OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, CC:LM:HMT:PHI
Attn: John R. Gilbert

FROM: ASSOCIATE CHIEF COUNSEL, CC:ITA

DATE: January 18, 2002

SUBJECT: : Sale and Leaseback of Leasehold Improvements

This Chief Counsel Advice responds to your e-mail dated November 5, 2001, forwarding an undated memorandum for our review. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Participants:

Taxpayer, Taxpayer
Group, Seller/Lessee =
Taxpayer Parent =
Sublessor Sub =
Affiliates, Sublessees =
Buyer/Lessor =
Bank =
Insurance Company A =
Insurance Company B =
Third Party Lenders =
Property, line of business:
Line of Business =
Facilities =
Leasehold Improvements =

Monetary amounts, instruments:

Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Note 1 =
Note 2 =

Years, dates:

Years 1-9 =

On November 5, 2001, you forwarded for our review a memorandum to the Group Manager in this case. In your memorandum, you recommended that the examining agent withdraw a Form 5701, Notice of Proposed Adjustment, issued to the taxpayer with respect to this issue, and substitute the more detailed and extensive analysis in your memorandum.

We have reviewed your memorandum, and we agree with its conclusions and analysis, although we have several comments. In subsequent conversations, you have indicated that the examiners and the taxpayer have expressed interest in submitting this issue for resolution under the LMSB "fast track" dispute resolution procedures announced in Notice 2001-67, 2001-49 IRB 544. Accordingly, in this memorandum, rather than repeat the factual and legal analysis in your comprehensive memorandum, we will restrict the discussion to a brief summary, followed by certain comments that may be useful to you in advising the examiners at this stage. Depending on how the case develops, you may wish to request review of additional written documents, or further advice, at a later date.

ISSUES

1. Whether the purported sale/leaseback transaction entered into by Taxpayer Group was devoid of economic substance and therefore should be disregarded for federal income tax purposes.

2. If so, whether Taxpayer Group is nevertheless entitled to deduct depreciation expenses on the leasehold improvements purportedly sold, and interest expenses for interest paid, in substance, two unrelated third parties.

3. Alternatively, whether the transaction should be recharacterized as a financing device.

4. In either event, whether Taxpayer Group is entitled to deduct or amortize the promoter fees it incurred in connection with the transaction.

CONCLUSIONS

You have concluded as follows:

1. The transactions lacked economic substance and should be disregarded; accordingly, Taxpayer's claimed capital loss and rent expense deductions should be disallowed in full.

2. Taxpayer may deduct depreciation expenses on the leasehold improvements and interest expenses for interest paid to third parties, notwithstanding the finding that the sale/leaseback transaction is devoid of economic substance.

3. If the sale/leaseback transaction is not determined to be entirely devoid of economic substance, it should be recharacterized as a financing arrangement between Taxpayer and the third party lenders.

4. Taxpayer is not entitled to claim any deductions for the promoter in professional fees incurred in the sale/leaseback transaction. Alternatively, if the transaction is recharacterized as a financing arrangement, Taxpayer may amortize the fees over the loan terms.

We agree with these conclusions and your supporting analysis. We have several comments, set out below.

FACTS

Briefly, Taxpayer Parent is a large national retailer in the Line of Business. Its subsidiaries generally operate Facilities under noncancellable operating leases, with lease terms averaging from 10 to 15 years, generally with renewal provisions.

Starting in Year 1, Taxpayer Group entered into a series of transactions whereby it: (1) sold the Leasehold Improvements, with an aggregate tax basis of Amount 1, to Buyer/Lessor for Amount 2; (2) immediately leased the Leasehold Improvements back over a term of 9 years under a Master Lease Agreement. To finance the purported purchase of these leasehold improvements, Buyer/Lessor entered into transactions with the Third Party Lenders whereby Buyer/Lessor sold the future rent streams due from Taxpayer in return for cash payments that were made to Taxpayer Parent.

For financial purposes, Taxpayer treated the transactions as loans from the Third Party Lenders. The cash proceeds from the sale of the rent streams were treated as loan proceeds, and the periodic "rent" payments were treated as payments of principal and interest. For tax purposes, however, Taxpayer treated the cash proceeds from the Third Party Lenders as proceeds from the sale of the leasehold improvements, triggering a capital loss of Amount 3 in Year 1; the rent payments were then deducted in full. In effect, Taxpayer's Amount 1 basis in the leasehold improvements will be recovered over the 9-year term of the rental agreement, or sooner, instead of through MACRS depreciation over a 39-year period.

DISCUSSION

1. *Nature and value of the property sold.* In your memorandum, you have applied the traditional, multi-factor analytical framework developed by the courts in analyzing sale/leaseback transactions. We agree with that approach, and agree that your memorandum correctly applies the analysis---both with respect to the economic substance argument and the alternative recharacterization argument.

At the same time, as you have recognized, it is important to stress the specific features of this transaction, since certain factors that may apply in the traditional analysis of other sale/leaseback transactions may apply differently here, or may not apply at all.

Most significantly, the nature of the property purportedly sold and leased back in this case should be emphasized throughout the analysis. A more typical sale/leaseback transaction involves real estate, equipment, or other property that is a separate, transferable asset---the value of which is generally the same regardless of who owns it. In this case, however, the subject matter of the transaction is a collection of "leasehold improvements"---which, as your memorandum points out in detail, are generally incapable of being physically severed from the Facilities without destroying most or all of the usefulness or value of the improvements. Moreover---again as established in detail in your memorandum---in many cases the improvements could not be transferred, legally, without the permission of the Facility landlord, which would not be forthcoming. In terms of value, while the leasehold improvements may be of significant value to Taxpayer in its operations---as indicated by the Amount 1 incurred in their acquisition or construction---they are generally of little value considered apart from the Facilities they were intended to improve.

The leasehold improvements appear similar to what the Service terms "limited use property," as to which the Service will not issue a favorable advance ruling with respect to a leveraged lease. See Rev. Proc. 2001-28, 2001-19 IRB 1156, § 5.02, modifying and superseding, inter alia, Rev. Proc. 76-30, 1976-2 C.B. 647. In § 5.02(2)(a) of Rev. Proc. 2001-28, for example, a masonry smokestack attached to a masonry warehouse building is considered to be "limited use property" because, among other facts, "It would not be commercially feasible to disassemble the smokestack at the end of the lease term and reconstruct it at a new location."

Although the guidelines in Rev. Proc. 2001-28 do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes, see id., § 3, there is some support for this principle in case law.

For example, in Starr's Estate v. Commissioner, 274 F.2d 294, 295-96 (9th Cir. 1959), the court held that the purported lessee of a sprinkler system was in fact the true owner:

> In this, Starr's case, we do have the troublesome circumstance that the contract does not by its terms ever pass title to the system to the "lessee." Most sprinkler systems have to be tailor-made for a specific piece of property and, if removal is required, the salvageable value is negligible. Also, it stretches credulity to believe that the "lessor" ever intended to or would "come after" the system. And the "lessee" would be an exceedingly careless businessman who would enter into such contract with the practical possibility that the "lessor" would reclaim the installation.

See also Adney v. Commissioner, T.C. Memo 1983-135 (equipment permanently affixed to "lessee's" real estate); Mt. Mansfield Television v. United States, 239 F. Supp. 539 (D. VT 1964), aff'd per curiam, 342 F.2d 994 (2d Cir.), cert. denied, 382 U.S. 818 (1965) (purported lease of microwave equipment).[1] The present case may go beyond even these authorities, to the extent that Taxpayer could not transfer even bare legal title to many of the leasehold improvements, since the rights of the Facility landlords were superior.

Although your memorandum repeatedly calls attention to these features of the transaction, we believe that these differences between this transaction and more traditional sale/leaseback transactions permeate almost all aspects of the analysis and cannot be emphasized enough.

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[1] In Lockhart Leasing Co. v. Commissioner, 54 T.C. 301 (1970), aff'd sub nom. Lockhart Leasing Co. v. United States, 446 F.2d 269 (10th Cir. 1971), the court held that the taxpayer, in the business of equipment leasing, was a true owner/lessor of equipment for investment tax credit purposes, even though in some cases the property (e.g., doors, signs) was unlikely to have more than scrap value to the taxpayer. The Tax Court observed, at 314:

> The factual situation in the instant case is a very close one. Although the leases are substantially all on the same form, the amounts provided for rental payments and for the option to purchase at the end of the term, where such an option is given, give a reasonably clear indication, when considered in light of the other provisions, that the leases are in substance as well as in form, leases. Particularly is this so with respect to most of the items covered by these leases which are easily removable equipment ... , and not an addendum to property such as were involved in [Starr's Estate and Mt. Mansfield]. A few of the items more nearly approach the situation in the Starr and Mt. Mansfield cases. ... The record shows a fair number of instances where property was actually returned to petitioner. Although we do not consider the facts here strongly to support either view, and in certain instances were the particular leases analyzed as a separate matter, we might be inclined to conclude that the substance of the transaction was a conditional sale, these items are minor as compared to the overall transactions which primarily give more the indication of leases.

Lockhart is clearly distinguishable from the present case, in which there is no evidence that the leasehold improvements were ever in Buyer/Lessor's possession, still less "returned," and in which items constituting "easily removable equipment" appear to be minor compared to items constituting an "addendum to property."

For example, one significant factor in the analysis of a sale/leaseback transaction is the relationship between the purported sales price and the fair market value of the property sold. As your memorandum indicates (see pp. 18-21), it can be established that the Amount 2 purchase price far exceeded the actual value of the leasehold improvements---to the Buyer/Lessor. However, this might suggest that Taxpayer did in fact suffer a loss that *exceeded* the claimed Amount 3 loss and that should be reflected, somehow, for tax purposes. It should be emphasized that, as discussed above, the leasehold improvements presumably were of significant value---but only to Taxpayer.

To take another example, a critical factor in analyzing a sale/leaseback transaction is the extent to which the buyer/lessor has acquired an interest in property that is likely to have a residual value at the end of the lease term, taking into account the anticipated useful life of the property and any termination or buyout provisions in the arrangement. In a traditional analysis, this factor is evaluated with respect to property that has a certain fair market value as a separate, transferable asset. The differences between such a typical analysis and the present case should be stressed, however: In a theoretical sense, the physical and legal restrictions on the transferability of the leasehold improvements result in a residual fair market value that is negligible or zero; however, one should not lose sight of the fact that---economic analysis aside---the primary reason Buyer/Lessor can never benefit from the leasehold improvements, either during or after the lease term, is the simple fact that, by and large, the leasehold improvements cannot legally or practically be severed from the leasehold Facilities. See Starr's Estate, quoted above.

This feature of the transaction does not, in our opinion, obviate the necessity of conducting the multi-factor analysis set forth in your memorandum. However, one should be careful in doing so not to "dignify" the purported transaction by treating it as though it involved more traditional real property or equipment. For example, it might be useful to emphasize the comment at footnote 25 of your memorandum, p. 29---stressing the artificial quality of *any* residual value analysis---by incorporating the footnote into the main text.

2. *The leasehold improvements as security; substance of the lending transactions.* On a related point, in many cases involving sale/leaseback transactions the issue is whether the transaction is a sale of the property, or a financing transaction in which title to the property is transferred solely as security for the debt. Here again, this transaction is distinguishable from such transactions.

You have argued, correctly in our opinion, that Buyer/Lessor is simply an accommodation party---a mere conduit who is neither a buyer nor a secured lender. The Third Party Lenders may have been, in substance, true lenders; however, for the reasons discussed above, it appears unlikely that even the Third Party Lenders were looking to the leasehold improvements as security for their loans. Instead, taking into account a number of factors---including the guarantee and put agreements entered into by Taxpayer, and the arrangement under which Taxpayer Parent made payments directly to the lenders "without regard to ... the Rent

Purchase Agreement"---it appears that to the extent there was debt it was primarily, in substance, a recourse borrowing by Taxpayer Parent.

This point may be relevant for at least two reasons. First, it emphasizes the insubstantial nature of the purported sale/leaseback aspects of the transaction: not only were the leasehold improvements not capable of being sold, they were not even capable of functioning as security for a loan.

Second, the fact that the lending was apparently recourse against Taxpayer Parent tends to belie the nontax motivation advanced by the taxpayer for the transaction. According to your memorandum, at p. 27, an official of Taxpayer stated that the business purpose behind the transaction was to "raise cash from idle assets." This avowed purpose seems implausible, however, to the extent that the leasehold improvements did not even constitute viable loan security.

3. *Demonstrating circularity of payments.* The offsetting legal obligations and circular cash flows involved in this prearranged transaction are a significant factor in demonstrating that the transaction---at least its sale/leaseback aspects---lacked economic substance. In your memorandum, at pp. 23-25, you set out how these offsetting obligations and circular cash flows operated so as to eliminate any significant upside or downside risks for the purported Buyer/Lessor and the other conduit entities in the transaction. It may be useful to refine this discussion further in order to highlight the artificial features of the transaction.

For example, consider modifying the discussion along the following lines, with subheadings keyed to the lease years and, perhaps, specific numbers demonstrating the circularity:[2]

> **Year 1:** Here, we suggest describing in more detail the circular nature of the purported "cash payment," supposedly raised by Buyer/Lessor through a sale of the Year 1 rental stream to Bank, and the circular treatment of Note 1. Taxpayer sold the improvements to Buyer/Lessor for cash plus two notes, Note 1 and Note 2. As you point out earlier in the memorandum, the "cash payment" of Amount 3 was originally paid directly to Taxpayer by Bank early in Year 1, and returned later in the same year to Bank, along with an additional amount presumably representing fees and interest, as indicated in Taxpayer's financial statements. For tax purposes, however, this circular flow was characterized as a purchase payment by Buyer/Lessor, offset by prepaid rent owed by the Taxpayer Group. Although your memorandum alludes to this circular cash flow, in footnote 20, in our view it highlights the artificial character of the entire transaction, and merits emphasis in the text.
>
> Note 1 is similarly insubstantial. Buyer/Lessor first issues Note 1 to the Affiliates, which then transfer the note to Sublessor Sub, which then either offsets that

[2] An alternative to this chronological structure might be to analyze in turn each of the three components of the purported purchase price---the cash payment, Note 1, and Note 2---making the same points discussed in the text.

obligation against its rental obligations for Years 2-6, or treats Note 1 as prepaid by the Year 1 transfer of Amount 4 from the Insurance Companies to Taxpayer Parent (the exact treatment needs clarification). In any case, Note 1 appears and disappears within the year with no substantive consequence; the only substance, apart from fees, is the payment of Amount 4, a loan from the Insurance Companies to Taxpayer, which is repaid over Years 2-6 as "rent."

Years 2-6: Here you would describe, as in the second full paragraph on page 24 but perhaps in more detail, the way the obligations cancel out with respect to Buyer/Lessor during this period. The only substantive transfers during Years 2-6 are the periodic payments of "rent" over these years to the Insurance Companies, as successors to Buyer/Lessor's putative interest in the rent stream for Years 2-6.

Year 6: In your memorandum, you discuss the various termination options in footnote 22, p. 24, concluding that the most likely option would be the early buyout provision. As you point out, this provision highlights the insubstantial nature of Note 2, since the purported buyout price is roughly equal to the amount then owed on Note 2 (payments on which are not due until Year 6). Unlike the "cash payment" and the issuance of Note 1---which at least reflected, to some extent, actual borrowings by Taxpayer from third party lenders---the early buyout primarily involves the simple cancellation of two offsetting obligations between Taxpayer and Buyer/Lessor; the only substantive aspect would be a very minor net cash payment, that might represent an additional fee to Buyer/Lessor. Since the discussion of the termination options is a significant aspect of the analysis, we suggest moving it into the main text.

Years 7-9: Having established that "early buyout"---which terminates the transaction---is the likely option, the analysis would stress that any projected "profit" for Taxpayer during these years is illusory.[3]

4. *Emphasis on financial treatment.* While it is true that the treatment of the transaction for financial accounting purposes and for tax accounting purposes may differ, both in general and with respect to lease financing transactions in particular, we find Taxpayer's treatment of this transaction on its books telling, as a reflection of the substance of the transaction. One useful way of emphasizing this disparity might be to use a consistent pattern of footnoting discussions of Taxpayer's asserted tax treatment with the treatment of the transaction on Taxpayer's books. For example, this could be done in the discussion of circular cash flows referred to in the previous comment.

5. *Focus on seller/lessee rather than buyer/lessor.* In this case, the primary abuse lies in the seller/lessee's use of rental and loss deductions under §§ 162 and 165, rather than in the use of depreciation deductions or other tax attributes of ownership by the purported buyer/lessor. In this respect, this case is more similar to earlier sale/leaseback cases than to more recent cases, which tend to focus on the treatment of the buyer/lessor. This fact tends to complicate the analysis to

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[3] Of course, you would also retain the discussion illustrating how the obligations of the financing intermediary between Buyer/Lessor and the Insurance Companies also offset.

some extent, since many of the factors typically employed by the courts---subjective nontax motivations, the objective possibility of pre-tax profits, etc.---are viewed in recent cases primarily from the perspective of the buyer/lessor. You point this out in your memorandum, in the context of discussing the parties' expectations of profit from the transaction, at p. 28.

To some extent, this confusion is unavoidable, and in our view the business motivation (or lack thereof) on the part of Buyer/Lessor is still relevant in evaluating the *bona fides* of the transaction in general. However, you may wish to research further cases involving the tax treatment of seller/lessees for supporting authority, since they would be most closely relevant to the present case. In addition, it might be useful to the reader of any future discussion of the issue to emphasize this characteristic of the transaction earlier.

6. *Tax treatment of Buyer/Lessor.* Although, as just discussed, this case focuses on the treatment of Taxpayer, the seller/lessee, it would be useful to understand, for context, as much as possible about the intended tax consequences to Buyer/Lessor. For example, did Buyer/Lessor or related parties also realize tax benefits from the transaction, or was their incentive limited to the receipt of fees? It would also be useful to understand the rationale behind the purported Year 2 sale of the leasehold improvements from Buyer/Lessor to a successor entity that became Buyer/Lessor. Was this done, for example, in order to offset its receipt of "rental income"?

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If you have any further questions, please contact Branch 1, CC:ITA, at (202) 622-5020.

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