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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR NORTH-SOUTH CAROLINA DISTRICT COUNSEL

FROM: Associate Chief Counsel (Passthroughs & Special Industries)
CC:PSI

SUBJECT: Lease-in/Lease-out Transaction

This Field Service Advice responds to your memorandum dated May 4, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

T	=
F	=
G	=
H	=
J	=
Equipment	=
Nation	=
Year 1	=
Year 2	=
Year 23	=
Year 34	=
Year 40	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
$<u>g</u>	= $
$<u>h</u>	= $
$<u>i</u>	= $
$<u>j</u>	= $
$<u>k</u>	= $
$<u>l</u>	= $
$<u>m</u>	= $
$<u>n</u>	= $
$<u>o</u>	= $
$<u>p</u>	= $
$<u>q</u>	= $
$<u>r</u>	= $
$<u>s</u>	= $
$<u>t</u>	= $
$<u>u</u>	= $
$<u>v</u>	= $
$<u>w</u>	= $
$<u>x</u>	= $
$<u>y</u>	= $
$<u>z</u>	= $
$<u>aa</u>	= $
$<u>bb</u>	= $
$<u>cc</u>	= $
$<u>dd</u>	= $
$<u>ee</u>	= $

$<u>ff</u>	= $
$<u>gg</u>	= $
$<u>hh</u>	= $
$<u>ii</u>	= $

ISSUE:

Whether the lease-in/lease-out transaction lacks economic substance.

CONCLUSION:

The lease-in/lease-out transaction lacks economic substance.

FACTS:

T is a financial institution. Pursuant to a trust agreement dated October 17, Year 1, G is the trustee of a grantor trust created by T.

F is a municipality of Nation. In the two years prior to October 17, Year 1, F purchased and operated Equipment. F owns, directly or indirectly, <u>a</u> percent of H, a foreign joint stock company. J, a company with limited liability organized under the laws of Nation, might be related to F.

On October 17, Year 1, F, T, H, J, and G entered into a Participation Agreement. Pursuant to this agreement, G proposed to lease Equipment from F, F proposed to sublease the Equipment from G, H and J agreed to finance a portion of certain lease payments and prepayments to be made by G, and the parties agreed to enter into other operative documents with respect to the transaction.

Concurrent with the Participation Agreement, through two lease agreements dated as of October 17, Year 1, F agreed to lease to G the Equipment. The amount of the lease payments was a stated percentage of closing date market value of the Equipment. The terms of the leases were from October 19, Year 1, until January 1, Year 40. Simultaneously, through two leases G agreed to sublease to F the Equipment. The terms of the sublease were from October 19, Year 1, until January 2, Year 23.

Under the Participation Agreement, prior to the expiration of the sublease, F could elect one of three options. First, under the purchase option, it could elect to purchase all of G's interest in the Equipment by paying an amount equal to the Purchase Option Price and the final sublease payment, or $<u>g</u>. The first installment in the amount of $<u>h</u> would be due January 2, Year 23. The second through fifth installments each would be in the amount of $i and would be due on April 15, Year 23; June 15, Year 23; September 15, Year 23; and December 15, Year 23.

Second, under the new sublease option, F could elect to arrange a new sublease of all the Equipment with a new sublessee. The terms of the new sublease would begin upon expiration of the sublease base term and end April 2, Year 34. The new sublease would contain substantive terms and conditions identical in all material respects to those contained in the sublease. Third, under the return option, F could return all of the equipment to G and pay G a specified amount.

The Participation Agreement provided that G would elect to prepay certain specific amounts of the lease base rent. Concurrent with the Participation Agreement, on October 18, Year 1, G notified F through a Prepayment Notice that G would prepay the lease base rents on the closing date of October 19, Year 1. G paid $j and $k (or a total of $l) for the first and second lease, respectively. These amounts represented the present value of the specified base rent prepayments, discounted at b percent per annum.

The Participation Agreement provided that T would finance a portion of the prepayment amount. Consistent with the agreement, T contributed to G $m and $n for the first and second lease, respectively.

The Participation Agreement provided that H would loan to G a portion of the prepayment amount. On October 17, Year 1, G and H entered into a Loan and Security Agreement.

On October 17, Year 1, F and H entered into two swap agreements. The agreements were effective October 19, Year 1, and terminated on January 2, Year 23. F funded swap payments in the amount of $o and $p, respectively, to H and H loaned these amounts to G. The total payments made by G are summarized as follows:

First Lease	
Contribution from T:	$m
Loan from H	o
Second Lease	
Contribution from T:	$n
Loan from H:	p
TOTAL:	$l

This total amount, $l, was paid by G to F on October 17, Year 1.

On October 19, Year 1, T paid brokerage and loan fees to various parties in the amounts of $q and $r for the first and second lease, respectively.

The Participation Agreement provided that J would loan to G a portion of scheduled lease base rent, prepayment, or mandatory prepayment amounts. On October 17, Year 1, G and J entered into a Loan and Security Agreement. On November 20, Year 1, G prepaid to F $s and $t (or a total of $u), for the first and second lease, respectively. The prepayment amounts were funded indirectly by a loan from F. F loaned the prepayment amounts to J and J loaned such amounts to G. The amounts represented the remaining rentals due under the lease determined at present value.

F purchased U.S. treasury strips maturing in Year 23 with a face amount of $v for $w. The Treasury Strips were held in a trust established on October 19, Year 1, and were to be used to pay the equity portion of the purchase option price if F elected to exercise the option at the end of the lease. The equity portion is the difference between the purchase option price under the sublease less the portion of the purchase option price that is required to be applied to the repayment of T's outstanding loans. The $x, representing the excess of the two prepayments received by F over the swap payments made to H, the loan amount paid to J, and amount invested in the treasury strips, was retained by F.

In Year 1 and Year 2, T reported the following income and expenses related to the lease and sublease agreement:

	Year 1	Year 2
Rental receipts	$ --	$ y
Expenses		
Amortization (note)	z	$aa
Interest Expense	bb	cc
Fee Amortization	dd	ee
Taxable loss	(ff)	(gg)

LAW AND ANALYSIS

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); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); 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 whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation 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); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). 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.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the purposed 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 were largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 T.C. at 769.

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 court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership, 157 F.3d at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

It is the position of the Internal Revenue Service that certain lease-in/lease-out transactions lack economic substance. Rev. Rul. 99-14, 1999-13 I.R.B. 3. When the form of a transaction lacks economic substance, the form is disregarded and, consistent with the substance of the transaction, the proper tax treatment is determined. ACM Partnership, Id.; Compaq Computer v. Commissioner, 113 T.C. 17 (1999).

Viewed as a whole, the objective facts of the above-described lease-in/lease-out transaction indicate that the transaction lacks the potential for any significant economic consequences other than the creation of tax benefits; the transaction lacks economic substance.

The payments due during the term of the subleases represent a circular cash flow. G is obligated to make lease payments to F. G prepaid to F $l and $u. The prepayment amount was funded, in part, indirectly by a loan from F through J and a loan from H which was funded with swap payments made to H by F.

F is obligated to pay rent to G, and G is obligated to pay debt service (interest plus small amounts of principal) to H and J. J is obligated to pay debt service to F. The amount of the debt service received by J from G is equal to the amount of the debt service J must pay to F. H is obligated to pay under the swap agreement to F. The amount of the debt service received by H from G is equal to the amount it is obligated to pay under the swap agreement to F. In sum, the amount of the rent obligation is equal to the amount of the debt service. Thus, all such funds represent a circular cash flow. As a result, the offsetting and circular nature of the obligations eliminate any significant economic consequences of the transaction.

The different options given F at the end of the sublease term do not present real economic risk to G or T. Under the first option, the purchase option, F could elect to purchase all of G's interest in the Equipment. If F made this election, on January 2, Year 23, F was obligated to pay G the first installment (plus the final sublease payment) in the amount of $g. On receipt of such payments, G would be required to pay off the loans from H and J. The total of G's payoff amount to H and J would be $g. Also, on January 2, Year 23, the total amount H was obligated to pay F under the swap agreement and the remaining amount J was obligated to pay F under the loan totaled $g. Thus, all such funds represent a circular cash flow. Accordingly, the first installment payment of the purchase option is circular in nature.

The second through fifth installments in the amount of $i would be due on April 15, Year 23; June 15, Year 23; September 15, Year 23; and December 15, Year 23. The treasury strips, funded with amounts contributed by T to G and paid to F to make the October 17, Year 1, prepayment, mature in precisely the required amounts one to two months before each of the four installments are due.

Under the second option, the new sublease option, a new sublessee (which could not be F or an affiliate) would be obtained. The new sublessee would be required to pay rent sufficient to discharge G's loans from H and J plus the amount of true rental value of the Equipment. Given the rent required under this option, to be economically viable, the Equipment would have to have a high fair market value. If the fair market value were at such value, then the more economical choice for F would be to purchase the Equipment under the first option. Because there is no scenario wherein the second option would be the least expensive, it will never occur. Furthermore, if F intended to lease (or sell) the Equipment to a third-party lessor at the end of the sublease, rather than subject a third-party lessee to the convoluted terms of the second option, it could exercise the purchase option, at no cost, and independently enter into a lease (or sale agreement) with the third party on terms to which they mutually agreed. Finally, the nature of the Equipment makes finding a substitute lessee not controlled by F or Nation impractical.

Under the third option, the return option, F could pay G $hh and return the Equipment to G for the next c years. This option would be economically feasible only if the rental value of the Equipment were less than the cost of the first option, the purchase option. Based on the facts provided and appraisals obtained by T prior to entering into the lease-in/lease-out transaction, it is highly unlikely that in Year 23 the value of the Equipment will be less than the cost of electing to purchase the Equipment; the appraisals note that this option is unlikely to be exercised. In addition, this option would be feasible only if F has other similar equipment to serve its customers and perform its duties during the remaining c years of the lease. There is no indication that F has such other similar equipment. Accordingly, it is highly improbable that F would elect the third option.

Based on the above, the parties expect F to exercise the purchase option. F has historically used the Equipment. In addition, because the purchase option payment obligation is fully defeased (the funds were specifically set aside in a trust), F need not draw on other sources of capital to exercise the option. Rather, the option can be exercised merely by book entries and giving the proceeds of the treasury strips held in trust to G as they mature.

Under the given facts, pretax return is nonexistent or, at most, insignificant. In substance, T through G has invested $ii ($m and $n contribution to G and $q and $r paid in fees) in Year 1 to receive the proceeds of the lease strips, or $i in each of four installments in Year 23. Without taking into consideration the time value of money, this return would be approximately d percent. Taking into consideration the time value of money, T would realize an economic loss on its investment.

Because the lease-in/lease-out lacks economic substance, the rent payments arising from the transaction are not deductible. In addition, no deductions for expenses arising out of the transaction are deductible under sections 162 and 467. Finally, the loans were an integral part of the lease-in/lease-out transaction. As such, a deduction for the interest on the loans is not allowable under section163.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]
Please call if you have any further questions.

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