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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB
CC:LM:MCT:WAS

FROM: William A. Jackson
Branch Chief CC:ITA:B05

SUBJECT: Sale-Leaseback Transaction

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

LEGEND

Parent Corporation =

Subsidiary Corporation =
Partnership or Lessee =

Investments or Lessor =

Fund =

Group =

Date A =

Date B =

Year A	=	
Equipment	=	
Purchase Agreement I	=	
Assignment Agreement I	=	
Purchase Agreement II	=	
Assignment Agreement II	=	
Leaseback	=	
x%	=	
y%	=	
z%	=	

ISSUE

Is the transaction at issue a true sale-leaseback or, alternatively, a financing arrangement for federal income tax purposes?

CONCLUSION

Based on the documents submitted and the facts as currently developed, we think the transaction should be characterized as a financing arrangement for tax purposes. Nevertheless, we think that further factual development is necessary in order for our office to provide a definitive answer concerning which party to the transaction owns the equipment which is the subject of the transaction.[1]

FACTS

On Date A, Partnership and Investments entered into a multi-step transaction structured as a sale-leaseback for Equipment. Investments is a corporation set up to acquire leases on behalf of certain investment funds. Once Investments acquires a lease, it purports to assign the title to the equipment subject to the lease and the “risks and rewards” of each lease to a fund. The fund involved in this case is Fund. According to Investments’ Directors Report and Audited Financial Statements for each year at issue, the income and expenses of Investments were both zero, and Investments’ lease holdings were not included in its balance sheet.

In Year A, Parent Corporation acquired the shares of Group. During the years at issue, Parent Corporation also was the owner of Subsidiary Corporation, a U.S. corporation. Subsidiary Corporation owned 99 percent of Partnership and Group owned the remaining one percent of Partnership, which was established in Year A upon Parent Corporation’s acquisition of Group.

The following description sets forth the various steps of the transaction. First, Group acquired Equipment, which it then leased out to various end users, who are United States corporations (“end-user leases”). Next, pursuant to Purchase Agreement I and an Assignment Agreement 1, both dated Date A, Group conveyed the following assets to Partnership: (a) all of Group's title to, interest in and rights to Equipment described in each "Schedule of Assets” attached to the agreements, and (b) all of Group's title to, interest in and rights under the Equipments' leases described in the Schedule of Assets (the "Lease"). At each closing, Partnership paid Group a purchase price for Equipment and lease interests equal to the sum of: (a) the price paid by Group for Equipment reduced by any rent that Group had received from the time it bought the Equipment and lease interests to the time it sold them (generally equal to one or two months' rent); (b) the costs accrued in maintaining Equipment; and (c) certain expenses of Group. At each

[1] We understand that additional sale-leaseback transactions virtually identical to the transaction in the main text have been the subject of examination. Because the legal issues are the same, your FSA request generally sets forth details concerning only the sale-leaseback transaction referenced in the text. Although there may be other sale-leaseback transactions with terms substantially similar to those here, our conclusions reflect only the specific transaction discussed in the text and should be limited to that one transaction.

closing, Group delivered to Partnership, inter alia, a Bill of Sale and an Assignment of Lease Agreement. Pursuant to the Assignment Agreement I attached as an exhibit to Purchase Agreement I, Group assigned to Partnership all of its right, title and interest in the end-user leases.

Under the third step of the transaction, Partnership and Investments entered into Purchase Agreement II and Assignment Agreement II on Date A pursuant to which Partnership sold to Investments: (a) all of Partnership's title to, interest in and rights in Equipment; (b) all of Partnership's title to, interest in and rights (but not obligations) under Lease; and (c) in the case of the first closing, all of Partnership's rights (but not obligations) under Management Agreement, dated Date A and entered into between Partnership and Group.[2]

The purchase price equaled y% of the amount Partnership paid for Equipment and the lease interests plus the costs accrued in maintaining such assets and certain other expenses of Partnership. Partnership gave Investments a Bill of Sale and a certain Assignment of Lease Agreement at each closing. Under the Assignment Agreement II, Partnership assigned to Investment all of its right, title and interest in Lease, Management Agreement and Purchase Agreement.

Upon acquiring Equipment and the end user leases, Investments conveyed Equipment, and assigned the rents payable to Investments for such Equipment and a security interest in the end-user leases, to Fund.[3] This conveyance was made subject to the Leaseback described below. Group, as Manager of Equipment and end-user leases, and Fund negotiated the rate of return that Fund would receive within the terms of the end-user leases.

As required by Management Agreement (as described in footnote 2), during the years at issue, the end users made rent payments to the Lockbox Account controlled by Group, as Manager. Manager took its x% management fee from these rent payments and forwarded the remaining amounts to Fund. The taxpayers have characterized the payments to Fund as principal and interest.

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[2]Pursuant to Management Agreement, also dated Date A, Group agreed to manage the assets and end-user leases that Partnership “leased back” from Investments. The Management Agreement requires Group, as Manager, to maintain certain Lockbox Accounts in Investments’ name. As consideration for Group's services, Partnership is to pay Group a "Base Management Fee" equal to x% of the rental income received into the Lockbox Accounts from the end-users leases.

[3]The taxpayer has not furnished the Service with the operative document.

Under the fourth step of the transaction, on Date A, Investments “leased” Equipment back to Partnership pursuant to Leaseback entered into between them. Under section 1 of Leaseback, the parties agreed that Investments, as "Lessor," would lease to Partnership, as "Lessee," each item of Equipment and property described in each specific Individual Equipment Record ("IER"). Each IER is considered a separate lease incorporating all of the terms and provisions of Leaseback. In the event of a conflict between Leaseback and an IER, the terms of the IER would prevail. The individual IERs also govern the lease terms for each item of Equipment. Each lease is for a "Base Term" as set forth in the IER for the relevant item of Equipment. The "Term" of the lease is the Base Term plus any extensions of the Base Term pursuant to the terms of the IER. Most of the lease terms involved here are for three to five years, with several for seven years. The parties' commitments under Leaseback expire on Date B unless extended by their mutual agreement.

Section 3 of Leaseback sets forth the language governing Lessee's payment of rent to Lessor. Under this provision, Lessee is to pay Lessor "Base Rent" for an item of Equipment in the amounts and at the times set forth in the applicable IER. For each such item, Base Rent is to equal: (1) the rent that Lessee receives from any end-user lease thereof; plus (2) the rent or proceeds realized from any sale, re-leasing, or other disposition (including an "event of loss") of that item of Equipment upon the termination of the initial end-user lease. However, Group, as Manager, is required to remit to Lessor the amount equal to the Base Rent less its Base Management Fee and certain Lease Expenses (“Net Base Rent Proceeds"). The Base Management Fee and Lease Expenses are referred to collectively as "Base Rent Deductions." Significantly, Base Rent for an item of Equipment is computed under its IER as an amount which will provide a "predetermined yield" to Lessor over the lease term.

Section 3 essentially guarantees Lessor an amount equal to Base Rent. It provides that Lessor shall in all events be entitled to receive an amount equal to aggregate Base Rent (without regard to Base Rent Deductions); and in the event an Item of Equipment is not sold by Lessee to the end-user lessee or some other third party at the termination of the initial end-user lease, but is re-leased, the unpaid portion of the Base Rent at the termination of the initial end-user lease shall first be paid from the Net Base Rent Proceeds from the re-leasing or disposition of the Item of Equipment as if such transaction were incorporated in the original IER ("Extended IER"), and second to be paid from the Net Base Rent Proceeds of other Items of Equipment to the extent that such Net Base Rent Proceeds exceed the Base Rent to be received by the Lessor with respect to such other Items of Equipment. Notwithstanding termination or expiration of an IER, including an Extended IER, if Base Rent with respect to the Item of Equipment subject to such

IER has not been paid in full, the obligation of Lessee subject to such IER to pay Lessor such Base Rent shall survive such expiration or termination until such Item of Equipment has been sold.[4]

Leaseback affords Lessor some profit potential above the Base Rent amount. A Contingent Rent Reserve Account will be set up as a segregated account into which will be deposited the Net Base Rent Proceeds of each Item of Equipment in excess of the Base Rent with respect to such Item of Equipment, less amounts described above that are applied to satisfy the Base Rent obligation with respect to another Item of Equipment. Lessor shall be paid by Lessee an amount of additional rent ("Additional Rent") above Base Rent with respect to each item of Equipment. Additional Rent shall be payable to the Lessor as follows: At such time that the balance in the Contingent Rent Reserve Account exceeds what Investments, as Lessor, and Group, as Manager, agree is in excess of the required amounts ("Excess Reserves"), 70% of the Excess Reserves shall be paid to the Lessor as Additional Rent. On the date of termination of this Lease, any sums remaining in the Contingent Rent Reserve Account shall be paid as follows: 30% to Manager and 70% to Lessor. However, in no event shall the aggregate Base Rent and

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[4] The contractual terms in the text assume that Net Base Rent Proceeds can exceed Base Rent. Mathematically, this result is impossible, given that Base Rent equals rent from end-user leases plus rent from re-leasing or proceeds from sales of Equipment. However, Net Base Rent Proceeds equals Base Rent less the <u>x</u>% management fee and certain lease expenses. In short, Net Base Rent Proceeds cannot exceed Base Rent since the term "Net Base Rent Proceeds" is defined as Base Rent <u>minus</u> Base Management Fee and Lease Expenses. To date, the taxpayers have been unable to explain this discrepancy.

The only way for Net Base Rent Proceeds to exceed Base Rent is if the definition of Base Rent is ignored and instead Base Rent is simply computed as the "predetermined yield" under the IER. On interest and principal worksheets provided by the taxpayer, "rate" and "final payment" figures appear. The rate figure may correspond with the predetermined yield figure, and the "final payment" figure may represent a balloon-type payment at the end of the lease term. However, these figures appear questionable given that the taxpayers acknowledge simply plugging in numbers consistent with previously-negotiated rates of return. This would suggest that the parties first negotiate the rates of return that each fund, including Fund, will receive from their investments and then compute the principal and interest due each month followed by a "final payment." The final payment really represents the above "shortfall." To date, there has been no indication that these "final payments" have ever been made. In fact, the amount of such final payments would exceed the residual values of the items of Equipment, as estimated by taxpayers and a Service engineer.

Additional Rent paid to the Lessor with respect to an Item of Equipment exceed z% of the Base Rent (the "Cap"). Any amounts in excess of the Cap shall be retained by Partnership, as Lessee.

Consequently, Lessor's profit potential is limited by this z% Cap. Lessee, in contrast, is purportedly entitled to any profit above the Cap. However, according to the taxpayers, Partnership never established the Contingent Rent Reserve Accounts because there were never any excess rents. In short, the aggregate rents, though fully paid, were insufficient for purposes of setting up the contingent rent accounts. Thus, there was no "Additional Rent" in excess of the Base Rent.

Pursuant to the second recital of a Cross Collateral Agreement entered into on Date A, Investments agreed to enter into Leaseback with Partnership subject to (a) the amounts in the Contingent Rent Reserve Account being available to provide Investments with a "predetermined yield" on the leases entered into with respect to another similar specified leaseback; and (b) the amounts in the Contingent Rent Reserve Account established under that similar specified leaseback being available to provide Investment with a "predetermined yield" on the leases entered into with respect to Leaseback. Each party agreed to treat both Leaseback and another similar leaseback as a single master leaseback so that all payments to Investments from both Contingent Rent Reserve Accounts were to be treated as if made from a single account pursuant to a single master lease agreement.[5]

Under Leaseback, as superseded by an Indemnity Agreement entered into by Partnership, Investments, and Fund, Lessee agrees to indemnify Lessor against all "taxes, fees or other charges" imposed against Lessor, Lessee or Equipment by any foreign, federal, state, local government or taxing authority, except for (1) any taxes imposed by the United States federal government on Lessor's gross or net income,

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[5] These cross-collateralization provisions may be meaningless given that no contingent rent reserve accounts were ever set up because there were no excess funds. In addition, Partnership may never be able to pay Investments sufficient rent to reimburse Fund for the total cost of Equipment. After the end-user lessees make the rental payments to the lockbox account controlled by Group (as explained above), Group takes its x% management fee from these rental payments. The remaining rental payments, characterized as principal and interest, are then forwarded to Fund, leaving Partnership, as Lessee, with no remaining income from the end-user leases -- which may be Partnership's only source of income. Thus, according to the IERs, taxpayer's interest and principal worksheets, and end-user lease schedules, there will be a large shortfall in principal payments over the life of the end-user leases and the life of Equipment absent a large "final payment" shown on the worksheets. Therefore, may never be able to satisfy its lessee obligations.

and (2) any income or franchise taxes imposed by any taxing authority other than the United States federal government on the gross or net income of Lessor.

Under section 6 of Leaseback, Lessor retains title to Equipment during the term of each IER and until Lessee fully performs all of its obligations thereunder. However, the Lessor's retention of title constitutes a "lease intended as security" or a "security interest," as the case may be under the Uniform Commercial Code. To secure Lessee's obligations to Lessor, Lessee grants Lessor a first priority security interest in the relevant Equipment. Importantly, upon Lessee's full performance of all of its obligations, title to Equipment automatically reverts to Lessee. However, if Lessee reasonably believes that the sale of such Equipment is necessary to satisfy Lessee's Base Rent obligation and to maximize the Additional Rent to which Lessor is entitled at the termination of Leaseback, then Lessor must transfer title to Lessee to permit Lessee to effect such sale.

This section of Leaseback also provides that Lessor and Lessee agree that, for federal and state income tax purposes: (1) the Leaseback is to be treated as a financing lease, not a true lease; (2) Lessee is the owner of the equipment; (3) Lessee will not claim any rental deduction for amounts paid to Lessor; (4) Lessor will not claim any cost recovery or depreciation deductions for Equipment; (5) neither party will file any returns or other documents inconsistent with the foregoing; and (6) the parties will file such returns, take such actions, and execute such documents as necessary to implement this intent. The parties thus agreed to treat the transaction as a financing for federal income tax purposes.

Leaseback specifically requires Lessee to keep Equipment in good operating order, repair, condition and appearance or to take diligent action to enforce each end-user lessee’s obligation to do so. Lessee is required to pay, or to cause each end-user lessee to pay, all costs associated with the use and operation of Equipment including, but not limited to, repairs, maintenance, storage and servicing. Further, Lessor must approve, by prior written consent, any alterations, additions or improvements that the Lessee or end-user lessee wish to make to Equipment. In addition, Lessee is required to maintain, or to cause each end-user lessee to maintain: (1) all risk of physical loss insurance; and (2) public liability and property damage insurance on each item of equipment as set forth in the applicable IER or sublease.

Under Leaseback, upon an Event of Loss (e.g., where Equipment is lost, stolen, destroyed, damaged beyond repair, seized or condemned), Lessee must notify Lessor thereof and pay to Lessor (or cause to be paid), to the extent of Net Base Rent Proceeds: (1) the accrued Base Rentals on a daily basis, if any; (2) the "Stipulated Loss Value" for such Equipment as set forth in the applicable IER; and

(3) all other unpaid amounts due. Upon payment of these amounts, Lessor's right, title and interest, if any, to the particular Equipment transfers to Lessee. If Equipment is merely damaged, Lessee is required to make all payments of rent and other amounts due, as well as to repair Equipment (or cause an end-user lessee to so repair Equipment).

Finally, Lessee agrees to indemnify Lessor from and against all losses, claims, patent infringements, costs, expenses damages and liabilities, however caused, resulting from the ownership, purchase/lease, maintenance, possession, return, disposition, or operation of the Equipment to the extent that such damages, losses, expenses or liabilities arise out of the negligence or willful misconduct of Lessee, its agents or employees.

Subsequent to the foregoing transactions, Parent Corporation assumed the interest of Group as the manager under the Management Agreement.

LAW AND ANALYSIS

The general characterization of a transaction for federal income tax purposes is a question of law. Frank Lyon Co. v. United States, 435 U.S. 561, 581 n. 16 (1978). The economic substance of a transaction rather than its form controls for federal income tax purposes. See Gregory v. Helvering, 293 U.S. 465 (1935). The fact that the documents contain labels that the transaction is, or is not, a sale is not determinative of the actual character. The issue of ownership is governed by the substance of the agreement, not labels used in the agreement. See Tomerlin Trust v. Commissioner, 87 T.C. 876 (1986).

The term "sale" is given its ordinary meaning for federal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). The key to deciding whether a transaction is a sale is to determine whether the benefits and burdens of ownership have passed to the purported purchaser. This is a question of fact which must be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attendant facts and circumstances. Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987); Torres v. Commissioner, 88 T.C. 702, 720 (1987) (citing Grodt & McKay Realty Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); and Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9^{th} Cir. 1956)).

Closely associated with the benefits and burdens of ownership is a long line of precedent holding that an agreement for the transfer or use of property will be considered a sale regardless of its labels if the period of use or term of the agreement results in the return of the property to the "owner" with little or no residual value remaining. Therefore, the transfer of property for substantially all of its useful or economic life will be considered a sale of the property to the user, even if the user must return the property at the end of the agreement. See Rev. Rul. 55-541, 1955-2 C.B. 19; Sprint Corporation v. Commissioner, 108 T.C. 384 (1997). The fact that the transaction does or does not make provision for the transfer of title will not prevent the transaction from being considered a sale. See section 4.02 of Rev. Rul. 55-540, 1955-2 C.B. 39; Leahy v. Commissioner, 87 T.C. 56, 66 (1986) (transfer of the benefits and burdens of ownership govern for federal income tax purposes, not the technical requirements of the passage of title under state law). .

The Tax Court has enumerated the following factors for determining whether a sale has occurred: (1) whether legal title passed; (2) whether the parties treated the transaction as a sale; (3) whether the alleged purchaser acquired an equity interest in the property; (4) whether the contract of sale creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays property taxes following the transaction; (7) whether the purchaser bears the risk of loss or damage to the property; and (8) whether the purchaser receives the profits from the operation and sale of the property. See Grodt & McKay Realty, 77 T.C. at 1237-38.

In this case, the issue is whether the transaction described above is a valid sale-leaseback, as structured, or a financing arrangement. In order to characterize a transaction as a valid sale-leaseback, the Tax Court examines the above factors, but also will look to (1) the existence of useful life of the property in excess of the leaseback term; (2) the existence of a purchase option at less than fair market value; (3) renewal rental rates at the end of the leaseback term set at fair market value rent; and (4) the reasonable possibility that the purported owner of the property can recoup its investment in the property from the income producing potential and residual value of the property. See Torres, 88 T.C. at 721 (citing Estate of Thomas v. Commissioner, 84 T.C. 412, 436 and 438 (1985)). If these factors are met, the transaction will constitute a valid sale-leaseback; if not, it will be characterized as a financing arrangement.

The Tax Court has been careful to note that some of the factors enumerated in Grodt & McKay Realty above are less relevant where the lease of the property back to the seller is a net lease. For instance, because net leases are common in commercial settings, it is less relevant that the lessor was not responsible for the payment of property taxes or that the lessor bears less of a risk of loss or damage to the property since the lessee is required to maintain insurance. Similarly, a lessor typically is not vested with the right of possession during the lease term.

Therefore, the more relevant consideration is whether the useful life of the property extends beyond the lease term so that the purchaser has a meaningful possessory right in the property. Also, in a leaseback transaction the lessee normally receives profits from the operation of the property while the lessor's receipt of payments depends less upon the operation of the property. Torres, 88 T.C. at 721.

Application of the above factors to the facts of this case is required in order to determine if this transaction is a valid sale-leaseback between Investments and Partnership, or a financing arrangement. With respect to legal title, Purchase Agreement I did require that legal title to Equipment pass from Partnership to Investments. In addition, Leaseback provides that Investments, as Lessor, retains title to Equipment during the term of each IER and until Partnership, as Lessee, fully performs all of its obligations. However, the intent of the parties concerning this factor can be discerned in part from the language in Leaseback, which expressly states that Investment's retention of title constitutes a "lease intended as security" or a "security interest" for Uniform Commercial Code purposes. Further, under this lease agreement, Partnership granted Investments a first priority security interest in Equipment, which is consistent with a financing arrangement. Consequently, although legal title may have been transferred to Investment, it apparently did so as security for Investment’s interest in Equipment. This would indicate that Investments holds legal title as a mortgagee, not as an owner.

This view is supported by those provisions in Leaseback which automatically require Investments to transfer title back to Partnership if Partnership deems the sale of Equipment necessary to satisfy its Base Rent obligation and to maximize the Additional Rent to which Investment is entitled. In our view, this action by Investments is consistent with the release of a security interest by a mortgagee in property in order to effectuate the sale of the property by its owner in satisfaction of a debt.

Further, if Partnership fully performs its obligations under Leaseback, title to Equipment automatically reverts to it. Certain facts in this case suggest that such full performance may be doubtful. As noted above, Partnership may never be able to pay Investment sufficient rent to reimburse Fund for payment of Equipment's total cost. As the end-user lessees make their rental payments to the lockbox account, Group deducts its management fee from these rental payments. The remaining amounts are then forwarded to Fund, leaving Partnership with no remaining end-user lease income. Since it appears that Partnership's sole source of income is the rental income from the end-user leases, absent a large final payment or the sale of the Equipment to satisfy its obligations (i.e., Base Rent includes sales proceeds during lease term), there will be a large shortfall in the principal payments over the life of the end-user leases and the life of Equipment. In that case, title would not pass back to Partnership. Satisfaction of the final payments is doubtful given that the final payment amounts generally exceed the residual values of the Equipment.

Arguably, this anticipated shortfall in rental payments and final payments may preclude the return of title to Equipment to Partnership, which lends support to treating the transaction as a true sale-leaseback. However, we think the better view is that Investments is contractually bound to automatically return legal title to Equipment if Partnership fully performs its obligations. In other words, Partnership does reacquire title to Equipment merely by doing what it has contracted to do. In our view, this supports treating the transaction as a financing. Only in the event Partnership cannot perform its financial obligations does Investments get to retain title permanently. Thus, in light of this feature, Investment's position is analogous to that of a mortgagee, who is permitted to retain the property securing the mortgage only upon the borrower's failure to repay the financing. Also, we note that as a result of the above cross-collateralization provisions, which are designed to ensure full payment to Fund, there remains the possibility that Partnership may ultimately have sufficient resources to perform its financial obligations and thus regain title.

Concerning whether the parties treated the transaction as a sale, we note that they consistently reported the transaction for federal (and state) income tax purposes as a financing arrangement, as required by the provisions in Leaseback,. This factor thus favors treating the transaction as a financing arrangement.

Concerning the third factor from the above test, which is whether the purported purchase (Investments) acquired an equity interest in Equipment, we note that equity generally is the difference between the fair market value of the property and the outstanding debt on it. Equity also is the amount of the owner/purchaser's investment in the property, provided that such amount actually is at risk. The terms of Leaseback essentially guarantee Investments, as Lessor, an amount equal to Base Rent. Although it enjoys some profit potential above that amount if Equipment appreciates in value, Investment's profit potential is capped at z% with Partnership to receive any profit above that cap. Furthermore, under Leaseback's terms, Partnership assumes the entire risk of loss. Investments' capital arguably was not truly at risk, and its investments resembled loans. Moreover, its rate of return appears to be predetermined and essentially limited to that set forth in the documents. In this regard, Investments' position is closer to that of a mortgagee, not an owner.

Concerning the fourth factor, pursuant to Purchase Agreement II Partnership, as seller, did convey a Bill of Sale to Investments, as buyer, at each closing. Given that title to Equipment will automatically revert back to Partnership upon its satisfaction of all obligations to Investments, arguably the Bill of Sale did not truly convey title to Equipment to Investments (that is, did not operate as a deed), but instead operated as a "loan" of title to Equipment (that is, as a security interest in Equipment) for the duration of Leaseback, after which Partnership will assume ownership of Equipment.

The fifth factor -- whether the lessor has a right of possession to the property-- is less relevant in a net lease context, such as the instant case, since a lessor normally is not vested with the right of possession during the lease term. Torres, 88 T.C. at 721. For instance, the end-user lessees technically have physical possession of Equipment during the end-user leases.

The sixth factor – who is obligated to pay the taxes and associated levies on the property – is also of lesser importance in the context of a net lease. Torres, 88 T.C. at 721. Since Leaseback requires Partnership to indemnify Investments against property taxes, on its face this factor does not support sales treatment of Equipment.

The seventh factor -- who bears the risk of economic loss or physical damage to Equipment -- also suggests that the burdens and benefits of ownership have not shifted to Investments. First, Investments bears less of a risk of loss or damage to Equipment since Partnership is required to maintain insurance on Equipment pursuant to Leaseback. Second, Partnership assumes the entire risk of loss under section 13 of Leaseback, as discussed above. Third, should an Event of Loss occur, upon payment of certain amounts to Investments, including the Stipulated Loss Value amount, Investments' right, title and interest to the particular Equipment transfers back to Partnership -- which is consistent with the release of title to damaged or destroyed property by a mortgagee upon being made whole by the mortgagor. Finally, Investments is guaranteed an amount equal to Base Rent, thus limiting its downside potential. These features are also consistent with a financing arrangement.

The final factor from the Grodt & McKay test concerns who receives the profit from Equipment's operation, retention and sale. Courts have consistently found that the potential for profit or loss on the sale or re-lease of property constitutes a key burden or benefit of owning property. Gefen v. Commissioner, 87 T.C. 1471, 1492 (1986); Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986).

Investments' theoretical profit potential was capped at z% with Partnership to receive any profit above that amount. However, the likelihood of an item of Equipment appreciating above z% percent is questionable. Investments' profit potential, while contractually limited to a specified amount, was not restricted as to the source of funds (i.e., sales proceeds during lease terms are included in Base Rent). Therefore, in reality, Investments (or Fund, since Investment is acting for Fund to which the assets and leases were conveyed) probably has greater profit potential than Partnership.[6] This factor suggests treating Investments (or through it, Fund) as the holder of the burdens and benefits of ownership to Equipment. However, we note that Investments' rate of return was not only capped but, as indicated above, was determined with reference to predetermined yields over the term of the agreements, not the fair rental values and fair market residual values of similar items of Equipment subject to comparable leases. Such a return is similar to that earned on a loan. That is, even though the bulk of any profit may actually accrue to Investments, that profit appears to be in the nature of interest earned on a loan. Accordingly, we think that on balance this factor also does not support the transfer of the burdens and benefits of ownership to Investments.

Additional factors specific to determining whether a transaction denominated as a sale-leaseback should be recharacterized as a financing arrangement are examined below. First, crucial to respecting the validity of a sale-leaseback is whether the useful life of the property exceeds the leaseback term. To be a valid sale-leaseback, the property or equipment must return to the purchaser/lessor at the end of the lease term with a significant residual value.

The IERs list the residual values of Equipment. The range of residual values depends upon the type of Equipment, but all appear high enough to suggest that the useful life of Equipment exceeds the leaseback term. The taxpayers determined these residual values when the IERs were executed. According to a Service engineer, however, the taxpayers' estimates of the residual values appear to be overstated by 10 to 15 percent. In the Service engineer's opinion, the overstatement is attributable to the following factors: profit motive of the lessor, expenses associated with finding a buyer for the used equipment, and time lag to find a buyer. According to Fund's fiscal year 2000 Annual Report, prevailing market conditions indicated a potential drop in the value of the its portfolios. Independent appraisers revalued the Fund's portfolio of Equipment. Consequently, Fund wrote down the value of its respective assets. Since the relevant

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[6] In fact, it is Fund, which holds the greatest potential for profit. As noted in the beginning of the facts, Investments' income and expenses were both zero for the years in question. Investments did not even include the lease investments on its balance sheet, since it immediately conveyed these interests to Fund. It was Fund which received all of the leasing income from the lockbox, and Partnership which took the interest and depreciation deductions. Partnership reported a loss on each of its tax returns since its expenses exceeded its leasing income. Fund, in contrast, reported all of the income as either a return of principal or interest.

consideration is whether the useful life of Equipment exceeds the leaseback term so as to give Investments, as purchaser/lessor, a meaningful possessory right to Equipment, this information strongly suggests that the originally estimated residual values were inflated and thus Equipment will have a far lower residual value at the termination of Leaseback. Such a reduction in residual values indicates that there may be little or no useful life remaining in certain Equipment at the end of the Leaseback term. Accordingly, this factor supports treating the transaction as a financing arrangement, not a sale-leaseback.

The second factor is whether there is a fair market value purchase option at the end of the leaseback term. The existence of such a fair market value purchase option supports characterizing the transaction as a valid sale-leaseback. In this case, the individual IERs provide for such fair market value options. Thus, this factor supports treating the instant transaction as a valid sale-leaseback.

In addition, the existence of a fair market value rental option at the end of the leaseback term supports characterizing a transaction as a valid sale-leaseback. The individual IERs provide for such options. Accordingly, this factor supports a valid sale-leaseback.

The last factor is whether there is a reasonable possibility that Investments, as Lessor, will recoup its investment in the Equipment from the income producing potential and residual value of Equipment. If there is a reasonable possibility that Investments will not recoup its investment in Equipment from the income producing potential and residual values of Equipment, then the transaction will be treated as a financing. In this case, there are facts that seem to go both ways. Investments (or more accurately Fund, on whose behalf Investments acquired Equipment) does appear to have a guarantee under the documents that it will receive its rental payments. However, any rate of return that it may receive from the transaction is capped and appears in the nature of a predetermined yield on a note. Moreover, any additional anticipated return from the residual values of Equipment appears questionable due to the decline in such residual values. Thus, as discussed above, there is a reasonable possibility that Investments, as Lessor, will never recoup its investment in Equipment from the income producing potential and the residual value of the property. Although this suggests that the transaction is a financing arrangement, in our view, this factor will require additional factual development in order to provide a more definitive conclusion.

Accordingly, while some of the above factors suggest the existence of a bona fide sale-leaseback, on balance the majority of factors support treating the transaction as a financing arrangement. Consequently, we conclude that this transaction should be characterized as a financing arrangement.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Since the characterization of transactions is a highly factual matter, the most important feature in the instant case is the need for further factual development. [redacted]

We note that the IERs list the residual values of Equipment as ranging from to percent (for) to percent (for and equipment), with at to percent. If accurate, Partnership should be able to re-lease or sell Equipment for amounts sufficient to fully fund its obligations to Investment and reacquire legal title. However, the funds' 2000 Annual Reports states that external appraisals showed a potential for material future losses in realizing residual values. In fact, the funds sustained sizable deficits according to their profit and loss statements. The reports warn investors of certain risks including residual value risks, liquidity risks, economic and market risks, and credit risks on lessees and sublessees, which would affect the funds' ultimate profit potential. Finally, according to the funds' fiscal year 2000 Annual Reports, prevailing market conditions indicated a potential drop in the value of the funds' portfolios. Consequently, the funds engaged independent appraisers to revalue their portfolios. As a result of these appraisals, both funds wrote down the value of their respective assets. This could suggest that Fund was acting as a mortgagee writing down a nonperforming loan, which would support treating the transaction as a financing arrangement, not a valid sale-leaseback.

We are thus aware of the argument that the transaction should be treated as a sale-leaseback because the residual values are highly inflated. This is based on the above facts, the engineer's report and perhaps on the fact that the taxpayers have warehoused Equipment whose original cost totaled approximately $[redacted] [redacted] including [redacted] . The fact that this property remains idle suggests low residual values. Therefore, one could argue that there is little possibility that Partnership will see any profit from this transaction because all of the Base Rent (less the Management Fee) flows to Fund leaving no source of rental income for Partnership. This would suggest that it did sell Equipment to Investments in a valid sale-leaseback since Partnership has little or no profit or income potential from either the operation of Equipment or the resale of Equipment.

This argument is problematic, however. Low residual values also suggest that Investments may not be able to recoup its investment in Equipment. This would deprive Investments of a key component of ownership, which would support financing treatment. It would also suggest that the useful life of Equipment does not exceed the leaseback term, which would deprive Investments of another key component of ownership and lend further support to characterizing the transaction as a financing arrangement.

Another possibility is that ownership to Equipment actually resides in the end-user lessees. Under Rev. Rul. 55-540, Rev. Rul. 55-541 and Sprint v. Commissioner, supra, equipment under lease for approximately its full useful life is considered owned by the lessee, not the lessor, since it will return to the lessor with little or no residual value. [redacted] For instance, computer equipment has a short useful life. If such computer equipment is the subject of a 4 or 5 year lease to an end-user, it may be considered owned for federal income tax purposes by such end-user. The lease would be recharacterized as a conditional sale and, in lieu of rent, the nominal lessor would receive payments of principal and interest (i.e., an installment obligation). In a transaction such as the instant case, the subject of the sale-leaseback between Investments and Partnership would not be the actual equipment subject to the end-user lease, but the paper itself, which would be treated as the factoring of an installment obligation. The Passthroughs and Special Industries Division should be contacted to discuss this area.

[redacted] equipment may have a substantially longer useful life at the time such equipment becomes the subject of relatively short-term end-user leases. In such cases, ownership does not reside in the end-user lessees. [redacted]

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Please call if you have any further questions.

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