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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR LEWIS R. MANDEL
Special Trial Attorney, CC:LM:F:SLLI

FROM: Paul F. Kugler
Associate Chief Counsel, CC:PSI

SUBJECT: Aggregation for of LILO investments for purposes of §6111(c)(4)

This Chief Counsel Advice responds to your memorandum dated November 13, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Promoter =

Date 1 =

Date 2 =

Type 1 =

Type 2 =

Type 3 =

Type 4 =

Type 5 =

Type 6 =

Type 7 =

Type 8 =

ISSUE

Whether Promoter's lease-in/lease-out (LILO) transactions may be aggregated for purposes of § 6111(c)(4).

CONCLUSION

Promoter's LILO transactions may be aggregated for purposes of § 6111(c)(4) because the transactions involved investments that are considered similar within the meaning of § 301.6111-1T, A-22.

FACTS

The present case involves the promotion of LILO deals generally consistent with the structure described in Rev. Rul. 99-14, 1999-1 C.B. 835. Promoter has described the structure as follows.

A LILO is a structure for a coordinated transaction consisting of at least two leases, a "head lease" and a "sublease." The lessor under the head lease is typically a municipality. The nominal lessee on the head lease, and the nominal lessor on the sublease, is typically a passthrough entity (grantor trust or partnership) maintained by a fiduciary institution for one or more U.S. investors. The municipality that is the head lessor is ordinarily the sublessee on the sublease transaction.

The sublease term is typically 80 percent of the head lease term. The head lease payment conditions ordinarily require an initial prepayment of rents for a term equal to the base term of the sublease with a subsequent payment when the head lease term expires. At the end of the sublease, the head lessor has an option to "buyout" the remaining term of the head lease by paying the investor/head lessee a fixed amount. Exercise of the fixed amount "buyout" will terminate the head lessee's obligation to make the subsequent head lease payment.

The investor (the head lessee/sublessor) participates through an equity investment and financing obtained through commercial lenders. The timing and amount of the sublessee's rent obligations under the sublease are generally designed to match the sublessor's repayment obligations to the lenders. The sublessee will also generally deposit an amount with an affiliate of the lending institution that generates interest income sufficient to satisfy the sublessee's rental obligations. The series of pledges and cross-pledges will generally result in a defeasance of all payment obligations. The sublessee will also invest in highly rated debt securities which (upon maturation) will be sufficient to fund the buyout.

On Date 1, Promoter provided the Service with written information regarding 24 specific transactions within the generic LILO parameters in which Promoter had been involved.

Promoter also has provided the Service a preliminary disclosure regarding the subject matter of the offsetting leases in these 24 transactions. Based on information included in that disclosure, fourteen of the transactions involved Type 1 assets, two involved Type 2 assets, two involved Type 3 assets, two involved Type 4 assets, one involved a Type 5 asset, one involved a Type 6 asset, one involved a Type 7 asset, and one involved a Type 8 asset.

Promoter argues that the subject matter of the offsetting leases in these transactions are the "business assets" of the LILO investment, and that the separate LILO investments may not be aggregated unless the business assets are similar.

LAW

Section 6111(a)(1) provides that a tax shelter organizer shall register the tax shelter with the Secretary (in such form and in such manner as the Secretary may prescribe) not later than the day on which the first offering for sale of interests in such tax shelter occurs.

Section 6111(c)(1) provides that the term tax shelter means any investment with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and which is (i) required to be registered under a Federal or State law regulating securities; (ii) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities; or (iii) a substantial investment.

Section 6111(c)(4) provides that an investment is a substantial investment if the aggregate amount which may be offered for sale exceeds $250,000, and there are expected to be 5 or more investors.

Section 6111(f)(1) provides that the Secretary may prescribe regulations which provide rules for the aggregation of similar investments offered by the same person or persons for purposes of applying § 6111(c)(4).

Section 301.6111-1T, A-22, of the Procedure and Administration Regulations provides that:

> For purposes of determining whether investments are parts of a substantial investment, similar investments offered by the same

> person or related persons (as defined in section 168(e)(4)) are aggregated together. Investments are considered similar if they involve similar principal business assets and similar plans or arrangements. Investments that include no business assets will be considered similar if they involve similar plans or arrangements.

Congress addressed the issue of aggregation in the legislative history, and stated, "For purposes of this definition [of substantial investments], similar investments organized by the same person are aggregated." House Report No. 98-861 at 979, reprinted at 1984-3 C.B. Vol. 2 233. Congress recognized the possibility that a promoter might be able to characterize the promotion of shelters as separate transactions, none of which could be characterized as a substantial investment.

ANALYSIS

A. The LILO transactions may be considered similar investments for purposes of § 301.6111-1T, A-22, because they involve similar plans or arrangements but do not include business assets.

Under § 6111 and § 301.6111-1T, A-22, similar investments offered by the same promoter will be aggregated together for purposes of determining whether investments are part of a substantial investment. The focus of these provisions, particularly § 6111(c), is on the investments as offered. More specifically, the focus is on the offering materials and the reasonable conclusions that the investors would draw from the materials regarding the actual interest offered to the investors.

The Committee Reports to the 1984 Act contain the following passage.

> A tax shelter is defined as any investment (including service contracts and leasing contracts) with respect to which a person could reasonably infer from the representations made or to be made in connection with any offer for sale of any interest that, as of the close of any of the first 5 years, the ratio with respect to any investor of (A) the aggregate of deductions and 200 percent of the credits potentially allowable to (B) the aggregate of the cash invested and the adjusted basis of other property contributed by the investor (reduced by any liability to which that property is subject) is greater than 2 to 1. House Report No. 98-861 at 979-80, reprinted at 1984-3 C.B. Vol 2 233-34.

Congress did not limit the tax shelter analysis to investments in a particular type of business asset. Congress contemplated that some investments not involving business assets would be subject to the registration requirements of § 6111(c). Thus, an issue exists as to whether investors would believe themselves to be obtaining an interest in business assets (that is, assets held primarily for the production of income or profit) as opposed to obtaining an interest in tax deductions and credits.

The analysis relating to the focus of the investment in a LILO transaction is relatively straightforward. In these cases, the generic LILO transaction calls for an investor to lease property from a municipality, and then sublease the property back to the municipality. While the lease and the sublease are not structured to offset exactly, they are designed to remove the risks and benefits typically associated with an investment in property. See generally, Rev. Rul. 99-14. The representations made to an investor in a generic promotion on these LILO transactions would not lead investors to conclude that the investment would result in the possibility of a profit from the underlying asset. Rather, the representations made to an investor in these generic LILO transactions would lead the investor to believe the investments were made in leases primarily to obtain tax benefits. Thus, we do not believe that the LILO transactions were investments involving business assets for purposes of § 301.6111-1T, A-22. Because Promoter's LILO transactions did not involve business assets, but involved a similar plan or arrangement, they may be aggregated under § 301.6111-1T, A-22.

B. If the LILO transactions involve business assets, the investments are considered similar for purposes of § 301.6111-1T, A-22, because the investments involve similar principal business assets and similar plans or arrangements.

Section 301.6111-1T, A-22, provides that investments are considered similar if they involve similar principal business assets and similar plans or arrangements. In these LILO transactions we believe that transactions involve similar plans or arrangements and if the underlying property is considered a business asset, the LILO transactions also involve similar principal business assets. Thus, the transactions would be aggregated for purposes of § 301.6111-1T, A-22.

1. For purposes of § 301.6111-1T, A-22, business assets are considered similar based on the nature of the benefits and burdens potential investors expect.

Promoter has argued that the various properties cannot be considered similar because they have inherently different physical characteristics. We do not believe that the phrase "similar business assets" necessarily requires an analysis of the underlying physical characteristics of the assets. Rather, we believe that the similar requirement refers to the nature of the benefits and burdens potential investors expected regarding the investment. That is, if the substitution of assets would not change the nature of the benefits and burdens a potential investor expected from the investment, the assets are similar for purposes of § 301.6111-1T, A-22.

In support of this view is the following example from the Committee Reports to the 1984 Act.

> For purposes of this definition, similar investments organized by the same person are aggregated. For example, assume a sponsor of tax shelters develops generally similar investment plans or arrangements involving 8 different partnerships, each investing in a different item (such as a separate master recording or film), each with a different general partner, and each with 3 limited partners. If each partner invests $1,000 cash and $10,000 in nonrecourse obligations, there will be 32 investors (1 general partner plus 3 limited partners times 8 partnerships) and an aggregate investment of $352,000 (32 partners times $11,000). Thus, each partnership will constitute part of a substantial investment. If, in this example, representations are made that $1,000 in tax credits and $3,000 in deductions are available to each limited partner in the first year, the sponsor will be required to register all of the partnerships. House Report No. 98-861 at 979-80, reprinted at 1984-3 C.B. Vol 2 233-34.

The example contemplates that the 8 different partnerships would be aggregated, even if some partnerships invest in a master recording and some partnerships invest in a film. From the standpoint of physical characteristics, master recordings and films are two different types of property. Thus, Congress did not intend to establish a "like-kind" standard for purposes of aggregating similar investments. While master recordings and films are physically different, investments in these two types of property frequently present a close correlation of the potential investors' expectations from the investment. Compare Anderson v. Commissioner, T.C. Memo. 1992-102 (master recording) and West v. Commissioner, 88 T.C. 152 (1987) (film). As these cases suggest, an investor's expectations are determined based on the benefits and burdens of the investment, not on whether the plan involves a master recording or a film. Thus, in the context of § 6111(c), master recordings and films would be considered similar principal business assets.

We believe § 301.6111-1T, A-22, should be interpreted consistently with the expression of legislative intent in the Committee Reports to the 1984 Act. However, Promoter argues that the regulation establishes a new and inconsistent rule for aggregation. Specifically, Promoter points to the example from the regulation that reads, in part, as follows.

> Assume, for example, that a person develops similar arrangements involving 8 different partnerships, each investing in a separate but similar asset (such as a separate master recording or separate piece of similar real estate), each with a different general partner and each with 3 different limited partners. Assume further that the arrangements of all of the partnerships are similar. These partnerships involving

> similar arrangements and similar assets would be aggregated together.
> . . .

Promoter argues that the parenthetical language in the example indicates that investments involving different types of assets may not be aggregated under the regulation. However, the language in the example assumes that master recordings and real estate may not be similar, and that all real estate may not be similar. We believe the assumptions in the example are consistent with the view that "similar" refers to the investor's expectations regarding the benefits and burdens of the investment. For instance, an investor that hopes to make an economic profit through eventual retail sales, but currently expects an investment tax credit and depreciation deductions, could satisfy those expectations by investing in any master recording.[1] Conversely, an investor that hopes to make an economic profit through rental income and eventual resale, but currently expects a § 42 credit and depreciation deductions, would not be able to satisfy those expectations through an investment in any parcel of real estate (even though the parcels might be physically similar). Thus, the regulation, like the legislative history, implicitly focuses on the expectation of the investor, rather than the differences between master recordings and real estate.

While we are not aware of any authority addressing the interpretation of "similar" in the context of § 301.6111-1T, A-22, we note that the interpretation of "similar" through reference to the investor's expectations is not a novel standard in the context of § 1033. Under § 1033 a taxpayer may qualify for nonrecognition on the involuntary conversion of property if the taxpayer obtains similar replacement property. Attention will be directed primarily to the similarity in the relationship of the services or uses that the original and replacement properties have to the taxpayer-owner. In applying this test to an owner-lessor, a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what the properties demand of the taxpayer in the way of management, services, and relations to its tenants. See Rev Rul. 64-237, 1964-2 C.B. 319; Rev. Rul. 76-391, 1976-2 C.B. 243; See also, Liant Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962). For instance, where the expectations of the taxpayer-owner are the same, a gas station can be similar to a warehouse. See Rev. Rul. 71-41, 1971-1 C.B. 223.

If the subject matter of the LILO transactions are considered business assets, the distinctions among the various types of property (Types 1 through 8) will not be significant if those distinctions would not affect the expectations of the investors. Accordingly, we conclude that the focus should be on factors such as whether the different types of property: 1) present different business risks; 2) make different demands in the way of management, services, and relations to the sub-

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[1] Or, as the legislative history suggests, any film would also satisfy the investor's expectations.

lessee; and 3) generate different tax benefits. Given the fundamental nature of these LILO transactions, we conclude that the property involved would be treated as similar (assuming it was appropriate to treat the property as business assets within the meaning of § 301.6111-1T, A-22).

2. Even if the phrase "similar principle business assets" referred to an aggregation by physical characteristics, Promoter's LILO transactions could be aggregated into substantial investments under § 301.6111-1T, A-22.

Although we recognize that the argument could be made that "similar" should be interpreted as referring solely to physical characteristics, we disagree with this argument because the argument is inconsistent with the intent of Congress for aggregation and the application of § 6111(c). However, we believe that in this case the business assets could be aggregated according to physical characteristics.

We note that while Promoter claims significant differences among the various underlying properties, the physical characteristics of those underlying properties fall into three similar groups (transportation, real estate, and utilities) each of which involve at least five transactions. We believe that under Promoter's argument, and based on the information Promoter provided regarding completed transactions, the 14 transactions involving Type 1 assets may be aggregated, the five transactions involving Types 2, 4, and 5 assets may be aggregated, and the five transactions involving Types 3, 6, 7, and 8 assets may be aggregated. Thus, using Promoter's analysis regarding aggregation, there would be three separate § 6111(c) tax shelters.

We also want to emphasize that the substantial investment requirement is based on investments that were offered for sale, rather than the investments that were actually sold. Because Promoter may have offered additional investments for sale without completing the sale, additional types of assets may be aggregated. Accordingly, examination of all investments offered for sale may result in additional aggregated transactions that satisfy the requirements of § 6111(c)(4).

<u>CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS</u>

[redacted]

[redacted]

Please call if you have any further questions.

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