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

OFFICE OF
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MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:CTM:LA2

FROM: ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES

SUBJECT: LEASING TRANSACTION

This Chief Counsel Advice responds to your memorandum dated April 10, 2002. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

A =

B =
C =
Trust =
Equipment =

Lender =
Foundation =
Appraiser =

Currency A =
Country C =

D =
E =
F =
G =
H =

I	=
J	=
Z	=
X	=
W	=
V	=
U	=
T	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
$1	=
$2	=
$3	=
$4	=
$5	=
$6	=
$7	=
$8	=
Equipment Cost Amount	=

ISSUES

With respect to the transactions described below:

1. Whether the transactions lack economic substance.
2. Alternatively, whether the transactions should be recharacterized as a financing, rather than a sale-leaseback.
3. Whether A received original issue discount income as a result of the transactions.
4. Whether A is liable for negligence penalties, pursuant to section 6662, for entering into the transactions.

CONCLUSIONS

1. The facts set forth below suggest that the transactions lack economic substance and should not be respected.
2. Alternatively, the transactions described below should be recharacterized as a financing, rather than a sale-leaseback.

3. If the transaction can be described as a sale-leaseback, A received original issue discount income as a result of the transactions.
4. A is liable for negligence penalties, pursuant to section 6662, for entering into the transactions.

FACTS

Pursuant to a Participation Agreement dated Date 1, A, B, Lender, and Trust[1], entered into a purported sale-leaseback transaction. A is a U.S. corporation. B's core business is C and is wholly-owned by the government of Country C.

On Date 1, B sold the Equipment to Trust and simultaneously leased the Equipment back pursuant to the Lease and Lease Agreement. The initial term of the Lease comprises an interim term of Z months followed by a Base Term. The Base Term commences on Date 1 and ends on Date 4. The Replacement Term of the Lease commences on Date 4 and extends for X years thereafter.

A invested in the transaction by providing $1 (Equity Contribution), which was J percent of the cost of the Equipment, to Trust and by paying the expenses in connection with the transaction. Trust borrowed from Lender the balance of the purchase price, $2, which was D percent of the cost of the Equipment. Also, on Date 1, the parties entered into a Loan Agreement, Lease Agreement, Lease Supplement, Swap Agreement, Custodial Agreement and additional agreements[2] to effectuate the Participation Agreement. To finance the purported purchase of the Equipment, A entered into a Loan Agreement with Lender and Trust. The Loan and Security Agreement is dated Date 7. Under the Loan and Security Agreement, Trust issued loan certificates to Lender and pledged the Loan Estate[3] as security for the loan certificates. The proceeds of the loan certificates were to be used by Trust to pay for a portion of the cost of the Equipment. Pursuant to the Loan Agreement, Lender agreed to lend to Trust D percent of the cost of the Equipment subject to the Lease, which was equal to $2. Payments on the loan certificates were to be made solely from the Loan Estate.

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[1] A entered into a trust agreement with Trust on Date 1 authorizing Trust to execute all documents and rights and perform all of A's duties with respect to this transaction.

[2] These agreements will be collectively referred to as the "Documents."

[3] The Loan Estate consists of the following:
Trust's rights and interests in the Equipment, the documents involved in the sale-leaseback transaction, all amounts of rent due under the Lease, any moneys arising out of the documents that are required to be deposited on Trust's account and any other property or rights of Trust arising out of the documents involved in the sale-leaseback transaction.

B sold the Equipment to Trust pursuant to a Deed of Conveyance. Trust pledged the Equipment and the Lease to Lender as collateral for Trust's loan from Lender. Trust agreed to pay all of the transaction costs. Trust and Lender agreed that they would not take any action that would increase the interest rate in the Loan Agreement which would, in turn, affect B's rent obligation under the lease. The parties further agreed that they could not exit from the agreement and could not transfer any of the property and/or leases and/or loans involved in the agreement unless the transferee agreed to undertake the transferor's obligations under the Participation Agreement.

The Lease sets forth a formula for calculating the rent due each month. Nonetheless, the Lease Agreement provides that the amount of rent due will, at a minimum, be sufficient to pay the principal installment and accrued principal due on all the loan certificates outstanding under the Loan Agreement. No lease payments were due during the interim term. Generally, lease payments were due biannually from Date 2 to Date 4. Additionally, no lease payment was due on Date 4.

The Lease is a net lease and B is liable for all costs and expenses in connection with the Equipment for construction, delivery, ownership, use, possession, registration, control, subleasing, operation, maintenance, repair, insurance, improvement and return of the Equipment.

According to the Appraisal, the Equipment has a useful life of approximately W years, which exceeds the Base Term by V years. Even if the term of a New Lease is aggregated with the Lease to B, the combined lease term is U years, which is T years less than the Equipment's useful life. In accordance with the Lease, B will cause each piece of Equipment to be serviced, repaired, maintained, overhauled and tested during the term of the Lease, which should allow the Equipment to reach or exceed the estimated useful life.

According to the Loan Agreement, the Lease specifies that B pay, directly to Lender, B's rent obligations to Trust, at the address specified by Lender. Pursuant to the Loan Agreement, Trust agreed that when Trust received money that was part of the Loan Estate, Trust would transfer such funds to Lender.

Lender and B entered into a currency swap transaction ("Swap") purportedly to protect B from the currency exchange risk involved in making its Lease obligation payments in U.S. dollars rather than Currency A. Pursuant to the Swap Agreement, fixed interest payment obligations were swapped for floating rate payment obligations. B gave Lender an amount equivalent to $2. Additionally, Lender was obligated to pay B a stream of payments in U.S. dollars. The termination date for the stream of payments for the Swap Agreement is Date 4. The Swap Agreement payments from Lender to B were due biannually each year from Date 2 through Date 4. On Date 4, the amount due under the Swap Agreement would be $3.

As a result of all of the above, the stream of payments due on the Loan Agreement, Lease Agreement and Swap Agreement are equivalent in amount and are due and payable on the same dates, except that on the first payment date, the Lease payment exceeds the Loan and Swap payments.

B and A entered into a Tax Indemnity Agreement on Date 7. Pursuant to the Tax Indemnity Agreement, B and A agreed to the following:

> A will be treated as the owner of the Trust Estate and will be required to take into account in computing its taxable income all items of income, gain, loss and deduction flowing from the Trust Estate;
>
> The Lease will be treated as a true lease by Trust as owner and lessor to B and the obligations on the Loan will constitute indebtedness of the Lessor; and
>
> A, as the beneficial owner of the Equipment, will be treated as the purchaser, owner and lessor of each Piece of Equipment and will be entitled to depreciation deductions for the Equipment, interest deductions on the Loan and amortization of transaction expenses related to the Lease.

Significantly, at the end of the Base Term, the Lease Agreement requires B to exercise one of the three following options:

1. to purchase the Equipment pursuant to a "Purchase Option";
2. to cause a New Lessee to enter into a new lease pursuant to a "New Lease Option"; or
3. to return the Equipment to Trust pursuant to the "Return Option."

(1) *The Purchase Option.*

Assuming all rents due were paid and the loans were not defaulted, on Date 4, B could purchase the Equipment from Trust for a price equal to E percent of the cost of the Equipment, or $4. Additionally, B would pay all the unpaid rent due and payable as of Date 4. When B paid these amounts, rent would stop accruing, the term of the lease would terminate, and title to the Equipment would be conveyed to B. Additionally, Trust would request that upon payment of all amounts due under the Loan Agreement and upon termination of the Loan Agreement, Lender would release Trust from its liabilities under the Loan Agreement and related pledge agreements. At B's expense, Trust would execute and deliver to B the appropriate documents conveying Trust's right, title and interest in and to the Equipment to B or B's designee.

B entered into an agreement with Foundation, purportedly to protect itself from currency fluctuation risk by providing a source of U.S. dollars to pay the Purchase

Option price if B chooses to exercise the Purchase Option on Date 4. B transferred funds from the Equity Contribution to the Foundation. Foundation used the funds to purchase two treasury strips. The first strip matured in an amount equal to the Net Rent amount due on Date 3. The Net Rent equals the amount by which a Lease payment exceeds a Loan payment. The second strip matured on Date 4 in an amount equal to the Net Purchase Option price. The Net Purchase Option price is the extent to which the Purchase Option price would exceed the principal and interest scheduled to be paid on the Loan certificates on Date 4. On Date 4, the Purchase Option price will exceed the principal and interest scheduled to be paid on the Loan certificates, in an amount equal to the amount that the second treasury strip will mature to.

(2) *The New Lease Option.*

To exercise the New Lease Option, B would have to find a new replacement lessee ("New Lessee") who would 1) use the Equipment in its business; 2) lease the Equipment to another business; 3) sublease the Equipment to another entity; or 4) enter into subleases for terms of less than three years with sublessees that are tax exempt entities. The new lease would begin on Date 4 and would extend for a period of X years or less. B could compensate the New Lessee to induce it to enter into the new lease. The rental payments on the new lease must preserve Trust's net economic return so that Trust's net economic return is the same as it was under the original lease. The Equipment must be delivered in Country C at the commencement of the new lease. If 30 days prior to the expiration date of the Base Term of the lease, Trust and the New Lessee have not entered into a new lease, then, no later than 25 days before the expiration date of the Base Term of the lease, B will give irrevocable notice to Trust of its election to exercise the Return Option or the Purchase Option. If either B gives notice that it is electing the New Lease option or Trust and New Lessee have not agreed to a new lease at least 30 days prior to the expiration date of the Base Term of the Lease, Trust may unilaterally make a preemptive election to require the return of the Equipment on the expiration date of the Base Term of the lease. In its notice of making a preemptive election, B must agree to pay Lender all amounts due and payable on Date 4 under the Loan Agreement. If Trust exercises this preemptive election, B will have to return the Equipment.

(3) *The Return Option*

If B exercises the Return Option, then B must return the Equipment to Trust on Date 4. On Date 4, B will have to pay Trust all the rent due and payable on that date and a Lump Sum Payment. [4] Trust would use commercially reasonable efforts to sell and

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[4]The Lump Sum Payment is equal to the Appraisal's projected Fair Market Value of the Equipment over F percent of the Equipment Cost, where the Equipment Cost equals Equipment Cost. The Appraisal projects that the Fair Market Value of the Equipment on Date 4 will be I percent of

dispose of the Equipment to the highest bidder at auction. If the loan certificates have been repaid in full, then the proceeds of the sale in excess of F percent of the Equipment's cost will be paid to B up to the amount of the Lump Sum Payment. However, if at Trust's option, Trust retained the Equipment and the entire principal amount and accrued interest of the loan certificates has been paid or the interest rate has been reset or the loan certificates have been purchased at par plus accrued interest through Date 4, then Trust will pay B an amount equal to the fair market value of the Equipment in excess of F percent of the Equipment's cost, up to the amount of the Lump Sum Payment.

According to the Appraisal of the Equipment obtained by A from Appraiser, B will not be under any economic compulsion to exercise any particular option. Thus, it was not possible for the appraisal to conclude which option A would be most likely to exercise at the end of the Lease Term.

LAW AND ANALYSIS

I. Whether The Sale-Leaseback Transaction Lacks Economic Substance

In order 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); 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.

Equipment Cost. I percent of the Equipment Cost equals $6. The Lump Sum Payment is equal to H percent of Equipment Cost which equals $5.

In determining if a transaction has economic substance, both the objective economic substance of the transaction and the subjective business motivation of the taxpayer 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). 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. Consequently, in considering whether a sale-leaseback case has economic substance, the Tax Court in Levy v. Commissioner, 91 T.C. 838, 856 (1988), found the following factors to be "particularly significant":

> The presence or absence of arm's-length price negotiations, Helba v. Commissioner, 87 T.C. 983, 1005-1007 (1986), affd. 860 F.2d 1075 (3d Cir. 1988); see also Karme v. Commissioner, 73 T.C. 1163, 1186 (1980), affd. 673 F.2d 1062 (9th Cir. 1982); the relationship between the sales price and fair market value, Zirker v. Commissioner, 87 T.C. 970, 976 (1986); Helba v. Commissioner, supra at 1005-1007, 1009-1011; the structure of the financing, Helba v. Commissioner, supra at 1007-1011; the degree of adherence to contractual terms, Helba v. Commissioner, supra at 1011; and the reasonableness of the income and residual value projections, Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 204-207.

Accordingly, an equipment sale-leaseback will be considered a sham if it (1) was not motivated by any economic purpose outside of tax considerations, and (2) was without any real potential for profit. See Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985).

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

Subsequently, the Court of Appeals for the Second Circuit applied an economic substance analysis in Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), affg. 44 T.C. 284 (1965). In that case, the taxpayer won the Irish Sweepstakes. In an attempt to shelter her winnings from tax, she borrowed from two banks and invested the loan proceeds in Treasury notes. The loans required her to pay interest at 4 percent, while some Treasury notes yielded one-half percent and others yielded 1-1/2 percent. Her financial advisers estimated that these transactions would produce a pretax loss of $18,500 but a substantial after-tax gain. The court disallowed the interest deductions because it found that the taxpayer's purpose in entering into the loan transactions "'was not to derive economic gain or to improve here [sic] beneficial interest; but was solely an attempt to obtain an interest deduction as an offset to her sweepstakes winnings." Id. at 738. The court stated further that the loan arrangements did not "have purpose, substance, or utility apart from their anticipated tax consequences," and that the transactions had no "realistic expectation of economic profit." Id. at 740.

Goldstein is significant because unlike many purported tax shelters, the tax-motivated transactions in that case were not fictitious. Goldstein v. Commissioner, supra at 737-738. They were real and conducted at arm's length. The taxpayer's indebtedness was enforceable with full recourse and her investments were exposed to market risk. Yet, the strategy was not consistent with rational economic behavior in the absence of the expected tax benefits.

Other courts have applied the teaching of Goldstein in varied settings. For example, in Sheldon v. Commissioner , 94 T.C. 738 (1990), the Tax Court denied the taxpayer the 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 was 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.

Even in cases in which a circular flow of funds was not the predominant feature, courts have indicated that a minimal profit should not be conclusive in finding economic substance or practical economic effects. Minimal or no profit has been held to be acceptable in highly risky circumstances, where a chance for large profits also existed. See Bryant v. Commissioner, 928 F.2d 745 (6th Cir. 1991); Jacobson v. Commissioner, 915 F.2d 832 (2d Cir. 1990). Conversely, a minimal profit should be less acceptable when a ceiling on profits from a transaction is all but certain. Thus, if tax considerations predominate, the courts will find that an equipment leasing transaction is a sham even if it holds out the promise of minimal profit. See Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990); Prager v. Commissioner, T.C. Memo. 1993-452. The fact that the taxpayer is willing to accept minimal returns in a transaction with little additional profit potential is evidence that the transaction was tax motivated.

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 Third Circuit Court of Appeals 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. In addition, the court specifically affirmed the Tax Court's adjustment of future income to net present value to determine the profit potential of a transaction under the judicially created economic substance doctrine. The court rejected the argument that there is no statutory basis for using present values, and cited several cases sustaining the use of present value computations to determine the true profit potential of a transaction.

In United Parcel Service of America, Inc., 254 F.3d 1014 (11th Cir. 2001) the Eleventh Circuit recently reversed the Tax Court on the issue of economic substance finding that UPS' restructuring of its excess-value business had both real economic effects and a business purpose. The Court reasoned that setting up a transaction (that otherwise has economic substance) with tax planning in mind is permissible as long as it figures in a bona fide, profit-seeking business purpose. We do not believe that this opinion will have a negative effect on the instant case because, for the reasons articulated below, we do not believe that the transactions had a bona fide profit-seeking business purpose. Also, unlike UPS, A is not in C in business. Moreover, the Eleventh Circuit recently affirmed the Tax Court's determination that a transaction entered into by the taxpayer was a substantive sham. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001).

In Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001), the Fifth Circuit found that Compaq made a pretax profit and had a non-tax business purpose on Royal Dutch ADR transactions. See also, IES Indus. v. United States, 253 F.3d 350 (8th Cir. 2001). While these cases have not changed our analysis in the instant case, we recommend that you carefully scrutinize any claim of pretax return and determine if it is insubstantial when compared to the post-tax returns.

A. The Circular Flows of Funds Involved in the Sale-Leaseback Transaction Entered into by A, Trust, B, and Lender Illustrates that A had no subjective profit motive and the transactions had no objective economic substance

On the funding date, the sale, leaseback, loan and swap transactions all commenced, creating two complete circular flows of funds yielding a net cash flow of zero. According to the Documents, the following three transfers of $2 took place on the funding date: (1) Lender lent $2 to Trust; (2) Trust contributed the $2 together with the Equity Contribution from A to B for the purchase of the Equipment; and (3) B transferred $2 to Lender pursuant to the Swap Agreement. Accordingly, $2 ended where it started, with Lender. Additionally, according to the Documents, the following three streams of payments were agreed to and initiated as of the funding date: (1) Pursuant to the Lease Agreement, B would pay lease payments to Trust for use of the Equipment; (2) Pursuant to the Loan Agreement, Trust would make loan payments to Lender for principal and interest owed on the purported $2 loan from Lender to Trust and the Loan Agreement also provided that B would pay the lease payments it owed Trust directly to Lender; and (3) Lender would make payments to B pursuant to the Swap Agreement. The amounts of all of the payments were equivalent and the payments were all due on the same date. However, the Lease payment made on Date 3 exceeded the amount of the Loan payments and Swap payments due on Date 4. Except for the payment made on Date 3, the three streams of payments yielded a net cash flow of zero. Thus, A does not appear to have an expectation of profit from the rental payments independent of tax benefits.

The Custodial Agreement entered into by B and the Foundation completed the circular flow of funds. B transferred funds from the Equity Contribution to the Foundation. The Foundation used the funds from the Equity Contribution to purchase two Treasury strips. One strip matured to the Net Rent due on the first Lease payment. The second strip matured to the Net Purchase Option price in the amount of $8. The remaining portion of the Purchase Option Price, $3 is part of another circular flow of funds. On Date 4, the amount due from A to Lender outstanding on the loan certificates is $3 and the amount due from Lender to B on the Swap Agreement also equals $3. On Date 4, the $3 makes a complete circle between the three parties to the transaction with no net outflow of cash from any of the parties. Accordingly, the amount of the matured treasury strip provided B with sufficient cash to exercise the Purchase Option price without any further outlay of cash by B. Thus, A has no risk that B would have insufficient funds to exercise the Purchase Option on Date 4.

Additionally, B has business motives to reacquire the Equipment. The acquisition of the Equipment was part of B’s modernization program. Furthermore, B is in the business of C in Country C and is the likely party to wish to operate the Equipment.

Since A had no opportunity to earn a profit on the deal during the Lease Term, the only opportunity for A to earn a profit was on Date 4. However, the following analysis of the three options shows that A would not earn a profit on Date 4, either.

1. The Purchase Option

The Purchase Option is the most economically preferable option. By drawing on the funds held by Foundation, by Date 4, B would have the funds necessary to exercise the Purchase Option without any additional costs. If the Equipment appreciated to a fair market value greater than the Purchase Option price, B, acting rationally, would exercise the Purchase Option to take advantage of the bargain price. If the Equipment depreciated to a fair market value lower than the Purchase Option price, B, acting rationally, would still exercise the Purchase Option because, as will be illustrated in the following discussion, the Purchase Option is still the most economically advantageous option. Additionally, B has a business motive to exercise the Purchase Option and retain the Equipment.

If B exercises the Purchase Option on Date 4, A receives a very small profit on its Equity Contribution. The Purchase Option Price is $4. However, A will owe Lender $3 leaving A a net return of $8 which is the Net Purchase Option Price. On Date 4, Lender will owe B $3 pursuant to the Swap Agreement. Accordingly, the $3 goes in a complete circle and ends where it started, with B. B can take the funds from the treasury strip that matures on Date 4 to $8 to pay the Net Purchase Option price. Accordingly, B has no additional outlay of costs to exercise the Purchase Option.

2. The New Lease Option

It also appears that exercising the New Lease Option would put B in a worse position, economically, than exercising the Purchase Option. Under the New Lease Option, the Lease payments were predetermined as of the funding date. Thus, if B were to find a New Lessee, the parties would not be able to renegotiate the New Lease payments so that they would be in accord with the then fair market value. If B wished to find a New Lessee and the Equipment appreciated in value so that the New Lease payments were less than fair market value, B, acting rationally, would exercise the Purchase Option and then lease the Equipment, itself, to take advantage of the appreciation in value. If the Equipment depreciated in value so that the New Lease payments would be a higher price than the market would otherwise bear, B would have to pay an inducement to the New Lessee. In this circumstance, B would have to pay the inducement and not have the Equipment. Acting rationally, we believe that B would exercise the Purchase Option and then lease the Equipment, itself. In doing so, B would be able to find another entity to lease and operate the Equipment but would not have any further costs with respect to the sale-leaseback transaction with Trust.

However, there are significant litigation hazards unless it can demonstrate that the New Lease Option is purely illusory. The New Lease Option could be viewed as a negotiated protection inserted into the Lease Agreement. For the Trust and Lender, the New Lease Option offers the protection of a long term, fixed rate of return based on a lease term of as many as X years for the Equipment in the event B does not exercise its Purchase Option. For B, the New Lease Option offers protection against being forced to either buy the Equipment or walk away with a large expenditure and no Equipment. Nonetheless, we believe that the rational choice is the Purchase Option.

3. The Return Option

Exercising the Return Option would put B in a worse position, economically than exercising the Purchase Option. If B exercises the Return Option, then B will be required to pay A the Lump Sum Payment equal to H percent of the original Equipment cost which is $5 and A will sell the Equipment at auction. A will pay B proceeds from A’s sale of the Equipment greater than F percent of the Equipment Cost and up to the amount of the Lump Sum Payment. If B exercised the Return Option, B would have funds available in the Foundation to pay the Lump Sum; however, B would not have any Equipment. Pursuant to the terms of the Return Option, B would get some of A’s Equipment sale proceeds. However, B would not be able to receive the first $7[5] of A’s Equipment sales proceeds and would not be able to receive more than the Lump Sum amount. B would not be able to recoup a sufficient amount to purchase the same or alternative Equipment. Thus, B would be in a worse economic position if it exercised the Return Option than if it exercised the Purchase Option. Since it is the economically rational choice to select the Purchase Option, regardless, of whether the property appreciates or depreciates in value, A has no opportunity to profit from appreciation in the property, nor to suffer a loss from depreciation in the property.

A's only net return on the transaction is the Net Rent paid on Date 3 and the Net Purchase Option price paid on Date 4. Those amounts are very small compared to the tax benefits that A enjoys during the Lease Term. A minimal profit should not be conclusive in finding economic substance or practical economic effects. Minimal or no profit has been held to be acceptable in highly risky circumstances, where a chance for large profits also existed. See Bryant v. Commissioner, 928 F.2d 745 (6th Cir. 1991); Jacobson v. Commissioner, 915 F.2d 832 (2d Cir. 1990). However, a minimal profit should conversely be less acceptable when a ceiling on profits from a transaction is all but certain. A's willingness to accept minimal returns in a transaction with a limitation on profit potential demonstrates that the transaction was tax motivated. Thus, a minimal profit in an equipment leasing transaction will not prevent the finding

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[5] F percent of the Equipment Cost is $7.

of a sham if tax considerations predominate. See Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990); Prager v. Commissioner, T.C. Memo. 1993-452.

Arguably, the only motivation for this transaction was A's desire to "purchase" tax benefits. This transaction could reasonably be viewed as a "sale" of tax benefits by an entity which cannot use them to a taxable entity which can. In exchange for its equity investment, A received a substantially greater amount of tax benefits by claiming depreciation, amortization and interest expenses each year over the life of the transaction. Because it appears likely that Trust will exercise the Purchase Option, and all amounts have been pre-funded, this transaction shares many factual similarities with other cases decided under economic substance principles. See Knetsch supra (offsetting legal obligations).

In form, this transaction was a sale/leaseback between A and B financed by a loan from Lender, with an embedded currency swap with the purported purpose of protecting B from currency exchange risk. In the instant case, a currency swap was used to complete a circular flow of funds. A currency swap agreement is two offsetting loans in two different currencies. By substituting a currency swap between Lender and B for a loan from B to Lender, the transaction embeds what is in substance a loan from Lender to B in what would otherwise be a sham transaction involving a circular flow of funds.

All the cash flows were circular and yielded net proceeds of zero, thus, A had no economic risk in undertaking the transaction; and A has a cap on the possibility of earning a profit from this transaction or bearing any significant costs either during or at the expiration of the Lease Term, this series of transactions lacked the potential for any significant economic consequences and therefore lacked economic substance and had no business purpose. See, e.g., Rice's Toyota World;Nicole Rose; Levy. For this reason we believe economic substance principles may be applied in this case.

Accordingly, A is not entitled to deduct the depreciation deductions claimed for the Equipment purportedly purchased by A pursuant to the transaction. Further, the interest deductions at issue in the instant case stem directly from the Loan taken by A through Trust. The loan cannot be separated from the purported sale transaction whose sole purpose was for A to obtain tax benefits. As such, the Loan was an integral part of the transaction and a deduction for the interest on the Loan is not allowable under section 163.

II. Whether The Transaction Should Be Treated As a Financing Rather Than As a Sale-Leaseback

Alternatively, the transaction should be treated as a financing. Whether a sale-leaseback is respected for federal income tax purposes is not determined by the labels of the parties. In Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939), the Supreme Court stated that, "taxation... [is] concerned with substance and realities, and formal written documents are not rigidly binding." 308 U.S. at 255. In Lazarus, the taxpayer conveyed property to a bank and then leased the property back for a term of ninety-nine years. The Court concluded that the transaction, though structured in the form of a sale-leaseback, was in substance a loan secured by the property. It held that the taxpayer was the party who bears the burden of exhaustion of capital investment in the property and thus, is entitled to deduct depreciation regardless of the fact that the taxpayer had by agreement designated another party as the legal owner. Lazarus stands for the proposition that, in the sale-leaseback area, the substance of the transaction rather than its form is controlling for federal tax purposes.

In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court set forth standards for determining when a sale-leaseback may not be ignored as a sham, holding that "so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes." Id. at 584. In Frank Lyon, the Frank Lyon Company's (Company) majority shareholder and board chairman also served on the board of Worthen Bank (Bank). The Company invested $500,000 of its own funds to acquire a new office building from the Bank and lease it back to the Bank for an initial term of 25 years. The Company financed the remainder of the building with a full recourse loan of $7,140,000 obtained from an unrelated insurance company. The rent for the first 25 years equaled the principal and interest payments that would amortize this loan. The Company also leased the land under the building from the Bank for 76 years. The Bank had the right to renew its lease of the building for eight additional 5-year intervals at a fixed rent making its total potential leasehold 65 years long. The Bank had the option to purchase the building at 11 years and at other points in the lease for the Company's investment with compound interest at 6 percent plus repayment of the loan balance. The Bank also had the option to purchase the building at fair market value under certain conditions involving a transfer of the Company's interest. Under applicable federal and state law, the Bank was precluded from financing an office building of that magnitude for its own use. However, the state and federal regulators approved the sale and leaseback so long as the Bank had an option to purchase the property after 15 years at a fixed price where another party owned the building.

The Government argued that the sale leaseback should be disregarded as a sham, because the Company was only acting as a conduit to forward rent payments to pay the mortgage and was doing so for a guaranteed return. In rejecting the sham argument, the Court distinguished Lazarus because it involved two rather than three parties. The third party (the lender) was necessary to the transaction in Frank Lyon because of the restrictions on borrowing imposed on the Bank. The Court found it significant that the Bank could not legally own and finance its own building. The Court emphasized that the Company had assumed recourse liability in the debt, and thus it had exposure to real and substantial risk. Moreover, the Court rejected the contention that the purchase options allowed the Bank to accumulate equity in the property over time because the Bank was free to walk away without further obligation without exercising any lease extension and, alternatively, the option prices represented fair estimates of market value on applicable dates. The Court also noted that the Company would be free to do with the building as it chose if the lease were not extended, but would remain liable for the ground rent. The Court concluded, at 583-84, that:

> Where...there is a genuine multi-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. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts.

The decision in Frank Lyon rested strongly upon the risks incurred by the Company, including the recourse debt, the ground rent, and the possibility the lease would not be extended (significantly, without any compensation to the Company), and the rewards of the use of the property if the Bank did not extend the lease. Such risks gave the Company the significant attributes of a lessor. No similar risks were incurred in the present case. Here, the Loan is subject to satisfaction and the risks as well as the potential gains from the transaction have been carefully collared to limit both potential loss and profit by A. While it is true that Frank Lyon suggests rental payments in a lease may match up to the amount of principal and interest necessary to amortize a loan, that case involved the construction of a building that, implicitly at least, could be used by any lessee. That the payments match up, therefore, is not significant unless it reinforces the view that the lessor's risks and rewards indicate the lessor is not the owner of the property. Significantly, therefore, the below analysis will show that the risks and the potential gains from the transaction to A have been carefully collared to limit both potential loss and profit to A.

Moreover, in Frank Lyon the Bank was precluded by federal and state regulations from financing and constructing the building itself. No such restrictions are present in this case because B owned the Equipment prior to the effective date of the transaction here. Accordingly, although the legal principles of Frank Lyon (that is, focusing on the substance of the transaction) are appropriate to an analysis of this transaction, that case is factually distinguishable from the present case.

Despite the government's inability to demonstrate, on the facts in Frank Lyon, that the Company was simply financing the Bank's building purchase, many courts have addressed whether a sale-leaseback was, in substance, a financing, that is, whether the purported owner/lessor simply lent money to the purported seller/lessee. A particularly instructive example is Pacific Gamble Robinson and Affiliated Companies v. Commissioner, 54 T.C. Memo. 915 (1987). There, petitioner (PER) sold its Yakima Apple Facility to Third Birkenhead Properties Inc. for $500,000; $490,000 of which was financed with a nonrecourse note payable to Minnesota Mutual Life Insurance Company. At the same time, the facility was leased back to PER for a 25-year primary term and six 5-year renewal terms. During the primary lease term, the rental payments equaled the payments due from Third Birkenhead to Minnesota Mutual on the note. Third Birkenhead had the right to require PER to buy the facility at the end of the basic lease term under a predetermined price schedule for a stated purchase price nearly equal to the then outstanding balance owed on the note. This lease provision was amended to require PER to offer to buy the facility at the end of the primary term for the greater of its then fair market value or the outstanding balance owed on the note. It was unlikely that the fair market value of the facility would exceed the outstanding balance on the note. New notes were later issued that provided that the lenders would look solely to the facility and to the sums due from PER under the lease for repayment on the notes. Under the new notes, PER agreed to pay the installments when they became due.

The Tax Court disregarded the form of the transaction as a sale-leaseback as inconsistent with its economic substance. It held that PER was in substance the "owner" of the facility for federal tax purposes. The court cited several factors to support its holding: (1) As a matter of economic reality, PER (the "lessee"), not the lessor, was principally liable on the debt; (2) PER, not the lessor, retained the primary benefits and burdens of ownership associated with the facility; and (3) the lessor had no reasonable opportunity for economic profit from the transaction absent tax benefits.

Similarly, in situations involving the characterization of sale-leaseback transactions, the Service consistently has held that the substance of a transaction is controlling for federal tax purposes. For instance, Rev. Rul. 72-543, 1972-2 C.B. 87, concluded that a transaction in the form of a "sale-leaseback" is in fact a financing where under the terms of the leaseback, the taxpayer-lessee never actually parted with the benefits and burdens of ownership to the property for federal income tax purposes. In that ruling, the taxpayer, a shipping company financed reconstruction of a vessel by "selling" title to the vessel to the subsidiary of a bank for the vessel's then fair market value. The subsidiary borrowed the cost of the acquisition and reconstruction from a group of lenders under a "charter party," an agreement whereby the subsidiary leases the vessel to the taxpayer for use in its transportation business. At the same time, the subsidiary assigned all of its rights, title and interest to the monies due under the charter party to the lenders. Under the agreement, the subsidiary chartered the vessel to the taxpayer for a 21-year term at a rental rate sufficient to pay the total costs of acquiring and reconstructing the vessel plus interest over the 21-year period. The 21-year term exceeded the vessel's useful life. The taxpayer was at risk for the vessel at all times during this term and had to maintain insurance. The charter gave the taxpayer the right to buy the vessel on the 9th anniversary of delivery for a predetermined price equal to the unamortized principal amount of the loan on that date.

Rev. Rul. 72-543 concluded that the taxpayer held the benefits and burdens of ownership to the vessel since (I) it was obliged to repay the costs of acquisition and reconstruction plus interest in the form of rentals; (ii) it had to pay the vessel's operating and insurance costs; (iii) it had an option to purchase the vessel for the unamortized principal amount of the loan at a specific anniversary date; and (iv) the parties intended for legal title to pass to taxpayer. Although cast in the form of a sale-leaseback, the ruling held that the transaction, when viewed in its entirety, was a financing arrangement with ownership of the vessel in the taxpayer.

Thus, whether a transaction is a sale, a lease, or a financing arrangement is a question of fact, which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). The judicial test for determining if a transaction is a sale, as opposed to a lease or a financing arrangement, is whether the benefits and burdens of ownership have passed to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229 (1987). For this purpose, the “refinements of title” are not dispositive. Corliss v. Bowers, 281 U.S. 376, 378 (1930). In fact, even if the vesting of title in someone other than taxpayer created a prima facie case that the taxpayer was not the owner of certain equipment for depreciation purposes, the Tax Court, in Coleman v. Commissioner, 87 T.C. 178, 202 n. 18 (1986), aff'd, 833 F.2d 303 (3d Cir. 1987), acknowledged that the location of title did not mean that it was holding that taxpayer was not the owner. Instead, the location of title meant only that the taxpayer had the burden of producing "strong proof" that the other benefits and burdens of ownership were held by the taxpayer. 87 T.C. at 203-04. The court's opinion in Coleman analyzed the benefits and burdens of ownership of the equipment and concluded that the taxpayers failed to demonstrate that it held the incidents of ownership to the equipment.

The Tax Court analyzes the following factors to determine if the benefits and burdens of ownership pass in a transaction: (1) whether legal title 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. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981). Although the potential for gain and amount of risk have been deemed the pivotal factors, the overall concentration should lie on the economic substance of the transaction. Mapco, Inc. v. United States, 556 F.2d 1107, 1111 (Ct. Cl. 1977).

The Tax Court has also considered the following factors as being relevant to determining whether a sale has occurred (that is, whether to respect a sale-leaseback): (1) the existence of a useful life of the property in excess of the leaseback term; (2) the existence of a purchase option at fair market value; (3) renewal rental at the end of the leaseback term set at fair market rent; and (4) the reasonable possibility that the purported owner of the property can recoup his investment in the property from the income producing potential and residual value of the property. Torres v. Commissioner, 88 T.C. 702, 721 (1987) citing Estate of Thomas v. Commissioner, 84 T.C. 412, 436 (1985); Mukerji v. Commissioner, 87 T.C. 926 (1986). The Tax Court in Torres has found the taxpayer's equity interest as a percent of the purchase price to be significant, and it further noted that a sale-leaseback involving a net lease has certain specific characteristics, 88 T.C. at 721:

> [B]ecause net leases are common in commercial settings, it is less relevant that petitioner was not responsible for the payment of property taxes or that petitioner bears less of a risk of loss or damage to the property because the lessee is required to maintain insurance on the property. Similarly, a lessor is normally not vested with the right to possession during the term of the lease and, therefore, the relevant consideration in this regard is whether the useful life of the property extends beyond the term of the lease so as to give the purchaser a meaningful possessory right to the property. Also, in a leaseback transaction it is normal for the lessee to receive profits from the operation of the property while the lessor's receipt of payments is less dependent upon the operation of the property.

Since no one factor is dispositive of the issue of whether a sale has occurred, the facts and circumstances determine the importance of each factor. For example, whether the buyer has acquired an equity interest in the property may be considered substantive evidence of a sale. See Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976). However, a taxpayer who acquires no equity interest in the property has no depreciable interest in the property, but instead will be viewed as having attempted to acquire mere tax benefits. Houchins v. Commissioner, 79 T.C. 570, 602 (1982). In this context, equity consists of a positive differential between the fair market value 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. Thus, a true owner has potential for gain or loss from increase or decrease in the market value of the property. In contrast, a mortgagee's economic return, consisting of interest payments and return of principal, is generally fixed at the time of the initial transaction, irrespective of fluctuations in market value of the property.

Given these overlapping lists of factors, we proceed first to examine the factors set out in Grodt & McKay and then analyze the factors set out in Torres to determine if the benefits and burdens of ownership pass in a transaction and whether a sale has occurred. This analysis will then determine whether A is entitled to the depreciation deductions A claimed for the Equipment purportedly purchased pursuant to the sale-leaseback transaction.

A. Grodt & McKay Factors

1. Whether Legal Title Passed

Pursuant to the Participation Agreement and Deed of Conveyance, B sold, assigned and transferred to Trust all of B's right, title, and interest in the Equipment. The Participation Agreement further provided that if B elects to exercise the Purchase Option on Date 4, Trust "shall execute and deliver to B appropriate instruments conveying Trust's right, title and interest in and to the Equipment to B or its designee." Even though title passed from B to Trust at the outset of the transaction, the facts also suggest the likelihood that B will exercise the Purchase Option to regain all right, title and interest to the Equipment on Date 4. Additionally, the purchase of the Equipment is part of B's modernization program giving B a business incentive to retain the Equipment. If B exercises the Purchase Option on Date 4, this feature indicates that title is only held temporarily by Trust in a form more akin to holding it as security. As such, the Sale-Leaseback Transaction looks more like a secured financing than a sale. See Rev. Rul. 72-543.

2. Whether the Parties Treated the Transaction as a Sale of Equipment

The Documents were prepared in the form of a sale. Moreover, A reported this transaction for federal income tax purposes as a sale and claimed United States tax ownership of the Equipment. A is deducting depreciation expenses for the Base Term and A treated the transaction on its books as an asset purchase. Pursuant to the Tax Indemnity Agreement, B agreed not to claim ownership of the Equipment for United States tax purposes which is consistent with treating the transaction as a sale. This factor appears to favor sale-leaseback treatment.

3. Whether A Acquired an Equity Interest in the Equipment

The Documents are drafted to indicate that A made a J percent equity contribution to the purchase of the Equipment. If "equity" is defined as the difference between the Equipment's fair market value and the amount of the Loan,[6] and assuming the sale price represents fair market value, then A has an equity interest equal to J percent of the Equipment. An owner's equity interest in property is distinguished from a mortgagee's security interest in property by the potential for appreciation or depreciation in the value of the property, the potential to profit from use of the property at the expiration of the lease term, and the nature of its risk of loss.

[6] Crane v. Commissioner, 331 U.S. 1, 7 (1947).

Here, A’s funds are more in the nature of principal on a secured financing than an equity interest in the Equipment since, as a result of the nature of the three options held by B at the end of the Base Term, it appears that A has capped its right to potential appreciation in the Equipment at the difference between the Purchase Option price and the amount necessary to repay Lender. If the value of the Equipment at the end of the Base Term exceeds this differential, B, acting rationally in its economic interest, will exercise the Purchase Option and reacquired title to the Equipment. As discussed above, the Purchase Option is the most economically advantageous option for B to exercise. Acting rationally, B would exercise the Purchase Option regardless of whether the Equipment had appreciated or depreciated in value compared to the projected fair market value set forth in the appraisal. Given B's exercise of the Purchase Option, A is prevented from obtaining a profit from potential appreciation in the fair market value and A is protected from suffering a loss due to depreciation in fair market value. Accordingly, A’s position is more in the nature of a secured mortgagee rather than as an equity owner. See Lazarus.

4. Whether the Sale Contract Obligated B to Execute and Deliver a Deed and Obligated A to Make Payments

B transferred to Trust all of B's right, title and interest in the Equipment. Additionally, according to the Documents, A must make semiannual payments to Lender on the Loan. However, pursuant to the Loan Agreement, those payments were to be paid to Lender by B in the form of B depositing its lease payments to Trust directly to Lender. Moreover, since the most economically realistic option for B to exercise on Date 4 is the Purchase Option, which will return title to the Equipment to B, it appears that the documents created a circular delivery of the deed. That is, it appears that A only has a "loan" of the deed or bill of sale during the Base Term, after which the title to the Equipment returns to B. Such circular delivery, or "loan," of the deed is more consistent with treating A as holding a security interest in the Equipment. See Lazarus.

This view is supported by the flow of funds concerning A, which is, with the exception of the first Lease payment, offset by the remaining Loan payments with rental income it receives from B. This point is further illustrated by the fact that pursuant to the Loan Agreement, B was to deposit its lease payments directly to Lender. In each instance, the amount of the rental income equals the amount of the Loan payment and the rent and loan payments are due and payable on the same date. If B exercises the Purchase Option, B is essentially "lending" title of the Equipment to Trust for A for the Base Term. In substance the deed transfer may only be temporary since it is more than reasonable to contemplate the return of the Equipment to B.

5. Whether the Purchaser Is Vested with the Right of Possession

The right of possession factor favors a financing since there is no indication that the parties ever manifested an intent for Trust or A to actually "possess" the Equipment.

Generally a sale-leaseback contemplates that the buyer-lessor wants possession of the property at the end of the lease term. In a financing, however, the mortgagee typically does not want use or possession of the property. When A acquired the Equipment pursuant to the Documents, A, through Trust, had no right to sell the Equipment to anyone other than B or even hold it out for lease to the highest bidder prior to its leaseback to B. In fact, B already had possession of the Equipment at the time the transaction was entered into. All of Trust's activities thus were circumscribed so as to keep the Equipment under the possession and control of B at all times. B also controls whether A will possess the Equipment on Date 4 by unilaterally determining which option it will exercise. Arguably, such limitations on possession are inconsistent with the benefits and burdens of ownership. A does not have control to determine if it will ever obtain possession of the Equipment.

In addition, the Lease prevents Trust, acting for A, from taking possession of the Equipment unless necessary to protect its rights, as in the event of default. These conditions are essentially the same as the conditions in which a secured creditor would take possession of the secured property. See Rev. Rul. 72-543. However, while the Documents appear to make possession by A a possibility, this possibility is unlikely since B is most likely to exercise the Purchase Option on Date 4. Consequently, when this transaction is taken as a whole, A has not shown any intent to possess the Equipment. This factor favors financing treatment.

6. Whether the Purchaser Pays Property Taxes after the Transaction

B is responsible for all property taxes. Under the Participation Agreement, B is responsible for all applicable customs duties and stamp taxes and all other taxes in respect of the Equipment. However, this factor is neutral since this is common to net leases. See Torres, 88 T.C. at 721.

7. Whether the Purchaser Bears the Risk of Economic Loss or Physical Damage

As discussed above, if the Equipment declines in value such that its fair market value on Date 4 is lower or higher than the fair market value projected in the Appraisal, then B, acting rationally, will still exercise the Purchase Option. This factor insulates A from suffering a loss due to depreciation in the market place. Rather, the loss would be suffered by B since B would reacquire its Equipment at a lesser value. Thus, B is the party that ultimately is affected by market decline.

The Lease requires B to maintain insurance on the Equipment and to replace or repair the Equipment in the event of damage or destruction. These requirements are typical in a net lease situation, nonetheless they do insulate A from obligations in the event of physical loss of the property. As noted above regarding the risk of loss of value of the Equipment, the Purchase Option price amount and the rental stream for any New Lease apparently were determined by reference to the amount necessary to repay the

Loan and guarantee that A would receive a certain rate of return on the transaction. These provisions essentially insulate A from any risk of physical loss of the property. Further, these conditions essentially shift the risks to B. B's risk of loss is more like that of an owner/mortgagor, while A's fixed return and entitlement to payment without regard to damage to the collateral are consistent with the risks of a mortgagee. See, e.g., Helvering v. F.& R. Lazarus & Co.

8. Whether the Purchaser Receives the Profit from the Property's Operation

Courts have consistently found that the potential for profit or loss on the sale or release of the property is a crucial benefit or burden of owning property. Gefen v. Commissioner, 87 T. C. 1471, 1492 (1986). At all times after the transaction is initiated, B operates the Equipment and receives the profit, if any, therefrom. This is consistent with a lessee's right to operate property under a valid lease. In this case, however, as previously discussed, the amount B must pay under the Purchase Option, the Return Option, or the New Lease Option, results in either a ceiling on A's potential for profit or a floor under its potential for loss. For example, if the Equipment appreciates to a fair market greater than that projected by the Appraisal, B will exercise the Purchase Option. As such, A's potential profit from the Sale-Leaseback Transaction is capped at the difference between the Purchase Option price and the amount owed by Trust to Lender on Date 4. Since the Purchase Option price is preset as of the funding date, A is not able to profit from appreciation in fair market value. Rather, B, having exercised the Purchase Option, will be able to benefit from appreciation in the fair market value. This factor indicates that the transaction has the character of a financial arrangement.

B. Torres Factors

1. The Existence of a Useful Life of Property in Excess of the Leaseback Term

According to the Appraisal, the Equipment has a useful life of approximately W years, which exceeds the Base Term by V years. Even if the term of a New Lease is aggregated with the Lease to B, the combined lease term is U years, which is T years less than the Equipment's useful life. In accordance with the Lease, B will cause each piece of Equipment to be serviced, repaired, maintained, overhauled and tested during the term of the Lease, which should allow the Equipment to reach or exceed the estimated useful life. However, since B is expected to exercise the Purchase Option at the end of the Base Term, the additional useful life may not benefit A. Because control of whether to exercise the Purchase Option rests with B and because the Purchase Option is the most likely to be exercised by B, this factor does not strongly support sale-leaseback treatment.

2. The Existence of a Purchase Option at Fair Market Value

The Appraisal provides that the fair market value at the end of the Base Term is estimated to be I percent of the cost of the Equipment. Under the Lease, the Purchase Option Price is set at E percent of the cost of the Equipment. Thus, the Purchase Option price exceeds fair market value by a small amount. Nevertheless, because the appreciation potential of the Equipment is capped by this amount, this factor arguably favors treatment as a financing arrangement.

3. Renewal Rental at the End of the Leaseback Term Set at Fair Market Value

The rental schedules appear to have been determined by reference to the amount required to repay the loan and Equity Contribution and to guarantee A's return on investment. This coupled with the fact that B may have to pay an inducement in order to acquire a New Lessee, indicates that the renewal rent is not set at fair market value.

Moreover, assuming rental rates increase, under the Documents, Trust has the right to reject the New Lessee chosen by B and recover the Equipment. This feature would seem to indicate that Trust has some appreciation potential in that it can find its own lessee to rent the Equipment at a higher rental rate. However, if the Equipment appreciates in value, B could simply exercise the Purchase Option, recover title to the Equipment, and either use it, or release it at the higher rental rate reflected by the Equipment's then fair market value. This factor actually indicates that the risks of a decline, or the rewards of an increase, in the then fair market rental value of the Equipment have shifted to B. This shift is inconsistent with the risks and rewards to a lessor associated with the requirement that any renewal or release of property be set at fair market value. Therefore, this factor supports treatment of the transaction as a financing arrangement.

4. The Reasonable Possibility That the Purported Owner of the Property Can Recoup its Investment in the Property Based on its Income-Generating Potential and Residual Value of the Property

Under the structure of the transaction, A actually received very little net income stream during the Base Term since, except for the first Lease payment, all Lease payments made by B equal all Loan payments made by Trust for principal and interest. Consequently, since the rental stream essentially equals the debt service, there is very little income-generating potential to A during the Base Term. Accordingly, A can only look to either the payment received upon exercise of the Purchase Option or the Return Option, or to payments under an extension of the Lease under the New Lease Option, for the recoupment of, and a return on, its investment.

In the event the Purchase Option is exercised, A would only recover its investment out of the Purchase Option payment and thus its profit is capped at the difference between the Purchase Option price and the amount owed to Lender on Date 4. If the New Lease Option were exercised, A would see a positive cash flow during the New Lease Term. Superficially, this factor favors the treatment of the transaction as a sale-leaseback since A would receive a profit on the New Lease. However, as the above analysis indicates, the terms of the transaction have shifted the risks and rewards of ownership essentially to B from Trust and A. Only if the transaction continues through the end of the New Lease term and the Equipment then returns to Trust, would A have an uncollared risk of loss and opportunity for appreciation. This will likely never occur because it is economically more advantageous for B to exercise the Purchase Option. Therefore, although A will recoup its investment, the specified rate of return and collared risk and reward indicate that it is in the position of a mortgagee, not a bona fide owner.

Since the above factors indicate that A stands more in the position of a mortgagee than a bona fide owner, the benefits and burdens of ownership did not pass to A as a result of this transaction. Accordingly, the transaction should be treated as a financing rather than as a sale-leaseback. As such, A is not treated as the owner of the Equipment and therefore is not entitled to the depreciation deductions A claimed on the Equipment.

III. Whether A Received Original Issue Discount Income as a Result of this Purported Sale-Leaseback Transaction.

If (1) the Sale-Leaseback transaction lacks economic substance and (2) the purchase price option will be exercised, A may be required to accrue income on a deemed loan from A to Lender. Section 1273 (a)(1) provides “[t]he term ‘original issue discount’ means the excess (if any) of (A) the stated redemption price at maturity, over (B) the issue price.” To impute OID income in a sale-leaseback transaction, there must be an unconditional obligation to return the principal sum. A “substantial likelihood” is not enough to characterize the Purchase Option as an unconditional obligation. Original issue discount (OID) is imputed on a constant yield basis. See section 1.1272-1(b).

Indebtedness is defined, for federal income tax purposes, as an unconditional obligation to pay a sum certain at a fixed maturity date. Gilbert v. Commissioner, 248 F.2d 399, 402 (2nd Cir. 1957). If we successfully argue that the purchase price will always be exercised, A’s equity payment might be appropriately viewed as a loan with the unconditional obligation to repay a principal sum being both the net rent payment due on Date 3 and the net Purchase Option payment due on Date 4. It is represented that the net rent payment and the net Purchase Option payment constitute the return on A’s equity investment. The amount by which the net rent payment and the net Purchase Option payment exceed the equity payment could be asserted to be OID includable in A’s income. If we are unable to prove that A will receive a fixed amount of cash at the end of the transaction, we will not be able to deem a loan between A and Lender.

Thus, we should also be able to argue that A’s equity payment is a loan if we demonstrate that either the Purchase Option or the Return Option will be exercised. Whether the Purchase Option or the Return Option is exercised, A will be receiving an amount that exceeds its equity payment. The OID calculation is slightly more complicated if we deem the equity payment a loan with repayment being either the amount of the Purchase Option (and net rent payment) or the Return Option (and net rent payment). As a loan with alternative payment schedules, the rules of section 1.1272-1(c) of the Income Tax Regulations would apply to determine the amount of OID includable in A’s income.

A accrues interest based on the ownership of the Treasury strips only if it can be shown that A has control over and derives readily realizable economic value from the Treasury strips. See James v. United States, 366 U.S. 213, 219 (1961). The issue price of the strips is the amount at which the Treasury strips were issued. As owner of the Treasury Strips, A would include in income the OID on the Treasury strips.

If the Sale-Leaseback transaction is viewed as a financing between A and Lender, we believe that A should properly include OID income from the deemed financing. The amount of OID income from the deemed financing would be calculated in the same manner as described above under the economic substance argument.

IV Whether A Is Liable for Penalties, Pursuant to Section 6662 as a Result of this Transaction.

Section 6662 imposes an accuracy-related penalty equal to twenty percent of the portion of the underpayment attributable to, among other things, negligence or disregard of rules or regulations, and any substantial understatement of income tax. Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components and, thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is twenty percent. The accuracy-related penalty does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that A acted in good faith. Section 6664(c)(1).

A. Negligence

Pursuant to section 6662(c) and section 1.6662-3(b)(1) of the Income Tax Regulations, negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of the tax return. Negligence has been defined as the failure to do what a reasonable and ordinary prudent person would do under the circumstances. Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967); Neely v. Commissioner, 85 T.C. 934, 947 (1985). Section 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable person to be "too good to be true" under the circumstances. Where the taxpayer is sophisticated, the court may still find liable even though highly paid professionals were involved. In Nicole Rose v. Commissioner, 117 T.C. No. 27, 2001 TNT 251-11 ¶64, the Tax Court found the taxpayer was liable for an accuracy related penalty pursuant to section 6662 for entering into a series of transactions lacking in business purpose and economic substance and stating that "[t]he participation of highly paid professionals provides petitioner no protection, excuse, justification, or immunity from the penalties in issue. Petitioner participated in a clear and obvious scheme to reap the benefits of claimed ordinary business expense deductions that had no business purpose and no economic substance. The facts and circumstance of this case reflect no reasonable cause and no good faith for petitioner's participation in the transactions before us."

The Tax Court likewise sustained the application of the negligence penalty in Sheldon v. Commissioner, 94 T.C. 738 (1990), stating that the taxpayer intentionally entered into loss-producing repurchase agreements to generate and claim tax benefits.

B. Substantial Understatement

Pursuant to section 6662(d)(1), a substantial understatement of income tax exists for a taxable year if the amount of the understatement exceeds the greater of ten percent of the tax required to be shown on the return or $5,000 ($10,0000 in the case of corporations other than S corporations or personal holding companies). Section 6662(d)(2)(B) provides that understatements are generally reduced by the portion of the understatement attributable to: 1) the tax treatment of items for which there was substantial authority for such treatment, and 2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or a statement attached to the return, and there is a reasonable basis for the taxpayer's tax treatment of the item. These exceptions, however, do not apply to tax shelter items of corporate taxpayers. Section 6662(d)(2)(C)(ii). Thus, if a corporate taxpayer has a substantial understatement attributable to a tax shelter item, the accuracy-related penalty applies to the understatement unless the reasonable cause exception applies. Treas. Reg. §1.6664-4(e), discussed below contains special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation. However, section 6662(d)(2)(C)(iii) which is applicable to the years at issue, defines a tax shelter, among other things, as a plan or arrangement the principal purpose of which is tax avoidance or evasion.

C. Reasonable Cause

Section 1.6664-4(b)(1) provides that the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, generally taking into account all pertinent facts and circumstances. The most important factor is generally the extent of the taxpayer's effort to assess its proper tax liability. Reliance on professional advice may constitute reasonable cause and good faith if, under all the circumstances, such reliance was reasonable. See United States v.

Boyle, 469 U.S. 241 (1985). The advice must also be based upon all pertinent facts and circumstances and the law relating to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose and the relative weight of such purpose for entering into a transaction and for structuring a transaction in a particular manner.

With respect to reasonable cause for the substantial understatement penalty attributable to a corporation's tax shelter items, a corporation is deemed to have acted with reasonable cause and in good faith if the corporation had substantial authority, as that term is defined in section 1.6662-4(d), for its treatment of the tax shelter item, and if at the time of filing the return, the corporation reasonably believed such treatment was more likely than not the proper treatment. Treas. Reg. § 1.6664-4(e)(2)(I).

The "more likely than not" standard can be met by the corporation's good faith and reasonable reliance upon the opinion of a tax advisor if the opinion is based on the advisor's analysis of the pertinent facts and authorities in the manner described in Section 1.6662-4(d)(3)(ii), and the opinion unambiguously states the advisor's conclusion that there is a greater than fifty percent likelihood the tax treatment of the item will withstand a challenge by the Service. Section 1.6664-4(e)(2)(I)(B)(2). A cannot hide behind an appraisal for a transaction lacking in economic substance and claim that it had reasonable cause for entering into the transaction. Nicole Rose.

The circular cash flows and the lack of a valid business purpose evidence that A's involvement in the sale-leaseback transaction was solely due or primarily motivated by the tax benefits, and thus is totally devoid of economic substance. Moreover, if the transaction lacked economic substance and/or A did not truly acquire the benefits and burdens of ownership of the Equipment, then A cannot, in good faith, claim depreciation and interest deductions flowing from the transaction. Therefore, based on the facts presented, assertion of the section 6662 accuracy-related penalty is appropriate in this case.

CASE DEVELOPMENTS, HAZARDS AND OTHER CONSIDERATIONS

In our view, there are several aspects of this case which must be further developed.

First, to support the view that B is compelled to exercise its Purchase Option to acquire the Equipment upon termination of the Basic Lease term, the Field must develop firm evidence that B has effected either a legal or economic defeasance of its obligations. Although it is possible to hypothesize that B purchased stripped bonds in order to meet any of the three options provided for at the end of the Lease, the term, “defeasance” is used as if it were a fact. In a true defeasance situation the lessee is either required by the documents (or informal agreement by the parties) to deposit into an escrow account an amount (in absolute terms or net present value terms) (economic defeasance), or it gives legal notice at the initiation of the lease (or shortly thereafter) of its intent to exercise its Purchase Option at the end of the lease term and reacquire the property (legal defeasance). We did not find either in the facts provided. Accordingly, to make this argument, the Field needs to develop facts that demonstrate a true defeasance.

In light of the hazards with the New Lease Option, we recommend that you develop additional facts to show that the New Lease Option is truly illusory. Such facts would include those that demonstrate that the Equipment is "limited use" property. See Rev. Proc. 2001-28, 19 I.R.B. 1156 (May 7, 2001). That is, if the facts developed show that the Equipment has little value to operators other than those in Country C, the ownership rights claimed by Trust become easier to challenge because its ability to release the Equipment to any lessee or operator other than B or to operate the Equipment itself would be severely limited. Development of such facts may require outside engineers and other experts. If such facts demonstrate that no one but B may have any commercially reasonable use for the Equipment, then exercise of the New Lease Option would be impracticable.

In addition, the Field should verify, that if Country C privatizes the B's business and restricts B's ability to own or acquire the Equipment, the only viable option for B may be the New Lease Option. Also, helpful facts include those that would demonstrate that it is highly unlikely that Country C will decide to acquire even more modern Equipment at the end of the Base Term.

Examination of any presentations to the Trust concerning this transaction may provide insight into whether its participation is primarily tax motivated. It is also recommended that the Field investigate any prearrangement aspects of the transaction. Persuasive evidence of prearrangement includes any additional evidence that the parties understood that B would exercise the Purchase Option.

Moreover, we note that this transaction is dissimilar to the lease-in, lease-out transaction described in Rev. Rul. 99-14, 1999-1 C.B. 835. In that revenue ruling, the taxpayer retained the power to require the lessee to continue with the lease of the property for an additional period of time by virtue of a put renewal option in the agreements. In this case, however, the facts as presently developed indicate that B, not A, has the sole power to determine which option will be exercised at the end of the Base Term. Thus, this feature of the transaction makes it important to develop facts which will demonstrate that the New Lease is not a viable option for B and, therefore, the transaction has little probability of continuing beyond the Base Term. Consequently, such facts will indicate if the return of the Equipment to B at that time is a foregone conclusion.

We recommend that you carefully scrutinize the pretax return and determine if it is insubstantial when compared to the post-tax returns. This analysis should be made using both constant dollars and relevant present value assumptions. The Field should compare its facts to those in other economic substance cases or in Rev. Rul. 99-14, in which the taxpayer's profit pretax in constant dollars was insignificant compared to the amount invested. In furtherance of this strategy, case development should include the employment of independent appraisers, economists and financial consultants, whose analyses could affect the results of these calculations.

With respect to the OID issue, a "substantial likelihood" is not enough to characterize the net Purchase Option as an unconditional obligation, and thus is a high hazard in this case.

If, upon further development, the facts do not indicate that the transactions lack economic substance or constitute a financing arrangement, we recommend you contact CC:ITA to develop whether A's depreciation deductions are based on a lease term that includes the period of the New Lease. In that case, the tax-exempt use property rules could apply to limit the availability of the deductions. I.R.C. Section 168(g)(3)(A) and Treas. Reg. Section 1.168(i) -2. We encourage you to raise this argument as early as possible in order to preserve it in case the transaction is determined to neither lack economic substance nor constitute a financing.[7]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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By: ______________________________

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[7] The enactment of the extended lease period in section 168 was not designed to supplant the traditional arguments challenging sale-leaseback transactions. The Conference Committee Report of the Deficit Reduction Act of 1984 provides "the primary objective of the conferees is that there be no relaxation of administrative rules and practices that would result in lease treatment for financing transactions in which the purported lessor does not have a significant ownership interest in the property." H.R. Rep. No. 98-861, 98th Congress, 2nd Sess. at 772.