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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated October 13, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Date 1	=
Taxpayer	=
SPE	=
$x	=
Financial Institution 1	=
Financial Institution 2	=
Financial Institution 3	=
Fiscal Year X	=
Fiscal Year Y	=
m%	=
n%	=
o%	=

ISSUE:

Whether for tax purposes transactions entered into between the Taxpayer and an unrelated third-party special purpose entity are lease arrangements or financing arrangements.

CONCLUSION:

Based on the facts presented, we believe the transactions entered into by the Taxpayer are financing arrangements. Accordingly, the Taxpayer is the tax owner of the properties.

FACTS:

Taxpayer is a retailer engaged in the sale of merchandise. Taxpayer also produces some of the products sold in its stores. Taxpayer's real estate needs include distribution warehouses, production facilities, and retail sites.

On or around Date 1, the Taxpayer entered into a series of interrelated agreements with SPE, a special purpose entity, and various financial institutions in order to enter into "synthetic leases" to purchase nonretail facilities (synthetic lease program). For years from Date 1 through Fiscal Year X, the synthetic lease program only involved nonretail facilities (distribution warehouses and production facilities). In Fiscal Year Y, retail sites were included in the synthetic lease program.

The transactions involved: (1) an Acquisition and Development Agreement for $x million between Taxpayer and SPE for the purchase and leasing of properties; (2) a Credit Agreement (line of credit) between SPE and Financial Institution 1; (3) a Depository Agreement between SPE and Financial Institution 2 as depository and issuing agent; (4) a Placement Agency Agreement between SPE, Taxpayer, and Financial Institution 3; (5) guarantees by Taxpayer to cover the costs of acquiring and constructing all facilities obtained under the Acquisition and Development Agreement; and (6) a Tax Treatment Agreement between SPE and Taxpayer (which stated that Taxpayer would be the tax owner for depreciation purposes).

A "synthetic lease" or synthetic real estate financing is a method used to provide off-balance sheet financing to a corporate entity for the acquisition and development of a commercial facility or site, with substantial credit support for debt issued by or through an investor or capital source, usually a financial institution. John C. Murray, Off-Balance-Sheet Financing: Synthetic Leases, 32 Real Property, Probate and Trust Journal 193, 195 (Summer 1997).

> Off-balance-sheet real estate financing is most attractive to large, publicly traded, creditworthy corporations and businesses, ...

> Major users of commercial real estate seeking medium-term, revolving-credit financing, that have substantial and highly specialized build-out costs, and that seek an opportunity to maximize the value of their companies' stock, are likely to benefit from off-balance-sheet financing. This method of structured financing may also be employed in connection with a number of planned corporate acquisitions by developing a master lease facility for the inclusion of numerous properties, to be brought into the facility as they are identified and acquired or made ready for the construction of improvements.

Ibid at 196 (footnote omitted). Although nominally secured by real property assets, a synthetic lease is "underwritten on the basis of a guaranteed minimum revenue stream and the financial strength and credit rating of the lessee or guarantor." Id. at 198. A synthetic lease is viewed as the best of both worlds because it is an operating lease for financial accounting purposes but (allegedly) is viewed as a financing arrangement for tax purposes. "The lessee/corporate user retains the tax benefits and operating control associated with ownership and debt, but, for [financial] accounting purposes, does not have to book the lease obligation as a liability or the leased property as an asset." Id. at 196.

For book purposes, Taxpayer treated the leases as operating leases because the leases failed to meet any of the capital lease criteria under Generally Accepted Accounting Principles. Under current accounting rules, if one or more of the following are met, the lease is a capital lease: (1) the lease automatically transfers ownership to the lessee at the end of the lease; (2) the lease contains a bargain purchase option; (3) the lease term is greater than 75% of the estimated economic life of the property; and (4) the present value of the rents equals or exceeds 90% of the leased property's fair market value.[1] Here, there are no ownership transfers at the end of the lease; no bargain purchase option; the lease term (maximum without extensions is 25 years) is less than 75% of the estimated economic life of the property for the distribution warehouses and production facilities (40 years); and the present value of the rents at a rate of 12% or less is less than 90% of the fair market value of each property.

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[1] Similarly, in determining the validity of a sale-leaseback transaction for tax purposes, the Tax Court looks to (1) the existence of useful life in excess of the lease term; (2) the existence of bargain purchase option; (3) if renewal rentals at the end of the lease term are set at fair market value; and (4) the reasonable possibility that the purported owner of the property can recoup its investment in the property from the income and residual value of the property. Torres v. Commissioner, 88 T.C. 702, 720-21 (1987).

For tax purposes, in the years involved, Taxpayer reported the leases on all its properties in the synthetic lease program as if Taxpayer were the tax owner, claiming depreciation on the properties.[2] At no time did SPE report an ownership interest in the leased properties.

SPE was created to provide flexible, low cost, off-balance sheet financing to Taxpayer by acquiring, financing, and leasing properties solely to Taxpayer. SPE is a nominally capitalized, bankruptcy remote,[3] special purpose corporation created solely for entering into the synthetic leases. SPE is unaffiliated with Taxpayer and Taxpayer has no ownership interest in SPE.

SPE entered into and Acquisition and Development Agreement with Taxpayer to acquire, construct, and lease nonretail and retail property to Taxpayer or its subsidiaries. Under the Acquisition and Development Agreement, Taxpayer investigated sites, negotiated the sale or lease, obtained a proposed sale or lease agreement, and paid all costs of identification and negotiation. At this point, Taxpayer would request that SPE purchase or lease the site. When SPE purchased or leased the site, SPE would reimburse Taxpayer all the costs of identification and negotiation. However, Taxpayer was responsible for developing plans for constructing all improvements.

Lease Agreements and Terms

Under the Acquisition and Development Agreement, Taxpayer acquired exclusive use and possession for stated terms and conditions under Lease Agreements entered into with respect to the properties. Under the Lease Agreement for each property, leases cover all real property, all improvements, and all other personal property. Further, SPE makes no warranty or representation, and has no responsibility or liability for defects, including tort damages. All risks incident to the quality of the title, the condition of the leased properties, and the liabilities for the properties are borne exclusively by Taxpayer.

Under a Lease Agreement involving unimproved real property, there may be a Construction Term and an Interim Term, which occur only where improvements are

[2] Taxpayer claimed interest deductions attributable to the amount of "interest" paid under the Basic Rent and claimed depreciation on the unamortized amount of the principal (m% on the fee interest properties (with n% allocated to the land)).

[3] A bankruptcy remote entity is designed so that "legal ownership of assets can be structurally isolated, creating a financing vehicle that is legally independent of and removed from the bankruptcy risks of the lessee/corporate user." Murray, 32 Real Property, Probate and Trust Journal at 204.

to be constructed or substantially renovated. The Construction or Interim Term only occurs prior to the assets being placed in service.

After a Construction or Interim Term or where the sale was for improved real estate, the Lease Agreement calls for either an Extended Term or a Fixed Term lease. An Extended Term lease is for a 364-day period with 24 renewals while a Fixed Term lease is for 10 or 25 years, after one 364-day period. The Lease Agreement also contemplates Renewal Terms which are for five years with up to 12 renewals (60 year maximum renewal length). Accordingly, under a Lease Agreement, the maximum term of the lease without renewals is 25 years (with renewals 85 years) and the minimum term is 11 years. During Extended or Fixed Term periods, Taxpayer pays a Basic Rent that includes an "interest" and "principal" amount. (No Basic Rent is paid during a Construction Term and only the "interest" component of Basic Rent is paid during an Interim Term.)

The "interest" component includes all the interest charges on Advances from Credit Agreement and any original issue discount on issued commercial paper. Thus, the "interest" component fluctuates. The "principal" component, which is fixed under the Basic Rent, is an amount equal to m% of the unamortized principal equal to SPE's acquisition and construction costs of fee interest property, with a yield or interest return of o%, with a 25 year maturity. Accordingly, for fee interest property, Taxpayer, SPE, and the financial institutions are assuming that n% of unamortized amount of costs are associated with the land itself (with that amount of land value available as collateral on the financing).

Taxpayer also paid additional rent beyond the Basic Rent, plus expenses associated with the agreements, plus all taxes of SPE, plus a management fee. The additional rent applies during all Terms, including the Construction and Interim Terms. The result of the Basic Rent and additional rent is that all the costs of financing the acquisition and construction of the facilities is borne ultimately by Taxpayer. Taxpayer guaranteed 100% payment and performance under the lease terms.

All leases are net, with Taxpayer paying all insurance, taxes, and maintenance costs. Taxpayer is responsible for payment of rent even in the event of damage or condemnation, unless a total casualty or possession. If a total loss, Taxpayer must make offer to purchase (which can be rejected) for the amount of borrowings outstanding. If partial loss, Taxpayer must restore the property and, if the proceeds are insufficient to cover the partial loss, Taxpayer must pay the difference. Additionally, Taxpayer gets no rent abatement for partial loss.

Taxpayer may vacate or assign a lease, but remains primarily liable for rents, maintenance, and repairs of the leased facilities. On the other hand, SPE may not sell or assign any of its leases without Taxpayer's permission. In the event of

default, Taxpayer agrees to pay all of SPE's costs. Taxpayer does not guarantee any residual values, and, at the end of an Extended Term of fee simple properties, n% of the debt is still outstanding and SPE is at risk.

In Fiscal Year X, at least nine properties were included within the synthetic lease program. All nine were nonretail sites, either distribution warehouses or production facilities. In Fiscal Year Y, retail sites were added to the synthetic lease program. Taxpayer has stated that it plans to use the synthetic lease program to construct its nonretail sites and to keep these facilities within the program for some period of time. However, Taxpayer indicates that its retail facilities will either be developed outside of the synthetic lease program or, if the synthetic lease program is used, it will only be used during the construction phase and a short period thereafter, with said stores being sold outside the program to investors and leased back to Taxpayer. For retail sites, Taxpayer primarily uses the synthetic lease program to finance the cost of renovations to the sites.

Taxpayer represents on its financial statements that it is the owner of the properties. Although it appears that Taxpayer does not have a right to any appreciation in the property, Taxpayer does report sales to investors outside the synthetic lease program as sales of its property. Consequently, in years after the years in suit, Taxpayer has reported gain on the sale of facilities that are sold to investors. During the construction period, Taxpayer capitalizes the construction interest to the property pursuant to I.R.C. § 263A.

LAW AND ANALYSIS

The question raised is whether the synthetic lease program entered into between Taxpayer and SPE, the Acquisition and Development Agreement, as expressed for individual properties in the Lease Agreements, are classified as sale-and-lease back arrangements or are financing arrangements. The characterization profoundly affects the tax consequences which flow from the transaction. If a transfer of property is considered a lease, reasonable rental payments are deductible by the lessee using the property in a trade or business. Because ownership remains with the lessor, the lessor is entitled to recover its costs through depreciation, and treats the rental payments as ordinary income. On the other hand, if the transfer of property is a financing arrangement, the transferee of the property (the nominal lessee) cannot deduct its payments as rent. But the transferee can claim depreciation because it is treated as the owner of the property by virtue of the sale. And the transferee can claim an interest deduction on borrowings associated with the financing arrangement.

In characterizing a transaction, the substance of the tax transaction, rather than its legal form, is controlling for federal income tax purposes. Helvering v. Lazarus & Co., 308 U.S. 252 (1939). The test for determining if a transaction is a sale, as

opposed to a lease, is whether the benefits and burdens of ownership have passed to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987). Thus, whether a transaction is a sale or a lease is a question of fact that must be ascertained from the intent of the parties as evidenced by the contract read in light of all the facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955).

The factual situation in this case makes characterization for tax purposes difficult. On the one hand, SPE was titled as owner of the properties and financed its acquisitions by borrowing from other third parties (Financial Institution 1 for the advances/mortgage and Financial Institution 3 for the commercial paper). It purchased the properties at issue in these years pursuant to the Acquisition and Development Agreement. SPE also had the rights and risks of residual value.

On the other hand, while SPE is unaffiliated with Taxpayer, its sole ability to finance and purchase the properties to lease to Taxpayer is contingent on Taxpayer. Furthermore, the Basic Rent covers a significant portion of the costs of SPE's borrowing, and the Basic Rent fluctuates to some degree because a portion of the Basic Rent is calculated off the cost of the line of credit and the commercial paper issued for SPE. These factors indicate a symbiotic relationship, adding credence to Taxpayer's claim for characterization as a financing arrangement.

Taxpayer could have engaged in these transactions by borrowing directly and purchasing and building the properties as owner in form and substance. Instead, Taxpayer chose to structure these transactions as synthetic lease transactions for financial accounting considerations. All extensions of credit, placement of paper, and lease payments rely exclusively on Taxpayer's fiscal health. Taxpayer receives the advantage of low cost financing that is off its balance sheet. A synthetic lease "substantially enhances the financial ratios of the lessee/corporate user because neither the real estate asset, nor any financing liability or equity ownership of the property appears on the ... balance sheet." Murray, 32 Real Property, Probate and Trust Journal at 209. A portion of all Basic Rent payments is calculated on financing (the line of credit and the commercial paper placements) granted exclusively on the credit worthiness of Taxpayer. Under the Credit Agreement, Taxpayer, not SPE, must make monthly filings to the financial institutions, which also look to Taxpayer, not SPE, for all lease payments.

Where there is a genuine multi-party transaction with economic substance that is compelled or encouraged by business realities, contains tax-independent considerations, and is not shaped solely by tax avoidance features, the government should honor the allocation of rights and duties effectuated by the parties. Frank Lyons Company v. United States, 435 U.S. 561, 583-84 (1978). We note that although SPE is the nominal owner of the properties in the synthetic lease program, it is nominally capitalized and intended to be merely a bankruptcy remote, special

purpose corporation created solely for entering into the synthetic leases. More importantly, the financial intermediaries here look to the Taxpayer's credit for financing the properties, and all the extensions of credit, placement of paper, and payment of the borrowings are based on Taxpayer and its financial strength. Taxpayer and SPE have both consistently treated the Taxpayer as owner of properties in the program. Thus, multi-party transactions exist (Taxpayer, SPE, and the financial intermediaries) here, which are compelled by Taxpayer's business considerations and which contain tax-independent considerations (i.e., to provide flexible, low cost, off-balance sheet financing to Taxpayer). Consequently, these transactions are not shaped by Taxpayer solely for reasons of tax avoidance.

Moreover, the proper tax characterization of a transaction is a question of fact, which must be ascertained by the intention of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Grodt & McKay, 77 T.C. at 1237. Concerning each transaction, the intention of Taxpayer and SPE (and the financial institutions) was to create a synthetic lease, with the advantages of off-balance sheet financing for financial accounting purposes and treatment of Taxpayer as the owner for tax purposes. The written agreements support this intent, with Taxpayer exclusively liable on all the Lease Agreements; with the Credit Agreement and Placement Agreement relying solely on the Taxpayer's credit worthiness and guarantees; and with the Tax Agreement specifically determining that Taxpayer is the owner for federal income tax purposes. In addition, Taxpayer has remained consistent in its treatment of the properties in the synthetic lease program, acting as tax owner throughout. The Taxpayer acted as the owner for purposes of capitalizing construction costs, and in reporting on its tax returns any interest, depreciation, and gain on any sales outside the synthetic lease program. Taxpayer also consistently reported sales outside the program on its financial statements.

We find this a difficult and close call, but determine that Taxpayer has entered into financing arrangements. Consequently, Taxpayer is the tax owner of the properties for purposes of deducting interest and depreciation.

Given the highly factual nature in characterizing the transactions as financing arrangements and not leases, any change in the facts, or misunderstanding of the facts, would require a new analysis which may lead to a different conclusion.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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By: ______________________________
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