payments under an extension of the Lease under the Replacement Lease Option, for the recoupment of, and a return on, its investment.

In the event the Purchase Option is exercised, the Owner Participant would only recover its investment out of the amount of Purchase Option Price payment. Using "Constant" dollars the Owner Participant would recoup its investment plus an economic profit of Taxpayer's Purchase Option Profit. In the event the Replacement Lease Option is exercised, it is only during the term of the Replacement Lease that the Owner Participant would see a positive cash flow with the majority of the cash flow coming after the principal and interest payments are completed at the end of the first two years of that lease. This positive cash flow, which the Field places at Replacement Lease Cash Flow plus Replacement Lease Equipment Residual (the anticipated residual value of in the Equipment at the end of the Replacement Lease term) would constitute Owner Participant's Replacement Lease Total Return on Taxpayer's Contribution. Superficially, this factor favors the treatment of the transaction as a sale-leaseback since it is clear that the Owner Participant will receive (in constant dollars) either double Taxpayer's Contribution at the end of D years, or better than triple Taxpayer's Contribution at the end of E years. However, as the above analysis indicates, the terms of the transaction have shifted the risks and rewards of ownership essentially to the Lessee from the Trustee and Owner Participant. Only if the transaction continues through the end of the Replacement Lease term and the Equipment then returns to the Trust, will the Owner Participant have an uncollared risk of loss and opportunity for appreciation. This may never occur because of the provisions permitting the Lessee to unilaterally determine the ownership and use of the Equipment based on economic and other considerations at the end of the Basic Lease Term. Therefore, although the Owner Participant will recoup its investment, the specified rate of return and collared risk and reward indicate that it is in the position of a mortgagee, not a bona fide owner.

Based on the overall evaluation of the factors discussed above, it appears that many benefits and burdens of ownership have not been transferred to the Owner Participant. In addition, the Owner Participant does not become the owner of the Equipment for United States tax purposes just because the Lessee agrees that it will not claim such ownership. We therefore believe it is reasonable to conclude that the substance of the transaction was that the Lender loaned A% of the cost of the Equipment to Lessee and the Owner Participant "loaned" the remaining B% of the cost of the asset (Sale Price). In addition, the Taxpayer paid fees totaling Owner-Participant's Fees (approximately 1.5% of the cost of the asset) and an initial loan payment (Interim Loan Payment) which will not be offset by any lease payment from the Lessee until the end of the Basic Lease Term. Consequently, the transaction involved Lender and Taxpayer each making secured loans to Lessee and, therefore, the Owner Participant should not be entitled to depreciation deductions for the Equipment and other tax benefits commensurate with property ownership. To properly reflect Taxpayer's income, the rental income received from the Lessee should be eliminated from Taxpayer's income, and the interest expense deduction for Loan payments to the foreign Lender should be denied. The amortization fees originally claimed by the Owner Participant should be allowed because they are similar to loan fees being amortized over the life of the loan.

2. Case Development, Hazards and Other Considerations

In our view, there are several aspects of this case which must be further developed.

[redacted] Although it is possible to hypothesize that the Lessee purchased stripped bonds in order to meet any of the three options provided for at the end of the Lease, the term, “defeasance” is used as if it were a fact. In a true defeasance situation the lessee is either required by the documents (or informal agreement by the parties) to deposit into an escrow account an amount (in absolute terms or net present value terms) (economic defeasance), or it gives legal notice at the initiation of the lease (or shortly thereafter) of its intent to exercise its purchase option at the end of the lease term and re-acquire the property (legal defeasance). We did not find either in the facts provided. [redacted]

Moreover, in our view, the Field risks a significant litigation hazard unless it can demonstrate that the Replacement Lease Option is purely illusory. For instance, if the Replacement Lease Option was inserted into the agreement as a result of negotiations between the parties and was intended to protect both parties, it will lend substance to the transaction. For the Owner Trustee and Owner Participant, the Replacement Lease Option offers the protection a long term, fixed rate of return based on a lease term of E years for the Equipment in the event the Lessee does not exercise its Purchase Option. For the Lessee, the Replacement Lease Option offers protection against being forced to either buy the Equipment or walk away with a large expenditure and no Equipment. Neither of these protections would be necessary if the parties intended to structure the transaction as a mere sale of tax benefits. The existence of a Replacement Lease Option thus undercuts the argument that the transaction lacks economic substance.

[redacted]

[redacted]

[redacted]

[redacted]

We note that the bidding instructions specify that the bids should be based on one lease term. [redacted]

Moreover, we note that this transaction is dissimilar to the lease-in, lease-out transaction described in Rev. Rul. 99-14, 1999-1 C.B. 835. In that revenue ruling, the taxpayer retained the power to require the lessee to continue with the lease of the property for an additional period of time by virtue of a put renewal option in the agreements. In this case, however, the facts as presently developed indicate that the Lessee, not the Owner Participant, has the sole power to determine which option will be exercised at the end of the Basic Lease Term. Thus, this feature of the transaction makes it important to develop facts which will demonstrate that the Replacement Lease is not a viable option for the Lessee and, therefore, the transaction has little probability of continuing beyond the Basic Lease Term. Consequently, such facts will indicate if the return of the Equipment to the Lessee at that time is a foregone conclusion.

Lastly, we recommend that you carefully scrutinize the pre-tax return and determine if it is insubstantial when compared to the post-tax returns. This analysis should be made using both constant dollars and relevant present value assumptions. We note that the Field's analysis shows that in constant dollars, the Owner Participant will have doubled its money at the end of the Basic Lease Term, and made triple the Taxpayer's Contribution if the Replacement Lease Option is exercised. [redacted]

If, upon further development, the facts do not indicate that the transactions lack economic substance or constitutes a financing arrangement, we recommend you contact CC:ITA to develop whether Taxpayer's depreciation deductions are based on a lease term that includes the period of the replacement lease. In that case, the tax-exempt use property rules could apply to limit the availability of the deductions. I.R.C. Section 168(g)(3)(A) and Treas. Reg. Section 1.168(i) -2.

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Please call if you have any further questions.

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