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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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

FROM: ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES

SUBJECT: CROSS-BORDER SALE-LEASEBACK

This Chief Counsel Advice responds to your memorandum dated February 6, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parties

Taxpayer =

Lessee =

Manufacturer =

Subsidiary =

Lessor FSC =

Grantor =

Guarantor =

X =

Lender =

Trust	=
Trustee	=
Intermediary	=
Nominee	=

Amounts

a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=

Dates

Date A	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=

Other

Equipment	=
Country 1	=
Country 2	=

Note 1 =

Note 2 =

Note 3 =

ISSUE

Whether the series of transactions involving Equipment is a financing arrangement or a sale-leaseback.

CONCLUSION

The series of transactions involving Equipment should be treated as a financing arrangement for federal tax purposes in that Lessor FSC did not acquire the benefits and burdens of ownership of Equipment.

FACTS

A. Overview of Foreign Sales Corporations

A foreign sales corporation (FSC) is a non-U.S. corporation that satisfies certain statutory and regulatory requirements, and that has elected to be treated as a FSC in the manner described in Internal Revenue Code § 927(f). § 921. A FSC and its U.S. shareholders obtain special tax treatment with respect to a portion of the FSC's foreign trade income (FTI). FTI is defined as the "gross income of a FSC attributable to foreign trading gross receipts." § 923(b).

This case involves a cross-border leasing transaction using what is known as an "ownership-foreign sales corporation" (O-FSC) structure. In the present case, the transaction was structured as the purchase of Equipment followed by a cross-border lease of Equipment to a non-U.S. lessee for use outside the United States.

B. The O-FSC Transaction

The sale-leaseback of Equipment, and the related financing, constituted a complex, multi-party transaction.[1] This memorandum addresses only those aspects of the transaction that are essential to the issue presented.

On Date A, Lessee, a foreign airline operating under the laws of Country 1, entered into a purchase agreement with Manufacturer for the purchase of Equipment.

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[1] We have relied primarily upon the description of the facts in the Form 886-A. We have not independently examined the underlying documents.

Equipment had an estimated delivery date of Date 1. On or about Date 1, Lessee, Subsidiary, and Lessor FSC, entered into an O-FSC leasing transaction. Subsidiary is organized under the laws of Country 2, and is a wholly owned subsidiary of Lessee. Lessor FSC is a FSC organized under the laws of Country 2, and is a wholly owned subsidiary of Grantor. Grantor is a wholly owned subsidiary of Guarantor, and Guarantor is a wholly owned subsidiary of X.

According to the documents submitted, the O-FSC transaction involved the following steps (which occurred over a two day period, from Date 1 through Date 2):

Step 1: Lessee purchased Equipment from Manufacturer pursuant to the existing contract.

Step 2: Grantor, established a grantor trust, Trust, and appointed Trustee as the trustee. Guarantor contributed $a to Trust. Trust borrowed $b from Lender, pursuant to the Loan Agreement.

Step 3: Trust transferred $c (the contributed amount $a and the loan amount $b) to Lessor FSC.

Step 4: Intermediary transferred the cost of Equipment to Nominee, a Country 1 Special Purpose Corporation. Nominee transferred this amount to Lessee, and Lessee transferred the money back to Intermediary. This resulted in the purported purchase by Nominee of Equipment from Lessee.

Step 5: With the contributed and borrowed funds, Lessor FSC purchased Equipment from Nominee for $c amount. Nominee retained title to Equipment.

Step 6: Lessor FSC leased Equipment to Subsidiary under a lease (Lease Agreement). The lease contained a Fixed Purchase Option that would be exercised on Date 3 for $d.

Step 7: Nominee transferred $c (less $1) to Intermediary which, in turn, transferred the money to Lessee. Lessee entered into an Installment Sale Agreement (ISA) with Subsidiary under which Subsidiary transferred its rights under the lease to Lessee. Lessee exercised a prepayment option in the ISA and transferred $e to Subsidiary, retaining the net present value (NPV) savings.

Step 8: Subsidiary transferred the ISA prepayment of $e to Intermediary; thus, creating a defeasance of Subsidiary's obligations under the lease.

Step 9: Lessee took possession of Equipment.

Coterminous with the above Steps, the parties executed the following relevant documents:

1. Loan Agreement

The Loan Agreement is dated Date 1, and evidences Trustee's borrowing $b from Lender. It is a f-year loan with g% fixed interest rate, compounded semi-annually for the first h years. At the end of h years, on Date 3, Lender will reset the interest rate if a replacement lease is executed. Trust is obligated to make loan payments of principal and interest on Date 4 and Date 5 of each year. Lender was not given a security interest in Equipment. Instead, Grantor gave Lender a security interest in Lessor FSC's shares of stock. In addition, Guarantor guaranteed Trust's performance under the loan, and Lessee agreed to indemnify Lender for any losses sustained as a result of the loan.

2. Lease Agreement

The Lease Agreement between Lessor FSC and Subsidiary is dated Date 1 and is a net lease. The lessee is responsible for the operation, maintenance, registration, and insurance of Equipment, and most costs, charges, fees and expenses. The initial lease term is h years, beginning on Date 1 and ending on Date 3. At the end of the initial lease term, the lessee has the following options: (1) purchase Equipment for a purchase price of $d; (2) secure a replacement lessee to continue leasing Equipment for i years for annual rentals, which average approximately j% of Lessor FSC's cost; or (3) return Equipment to Lessor FSC and pay Lessor FSC a termination payment of $k.

3. Installment Sales Agreement (ISA)

An ISA between Lessee and Subsidiary is dated Date 1. Under the ISA, Subsidiary agreed to sell all of its rights in Equipment and in the lease to its parent, Lessee. The ISA contains a prepayment option, which provides Lessee with the option to prepay an amount equal to the present value of the amount outstanding under the ISA. Lessee exercised this prepayment option on Date 2, and remitted the sum of $e to Subsidiary. The prepayment was deposited with Intermediary, and was used to purchase Note 1 and Note 2, both of which mature on Date 3 and provide for semi-annual payments of principal and interest. In addition, Subsidiary contributed an additional $l to Intermediary's account. This deposit was used to purchase Note 3. The deposited amounts and the anticipated interest thereon generate sufficient funds to make the lease payments as they come due. In addition, it is expected that on the date the notes mature, Date 3, sufficient funds will exist for Subsidiary to purchase Equipment.

4. Interest Rate and Currency Exchange Agreement

Subsidiary and Lender entered into an Interest Rate and Currency Exchange Agreement (Swap Transaction). On each rental payment date under the lease (Date 4 and Date 5), Lender agreed to pay Subsidiary fixed rate payments equal in amount to the scheduled principal and interest on the loan. In return, Subsidiary agreed to pay Lender floating-rate payments on the same dates at a rate of LIBOR plus m%. In other words, Lender and Subsidiary agreed to exchange payments based on applying two distinct indices rates to a notional principal amount. Presumably, Lender and Subsidiary do not actually exchange the underlying funds, but only net the difference on the individual legs. The swap is intended to hedge interest-rate risk.

C. Lessor FSC's Appraisal

Lessor FSC obtained an appraisal dated Date 1 as to Equipment's: (1) economic useful life; (2) current and future fair market values (FMV); and (3) future leasability. The appraisal concluded that: (1) Equipment will have a physical and economic useful life of at least n years; (2) Equipment had a current FMV of $c; (3) Equipment will have a FMV of at least $o on Date 3 (the end of the initial lease term); and (3) it should be possible to locate a replacement lessee for the i years of the replacement lease term, commencing on Date 3.

D. Treatment of Transaction for U.S. Tax Purposes

Taxpayer (including Grantor, Guarantor, and X) treated the transaction as a bona fide purchase of Equipment and then a subsequent lease for U.S. income tax purposes. Lessor FSC is treated as the owner of Equipment, and claims depreciation deductions associated with the asset.[2]

A FSC and its U.S. shareholders obtain special tax treatment with respect to a portion of the FSC's FTI. FTI is defined as the "gross income of a FSC attributable to foreign trading gross receipts" (FTGR). § 923(b). A FSC may derive FTGR from the "lease or rental of export property for use by the lessee outside the United States." § 942(a)(1)(B). Where, as claimed here, the FSC owns the underlying asset and leases it at arms length to an uncontrolled party, 30% of FTI is treated as exempt, and the remaining 70% is treated as non-exempt. § 923(a)(2), as modified by § 291(a)(4)(A).

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[2] Depreciation should be calculated by reference to the recovery period specified in § 168(g)(3)(A). Because Lessor FSC is a "tax-exempt entity" (a foreign corporation) within the meaning of § 168(h)(2)(A)(iii), the recovery period must be at least 125% of the stated lease term. §168(g)(3)(A). In this case, the recovery period was probably determined by reference to the initial lease term, although the recovery period might arguably include both the initial and replacement lease terms.

Exempt FTI is treated as foreign-source income that is not effectively connected with the conduct of a trade or business (i.e. non-ECI/TB) in the U.S. § 921(a). Therefore, such income is not subject to U.S. tax in the hands of the FSC. Moreover, distributions from earnings and profits (E&P) attributable to such exempt FTI, when made to a qualified U.S. shareholder of the FSC, are subject to a 100% dividend received deduction (DRD). See § 245(c)(1)(A). Thus, in practice, exempt FTI is exempt from U.S. income tax for all purposes.

Non-exempt FTI, in contrast, is subject to additional analysis under the FSC provisions, as well as provisions generally applicable to controlled foreign corporations (CFCs). In general, non-exempt FTI is taxable to the FSC if it is from sources within the United States and if it constitutes ECI/TB with respect to the FSC. See § 864(c).

Here, 30% of the net leasing income of Lessor FSC was exempt FTI, pursuant to § 932(a)(2). This amount was deemed to be foreign-source, non-ECI, and thus was not subject to U.S. tax. § 921(a). Dividends paid by Lessor FSC (which are needed by Grantor to service the debt) are not subject to further U.S. tax in light of the 100% DRD. § 245(c)(1)(A). Thus, the net FSC benefit is a 30% exclusion of Lessor FSC's net rental income.

The remaining 70% of the net leasing income was non-exempt FTI, pursuant to § 923(a)(2). This non-exempt FTI was potentially subject to U.S. tax. However, it appears that the transaction in this case was constructed to eliminate the potential that either Lessor FSC or Grantor would be subject to U.S. tax on non-exempt FTI.

Lessor FSC claimed that its § 923(a)(2) non-exempt income was exempt from U.S. tax as international transportation income. We believe this is based on the fact that Country 2, the country in which Lessor FSC was incorporated, grants a reciprocal exemption to this type of income. § 883(a)(2). For purposes of this Code section, the Service recognizes Country 2's domestic law as granting such an exemption. Grantor reported the § 923(a)(2) non-exempt income generated by Lessor FSC as subpart F income, pursuant to § 951(e)(2)(i.e. foreign base company shipping income, as defined in § 954(f)). However, Grantor also allocated and apportioned to that subpart F income interest expense from the Lender loan (and other amortized expenses), sufficient in amount to eliminate net income (i.e. the transaction generated an operating loss).[3] By reporting gross leasing income (i.e., prior to allocation of expenses) as subject to subpart F, Grantor took the position that it was entitled to exclude from gross income subsequent distributions by Lessor

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[3] In a typical O-FSC leveraged lease, an entity in the U.S. consolidated group incurs non-recourse asset-acquisition debt, and the resulting interest expense reduces the consolidated group's subpart F income (and other income). In contrast, if the FSC held the asset-acquisition debt, the associated interest expense would reduce FTI, and would thereby reduce or eliminate FSC benefits.

FSC from E&P attributable to § 923(a)(2) non-exempt income. This claimed exclusion resulted not from a DRD (i.e., § 245(c)(1)(A) or (B)), but rather under § 959(a), which excludes from gross income distributions by a CFC of income that constitutes "previously-taxed income" under subpart F. Importantly, this exclusion applies despite the fact that no U.S. tax was actually imposed on the subpart F income, on account of Grantor's allocation and apportionment of interest deductions (and other expenses) from the Lender loan.

To summarize, for practical purposes, the net leasing income generated by the transaction was exempt from U.S. tax. Exempt FTI was not taxable to Lessor FSC, and was subject to a 100% DRD upon distribution to Grantor. Lessor FSC claimed that its § 923(a)(2) non-exempt income was exempt from U.S. tax as international transportation income. Although Grantor reported the § 923(a)(2) non-exempt income as subject to subpart F, it in fact paid no U.S. tax on this income, due to offsetting deductions for the equipment-loan interest and other expenses. Upon receipt of distributions from Lessor FSC, Grantor excluded this income as "previously-taxed income" under subpart F.

LAW AND ANALYSIS

The distinction between a true lease and a finance lease for federal tax purposes is critical.[4] For the lessor to take advantage of the tax benefits associated with the ownership of the leased equipment, the lease must qualify as a true lease. If the transaction does not constitute a true lease for federal tax purposes, but instead is more properly characterized as a financing lease, then there was never a sale of the asset by the lessee. The existence of a valid sale is a prerequisite to a valid sale-leaseback. If the lessor has not acquired the benefits and burdens of ownership, then the lessor is not entitled to the tax benefits associated with ownership.

The income tax treatment of the transaction in the present case is determined by reference to authorities in the sale-leaseback area. The term "sale" is given its ordinary meaning and is generally defined as a transfer of the ownership of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). Whether a transaction is a sale, lease, or a financing arrangement is a question of fact that must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir.

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[4] In Rev. Proc. 75-21, 1975-1 C.B. 715 (which has been modified and superceded by Rev. Proc. 2001-28, 2001-9 I.R.B. 1156), the Service issued advance ruling guidelines setting forth the criteria that need to be met for the Service to provide a favorable true lease ruling in a leveraged lease transaction. The guidelines represent the Service's position as to what constitutes a true lease.

1956). The primary test for determining whether a transaction constitutes a sale, as opposed to a lease or a financing arrangement, is whether the purported purchaser obtained the "benefits and burdens" of equity ownership. A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms v. Commissioner, 106 T.C. 237, 253 (1996); Larsen v. Commissioner, 89 T.C. 1229 (1987), aff'd in part and rev'd in part, Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

Courts examine the following factors as relevant to the benefits and burdens of ownership: (1) whether legal title has passed; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the sale contract obligated the seller to execute and deliver a deed and obligated the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the property's operation, retention and sale. Id., at 1237-38. Courts have consistently found that the potential for profit or loss on the sale or re-lease of property is 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); Grodt & McKay Realty, Inc., 77 T.C. at 1237.

The following additional factors are relevant in sale-leaseback transactions: (1) useful life of the property in excess of the term of the lease; (2) presence of a purchase option at less than fair market value; (3) whether renewal rentals at the end of the leaseback term are set at a FMV rate; and (4) reasonable possibility that the purported owner of the property can recoup its investment in the property, based on the income-generating potential and residual value of the property. Torres v. Commissioner, 88 T.C. 702, 720-21 (1987); Estate of Thomas v. Commissioner, 84 T.C. 412 (1985); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 201-03 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985).

These factors are analyzed in view of the facts and circumstances surrounding the transaction, including business setting and prevailing practices in the industry. For example, in the net-lease context, certain factors, such as responsibility for taxes and insurance, may have little importance. See Torres, 88 T.C. at 721. Courts also evaluate business purpose or economic purpose to determine whether a sale-leaseback had any potential to generate a profit, without regard to anticipated tax consequences. Estate of Thomas, 84 T.C. at 438-39; Rice's Toyota World, Inc., 81 T.C. at 201-03.

Although no one factor is definitive as to which party to a transaction holds the benefits and burdens of ownership to the property, whether the buyer has acquired an equity interest in the property is often considered significant evidence of a sale.

See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976). In this context, "equity" consists of a positive differential between the FMV of the property and the balance of any loans owed on the property. Equity may also be viewed as the amount of the purchaser's funds at risk in the property. A taxpayer acquiring no equity interest in the property has no depreciable interest in that property, but instead will be viewed as having attempted to acquire mere tax benefits. Houchins v. Commissioner, 79 T.C. 570, 602 (1982). An owner's equity interest in property is distinguished from a mortgagee's security interest in property by the former's potential for (1) gain from any appreciation in the value of the property; and (2) risk of loss from a decline in the value of the property. A mortgagee's return (i.e., interest) from its participation in a transaction is generally fixed when the parties enter into the agreements.

In analyzing the benefits and burdens of ownership in the present case, the first factor to be examined is whether Lessor FSC obtained legal title to Equipment. Under the facts presented, the Nominee issued a bill of sale to Lessor FSC. However, legal title was retained by Nominee, a Country 2 corporation, and would only pass to Lessor FSC upon payment of the final $1 of the sale price. Taxpayer might argue that this means that Lessor FSC had title to Equipment because the $1 amount held back is so de minimus that title effectively passed. However, this argument is not persuasive in that this factor focuses on legal title, and not equitable title. Additionally, titling Equipment in the name of Nominee was most likely done to create a result where the parties could argue that Lessor FSC was the owner under U.S. law, and Lessee was the owner under Country 1 law. In any event, the fact the legal title remained with Nominee makes this transaction look more like a financing rather than a sale.

The second factor is whether the parties treated the transaction as a sale or as a financing. Here, Taxpayer reported the transaction as though Lessor FSC obtained ownership of Equipment, which is consistent with a sale, not a financing. However, a substance over form analysis negates this factor. It is the substance of a transaction and not its legal form which is controlling for federal income tax purposes. Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939). The facts presented suggest an economic substance of the transaction different than the form, namely a financing arrangement.

The third factor is whether Lessor FSC acquired an equity interest in Equipment. Equity can be viewed as the difference between the FMV of the property and the outstanding debt with regard to the property. The term equity investment generally refers to the amount the owner/purchaser has invested in the property that is at risk (upside and downside potential). Here, this factor supports the argument that the transaction was not a valid sale.

Lessor FSC's profit from the transaction, without regard to tax consequences, was fixed when it entered into the transaction and there was no upside or downside. Lessee may be economically compelled to purchase Equipment at the end of the lease term rather than exercise one of the other two options. While Lessor FSC does not profit (or lose) from the operation of Equipment, this fact is not sufficient in itself because not profiting from the operation of leased property is characteristic of a legitimate lease. Accordingly, in determining whether Lessor FSC will ultimately make or lose money on the transaction as a whole, it is necessary to determine whether it can profit or lose on the disposition of Equipment. What happens at the end of the lease term is important.

If Lessee can walk away from the transaction without incurring further liability, the transaction is more likely to be as the parties characterized it--a lease. In such a case, Lessor FSC would own Equipment at the end of the lease term and have the risk of loss/opportunity for profit characteristic of the benefits and burdens of ownership. However, Lessee cannot do this. Instead, it must either make a termination payment, find a replacement lessee, or purchase Equipment.

The incoming request's economic analysis concludes that Lessee would neither pay as much (or almost as much) to terminate rather than exercise the purchase option nor find a replacement lessee under the terms prescribed.

The fourth factor is whether the transaction obligated Lessee, as seller, to execute and deliver a deed or bill of sale to Lessor FSC, and obligated Lessor FSC to make payments to Lessee. Although this factor appears to favor Taxpayer, an argument can be made that the transaction created, in effect, a circular delivery of title. That is, concurrent with the delivery of a deed or bill of sale to Lessor FSC, the parties executed documents virtually guaranteeing redelivery of the deed to Lessee at the end of the initial lease term. The facts presented indicate that Lessee is likely to exercise the purchase option at the end of the first lease term. As such, the substance of the transaction is a financing arrangement with Lessor FSC a loan participant for h years.

The fifth (whether Lessor FSC had a right of possession), sixth (whether Lessor FSC paid property taxes with respect to Equipment), and seventh (whether Lessor FSC bore the economic risk of loss or physical damage with respect to Equipment) factors are neutral factors in this transaction.

The last factor is whether Taxpayer received the profit from the operation, retention and sale of Equipment. Lessee operated Equipment and benefitted from any profit arising from the operation; however, as indicated above, this is typical in a net lease situation. Who benefits from the retention and sale of the property after the lease term has expired is a key issue to be considered. Here, Taxpayer does not

have a potential for profit in any aspect of this transaction and the rationality of Taxpayer's actions can only be explained by the availability of tax benefits. If tax benefits are not included in the rate of return, the transaction does not make economic sense. On the other hand, if the tax benefits are included in the rate of return, the rate of return increases.

In addition to the above eight factors, the court in Torres and Estate of Thomas consider four additional factors specifically relevant in the context of sale-leaseback transactions.

First, a sale-leaseback is respected if the life of the property exceeds the terms of the lease. If Equipment was leased for its entire useful life, Lessor FSC should be viewed as having no economic interest in Equipment. The useful life of Equipment is estimated to be n years, which is longer than the h year initial lease term, and the i year replacement lease term. This factor tends to indicate that the transaction qualifies as a true lease. However, as noted above, the economics of the transaction strongly indicate that Lessee will exercise the purchase option at the end of the initial lease term; therefore, Lessee will have the benefit of the remaining useful life of Equipment.

Second, a sale-leaseback is generally respected if the purchase option price is set at the FMV of the property, rather than at a discount. It is expected that Equipment will have an estimated FMV of at least $o at the end of the initial lease term. The lease agreement sets the purchase option price at $d. The purchase option price is greater than the projected FMV of Equipment at the end of the initial lease term. Thus, this factor tends to indicate that the transaction qualifies as a sale-leaseback.

Third, a sale-leaseback is respected if renewal rentals at the end of the leaseback term are set at a FMV rate. Here, the documents indicate that the renewal rentals, if that option is exercised, are not at market rates. The documents further indicate that the present value of the replacement lease payments exceed the purchase option price. Thus, even if a replacement lessee could be found that was willing to enter into a replacement lease, no reason exists for Taxpayer to do so – it would make more sense for Taxpayer to buy-out Lessee and re-lease Equipment itself. Again, it is important to demonstrate that Lessee will be economically compelled to exercise the purchase option.

Finally, a sale-leaseback is respected if it is reasonably possible for the purported owner of the property to recoup its investment in the property from the income producing potential and residual value of the property. From the facts presented, it does not appear that there is a reasonable possibility that Taxpayer can recoup its investment in Equipment from the income producing potential and residual value of Equipment, exclusive of the tax benefits.

As noted earlier, the substance of a transaction is controlling for federal income tax purposes. In Frank Lyon Co., 435 U.S. 561, the Supreme Court overturned the

Commissioner's determination that a sale-leaseback should be disregarded for tax purposes. The case involved the construction of a new bank building. The banking regulations adversely affected the bank's ownership of the building and as such, the bank found an investor to take title to the property and lease it to the bank for 25 years. At trial, the government conceded that more than mere tax avoidance was behind the form of the transaction. The Court held that:

> Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

435 U.S. at 583-84.

Frank Lyon presents a hazard of litigation that we must expect will be raised. However, Frank Lyon is distinguishable from this case. In Frank Lyon, the rationale for the transaction was the clear, non-tax reason for the bank to find an independent investor to take title to the property. Here, given the economic analysis, there appears to be no non-tax reason.

Based on the factors in Grodt & McKay Realty and the additional sale-leaseback factors espoused in Torres, the O-FSC transaction in the instant case could be recharacterized as a financing transaction in that Lessor FSC did not acquire all the burdens, risks, and responsibilities for Equipment. Re-characterization of the transaction as a financing would eliminate most elements of the favorable tax treatment claimed by Taxpayer.

The definition of FTGR specifically excludes "investment income," which includes interest. §§ 924(f)(2) (exclusions from FTGR); 927(c) (definition of investment income). If the Service re-characterizes the transaction as a financing, as opposed to a lease, the income earned by Lessor FSC would constitute investment income, which by definition cannot give rise to FTI (i.e., exempt or non-exempt). Thus, the income would not qualify for the FSC partial exemption, and would become subject to the rules in § 921(d).

Under this scenario, the periodic rent payments and the lump-sum purchase-option payment would be treated as made with respect to a debt instrument issued by Lessee. To the extent those payments (the periodic rental payments and the lump-sum purchase option) exceed the amount loaned to Lessee, there is OID on the loan. The amount of OID income would need to be determined under the OID regulations. See § 1.1272-1 of the Income Tax Regulations. Interest and OID would be considered ECI/TB and would be taxable to Lessor FSC. §§ 921(d)(2) and 882(a),(b).

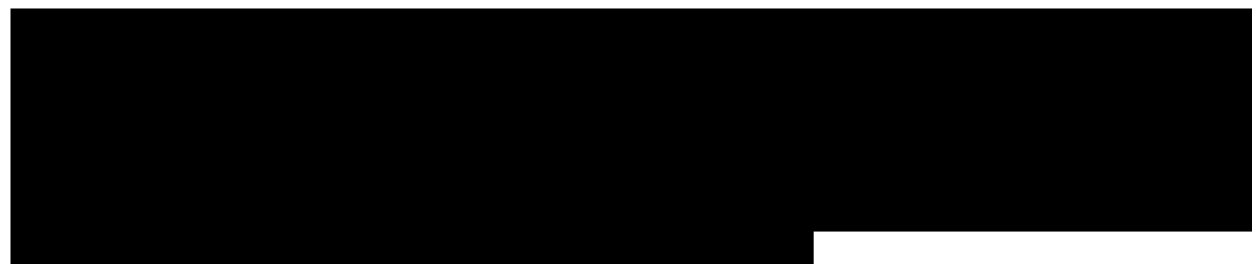
Interest income is generally sourced by reference to the residence of the payor. § 861(a)(1); Treas. Reg. § 1.861-2. Payments of interest by Lessee would thus be foreign-source income. Source is important because deductions under § 862(b) apply only to foreign-source income, and foreign taxes paid (if any) might be creditable on foreign-source income. Lessor FSC would probably be entitled to deductions allocated and apportioned to interest income. Lessor FSC would not in any event be entitled to claim depreciation deductions on Equipment, as it would not be the owner of Equipment for Federal income tax purposes.

Finally, Lessor FSC's exemption claim would be invalid. Payments that are re-characterized as interest, principal, or OID do not constitute international transportation income and therefore would not be exempt from U.S. tax.

If, as we concluded above, the investment income is taxable to Lessor FSC, that income would be outside the scope of subpart F, because it is ECI/TB of a CFC. See § 952(b). In theory, however, the interest income might constitute foreign personal holding company income to Grantor, pursuant to § 954(a)(1).[5]

Upon distribution to Grantor, such income would be subject to an 80% DRD. § 245(c)(1)(B). That is, although the income items would not qualify for FSC benefits, they would nonetheless constitute distributions from E&P attributable to ECI earned by Lessor FSC while it was a FSC. See § 245(c)(1)(B). Moreover, the exclusion from gross income for distributions of previously-taxed income under subpart F (§ 959(a)) would not be available, as the income would not qualify as previously-taxed income.

Re-characterizing the transaction as a financing would make the investment income of Lessor FSC subject to partial double taxation, i.e., once in the hands of Lessor FSC as ECI/TB, and again (in part) upon distribution of E&P, on account of the 80% (rather than 100%) DRD applicable to such distributions.



[5] Alternatively, the investment income of Lessor FSC might be taxable to the U.S. shareholder on a current basis under the PFIC regime of §§ 1291 et seq. Interaction between subpart F and the PFIC rules is outside the scope of this FSA.

In addition, this case implicates international tax rules that are outside the scope of this FSA. Please note that issues relating to subpart F and PFIC, and issues relating to international transportation income are not addressed in detail.

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Please call if you have any further questions.

ASSOCIATE CHIEF COUNSEL
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