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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, OHIO DISTRICT
CC:NER:OHI:CIN

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Lease-in/Lease-out Transaction

This Field Service Advice responds to your memorandum dated April 3, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

Corp X	=
Corp Y	=
Type A equipment	=
Entity B	=
Country C	=
Bank D	=
Corp E	=
f	=
g	=
Bank H	=
i%	=
j%	=
Firm K	=
m%	=
n%	=
$o	=
Bank P	=
Bank Q	=
$r	=
$s	=
Agreement T	=
$u	=
$v	=
Tax Year 1	=
Tax Year 2	=

ISSUES:

1). Whether Corp X is entitled to the deductions claimed under I.R.C. § 162 and § 467 with respect to lease payments incurred in a lease-in/lease (LILO) transaction.

2). Whether Corp X is entitled to deduct the interest accrued on the nonrecourse loan incurred to prepay the lease payments.

CONCLUSIONS:

1). Corp X is not entitled to the deductions claimed under sections 162 and 467 with respect to lease payments incurred in a LILO transaction because the transaction lacks economic substance.

2). Corp X is not entitled to deduct the interest accrued on the nonrecourse loan incurred to prepay the lease payments, because the LILO transaction lacks substance and the interest deductions and the loans on which it was incurred are an integral part of the transaction.

FACTS:

The Internal Revenue Service is currently examining Corp X's federal income tax returns for Tax Year 1 and 2. During Tax Year 1, Corp X entered into one or more lease-in/lease-out (LILO) transactions with foreign governments. Specifically, the LILO transaction at issue involves a series of interrelated legal documents entered into by Corp Y, a wholly-owned subsidiary of Corp X. Under the transaction, Corp Y was said to have leased Type A equipment at Entity B located in and ultimately owned by the government of Country C. All of the leased equipment has been owned and operated by Entity B for a number of years. Apparently, Corp E wanted money to fund a major expansion of Entity B.

Initially, the parties to the transaction executed a Participation Agreement generally describing the LILO transaction. Next, Corp Y formed a Grantor Trust with Bank D as trustee. Acting on behalf of Corp Y, Bank D entered into a lease transaction (the "headlease") with Corp E, a limited liability company incorporated under the laws of Country C and owned by the various governmental bodies of Country C. The f -year headlease (a g-year basic lease term with a g-year renewal period) called for the payment of annual lease amounts, payable in United States dollars, paid to Corp E at Bank H. According to the headlease, the amount of each payment (Basic Lease Rent) was calculated by multiplying a predetermined percentage rate times the equipment cost. The stated lease percentage rates decreased from i% to j% over the term of the headlease. The "cost" of the equipment used in the calculation was based upon the fair market value of the equipment as determined by an appraisal performed by Firm K. With certain limitations, the headlease permitted Corp Y to prepay the lease rental payments. The headlease also granted Corp E a one-time right to require Corp Y to prepay in full lease payments for the entire headlease term.

Corp Y has the option to purchase the equipment at the then current fair market value, (i) at the expiration or termination of the replacement sublease, (ii) upon expiration of the renewal lease term, (iii) upon exercise of the sublessee of its right to terminate the sublease, and (iv) on the basic sublease termination date if the sublessor exercises the preemptive option.

Simultaneous with the headlease, Bank D, acting on behalf of Corp Y as its trustee, entered into a sublease agreement with Corp E, leasing the same equipment back to Corp E. Similar to the headlease, the g-year sublease required the payment of rent based on a percentage of the equipment cost. The stated percentage rates for the sublease generally increased from m% to n% over the term of the sublease. At the end of the sublease, it was contemplated that Corp E would either (i) purchase Trust's residual leasehold interest under the original headlease for a fixed amount,

(ii) arrange a replacement subleasee, or (iii) return the equipment and pay a termination payment.

Bank D, as trustee for Corp Y, entered into a nonrecourse loan agreement to borrow approximately $o from Bank P. Bank P is a subsidiary of Bank H and, apparently, the loan principal was first loaned by Bank H to Bank P before being loaned to the trustee. To secure the payment of the borrowed amount, the trustee pledged all its rights to the leased equipment (including all sublessor rights to payments arising under the simultaneous sublease) to the lender, Bank H. Consistent with the loan, the trustee executed two Loan Certificates totaling approximately $o. Principal and interest due under the loans were to be paid to Bank Q in favor of Bank H for the account of Bank P.

Late in Tax Year 1, at the closing of the LILO transaction, Corp Y transferred to Bank D as its trustee approximately $r, representing the prepayment of the first year's rent under the headlease. Bank D immediately transferred the funds to Corp E. In addition, the $o borrowed by the trustee, less certain transaction costs, was transferred to Corp E, initially as a "security deposit" securing the trustee's obligations under the lease. Six months later, in Tax Year 2, the "security deposit" was applied as the prepayment of all of the rent permitted to be prepaid under the headlease.

In order to fund its obligations under the sublease, Corp E immediately transferred the majority (approximately $s) of the security deposit payment to Bank H under Agreement T. According to the agreement, Bank H agreed to make payments to Corp E as were required of Corp E under the sublease. While Bank H assumed the contractual obligation to pay the debt portion of the sublease rent, Corp E was not legally released from its obligation under the sublease to pay rent. Corp E immediately pledged the payments it was due pursuant to the undertaking agreement to the Bank D, as trustee, as satisfaction of Corp E's sublease obligations. As a result of this pledge and Bank D's, as trustee, simultaneous pledge to Bank P of all rights arising under the sublease, any sums paid were returned directly to the original lender. In addition, shortly after the closing, Corp E used another portion of the "security deposit" to purchase medium term notes sufficient to fund the purchase option price.

In short, Corp Y is expending $u for equity and $v for transaction fees for its participation in the LILO transaction. Taking into consideration the present value of the cash flow, the IRS agent believes that the pre-tax economic return is either nonexistent or, at most, insignificant. However, Corp X disputes this finding.

LAW AND ANALYSIS

Section 162(a)(3) allows as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rent.

Section 467 determines the timing of rental accruals for certain large leases.

Section 163 allows as a deduction all interest paid or incurred within a taxable year on indebtedness.

However, a transaction that lacks substance is not recognized for Federal income tax purposes. See ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995). Denial of recognition means that such a transaction cannot be the basis for a deductible expense. Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 278 (1999).
See Wexler, 31 F.3d at 122.

The Service position on the economic substance of certain LILO transactions was set forth in Rev. Rul. 99-14, 1999-13 I.R.B. 3. In the revenue ruling, a United States corporation (X), entered into a LILO transaction with a foreign municipality (FM). FM had owned and used the subject property, which had a remaining useful life of 50 years and a fair market value of $100 million.

On January 1, 1999, X leased the property from FM under a headlease with a term of 34 years and immediately leased the property back to FM under a sublease of 20 years. The sublease also included a “put renewal” term of 10 years.

The headlease required X to make two rental payments - an $ 89 million prepayment at the beginning of first year of the headlease and a payment at the end of year 34 that has a discounted present value of $8 million. For federal income tax purposes, X and FM agreed to allocate the prepayment ratably to the first six years of the headlease and the future value of the final payment ratably over the remaining 28 years of the headlease.

The sublease required FM to make fixed, annual rental payments over both the primary term and, if exercised, the renewal term. The payments during the renewal term are substantially higher that those for the primary term, but are still projected to be only 90 percent of the fair rental value for the property at that time.

At the end of the primary term of the sublease, FM has the option to purchase the headlease residual for a fixed amount that is projected to be equal to its fair market value. If FM exercises this option, the transaction is terminated and X is not required to make the final payment. If FM does not exercise this option, X may elect to 1) use the property itself during the remaining term of the headlease, 2) lease the property to another party for the remaining term of the headlease, or 3) compel FM to lease the property for the 10-year put renewal term of the sublease.

If X exercises the put renewal option, it can also require FM to purchase a letter of credit guaranteeing the rents during the renewal term. If FM does not obtain the letter of credit, it must exercise the option to purchase the residual of the headlease.

In order partially to fund the $89 million prepayment, X borrowed $54 million from one bank (BK1) and $6 million from another (BK2). Both loans are nonrecourse, have fixed interest rates, and provide for annual debt service payments that fully amortize the loans over the 20-year primary term of the sublease. The amount and timing of the debt service payments mirror the amount and timing of the rental payments due during the primary term of the sublease.

Upon receipt of the prepayment, FM deposits $54 million with an affiliate of BK1 and $6 million with an affiliate of BK2. The deposits earn interest at the same rates as the respective loans from BK1 and BK2. FM directs the affiliates to pay the interest to BK1 and BK2. The parties treat these payments as payments from the affiliates to FM as interest, from FM to X as rental payments, and from X to BK1 and BK2 as debt service. Further, FM pledged the $54 million dollar deposit as security for its rental payments.

X requires FM to invest $15 million of the prepayment in highly-rated debt securities that will mature in an amount sufficient to fund the fixed amount due under the purchase option and to pledge these securities to X.

On its federal income tax returns, X claims deductions for interest on the loans and rents under the headlease. X includes in gross income the rents received under the sublease and, if and when exercised, the payment from the purchase option. By accounting for reach element of the transaction separately, X purports to generate a substantial net deductions in the early years of the transaction followed by income on or after the primary term of the sublease. X also anticipates a positive pre-tax economic return from the transaction. However, this pre-tax return is insignificant in relation to the net after-tax return.

Rev. Rul. 99-14 holds that the LILO transaction it describes lacks economic substance, indicating that a transaction will be respected for tax purposes if it has -

> 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.

Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978); James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990).

In assessing the economic substance of a transaction, the revenue ruling notes a key factor is whether the transaction has any practical economic effect other than the creation of tax losses. Courts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer’s beneficial interest except to reduce tax. The presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes. In reaching these conclusions, the revenue ruling relied upon Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, 157 F.3d at 248; and Sheldon v. Commissioner, 94 T.C. 738, 768 (1990).

In determining whether a transaction has sufficient economic substance to be respected for tax purposes, courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. For example, in Knetsch, the taxpayer purchased an annuity bond using nonrecourse financing. However, the taxpayer repeatedly borrowed against increases in the cash value of the bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon, the Tax Court denied the taxpayer the purported 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 consequences of holding the Treasury bills were largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 at 769.

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

The revenue ruling finds that, viewed as a whole, the objective facts of the LILO transaction it describes indicate that the transaction lacks the potential for any significant economic consequences other than the creation of tax benefits.

First, during the basic lease term of the sublease, X's obligation to make the property available under the sublease is completely offset by X's right to use the property under the headlease. In addition, X's obligation to make debt service payments on the loans is completely offset by X's right to receive sublease rentals. The same or similar circumstances are found in the present case.

Moreover, the revenue ruling notes that X's exposure to the risk that FM will not make the rent payments is further limited by the arrangements with the affiliates of BK1 and BK2. The defeasance arrangements almost eliminate all risk. As a result, neither bank requires an independent source of funds. Thus, during the primary term, the offsetting and circular nature of the obligations eliminate economic consequences.

Similarly in the present case, Corp Y's exposure to the risk that Corp E will not make the rent payments is limited as a result of Corp E's payment undertaking agreement with Bank H. Corp Y's economic risk as to the $o loan is almost eliminated by the deposit arrangement. As a result, neither Bank P nor its parent, Bank required an independent source of funds. The majority of the remaining money flows from the banks through the hands of the parties to the transaction and back to the banks. Like the revenue ruling there is a close relationship between the lender and the defeasance depository bank. The circular nature of the cash flow appears to eliminate any significant economic consequences of the transaction. Corp Y is expending relatively small amounts of equity and transaction expenses to generate substantial tax deductions.

The revenue ruling also considered the economic risks regarding residual of the headlease after the basic lease term. It found that the fixed payment option to purchase the residual and put renewal option operated to "collar" the value of the headlease residual. In addition, the revenue ruling also finds that there is little economic consequence from the nominal exposure to FM's credit. Lastly, the revenue ruling notes that the facts indicated that the purchase option would be exercised.

Similarly, in the present case, the different options given Corp E at the end of the basic lease term do not present real economic risk to Corp Y. The nature of the equipment makes finding a substitute lessee not controlled by Entity B or the government of Country C impractical. That is, the leased equipment appears to be essential to running Entity B and cannot be separated from it. And, like the revenue ruling, the equipment has been used by Entity B for years. There is no real credit risk given the nature of equipment and the ultimate involvement of Country C. Further, it is apparent that, very much like the revenue ruling, the deposit made by Corp E with Bank H, along with the medium term notes, will fund and are intended to fund the purchase option price, which will cover the eventual payoff of the loan.

Finally, the revenue ruling found that X's pretax return was too insignificant when compared to its after tax yield, to support a finding that the transaction has significant economic consequences. Here, according to the Agent, the pre-tax return is apparently either nonexistent or, at most, insignificant.

Rev. Rul. 99-14 holds that neither the rent nor interest arising from the LILO transaction are deductible. Although the facts presented by the Agent in the present case differ somewhat from the Rev. Rul. 99-14, we believe the revenue ruling is controlling under these facts and that the LILO transaction involving Corp Y lacks economic substance. As a result, no deductions for expenses arising out of the transaction are deductible under sections 162 and 467. In addition, the interest at issue and the loans on which it was incurred are an integral part of the LILO transaction. As such, the interest is not allowable under section 163.

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