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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR AREA COUNSEL (NATURAL RESOURCES: HOUSTON)
CC:LM:NR:DEN
Attn: Virginia Hamilton

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX & ACCOUNTING)
CC:ITA:05

SUBJECT: Agreement – Sale or Lease

This Chief Counsel Advice responds to your memorandum dated February 28, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

User =

Agreement =

Exploit or Exploitation =

Date A =

Date B =

Product =

Related Assets =

Other Assets =

Location =

A =

B =

Capability =

x =

y =

z =

W Years =

X Years =

Y Years =

Z Years =

ISSUES

1. Whether the transfer of x Product to User under the exclusive terms and conditions of the Agreement is considered a sale for Federal income tax purposes.

2. Whether the transfer of Related Assets, which is required in order to exploit Product, under the nonexclusive terms and conditions of the Agreement, is considered a sale for Federal income tax purposes.

CONCLUSIONS

1. On the facts of this case, we agree with your conclusion that the transfer of the x Product under the exclusive terms and conditions of the Agreement should be treated as a sale and thus the Taxpayer should not be considered the owner of the x Product for Federal income tax purposes.[1]

2. Concerning the transfer of the Related Assets under the nonexclusive terms and conditions of the Agreement, our view is that except for certain real property interests, to the extent each item or type of Related Assets is transferred to User for essentially its entire useful or economic life, Taxpayer cannot be considered the owner of such property. However, only an undivided interest or share in each such item or type of Related Assets equal to that share of Product transferred under the exclusive terms and conditions of the Agreement as a proportion of the total number of Product dependent on the Related Assets should be considered subject to sale. With respect to those interests in real property included in the Related Assets, further factual development will be necessary before we can support a conclusion that such real property interests was the subject of a sale.

FACTS[2]

Taxpayer develops and operates Capability in the A industry. Taxpayer also provides certain services within that industry. Taxpayer determined that it would install Product along Location for the A industry. Along one route, Taxpayer provided for a total of y Product.

On Date A, Taxpayer and User entered into Agreement under which Taxpayer granted to User (i) exclusive exploitation, and under some circumstances, purported ownership, of x (and under certain options, z) Product along the selected Location of

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[1] Although the Taxpayer may have entered into other agreements with terms similar to those in the Agreement here, our conclusion reflects only the specific transaction discussed in the text and should be limited to that one transaction. It should not be used for, or treated as, a determination with respect to any other transaction. Thus, the above result could change with respect to transactions based on other Agreements with different provisions, conditions, or length of term, even if the other agreements contain terms and conditions that are exclusive in nature.

[2] The facts in this case are either unique to Taxpayer and its agreements, or descriptive of such a small population of businesses and agreements, as to raise the possibility of disclosing Taxpayer's identity by its publication. For that reason, we shall limit the exposition of facts to a brief summary in order to protect Taxpayer's identity.

Taxpayer's Capability, and (ii) associated and non-exclusive exploitation of certain other property required to employ Product, which include, but are not limited to, the Related Assets, and Taxpayer's rights in all Other Assets. The Agreement, however, does not provide User with any ownership interest in or other rights to access or control the Capability retained by Taxpayer. Taxpayer remains free to enter into Agreements for other Product with other parties, who may also become "owners" and exploit certain Product and the associated exploitation of Taxpayer's Capability ("Interest Holders").

The term of the Agreement specifically extends from acceptance by User to the end of the economically useful life of x Product, as reasonably determined by User. If at any time during or after the last year of X Years, User fails to exploit any of the Product comprising any segment for a period of thirty consecutive days, the term shall effectively expire and all rights to Product will revert to Taxpayer. Taxpayer warrants that the Other Assets will cover this minimum period. Taxpayer is also committed to using its best efforts, without having to spend unreasonable amounts, to obtain extensions of the Other Assets for an additional period of, in the aggregate, X Years or until the earlier expiration of the economically useful life of the Product.

Under the Agreement, User has the right to obtain title to x Product while continuing the grant of the property rights transferred under the non-exclusive exploitation provisions under certain very specific circumstances. However, even if title to Product is actually transferred to User and a sub-right to exploit the Other Assets is also granted to User, this sub-right will terminate and title to x Product will revert and be reconveyed to Taxpayer at the expiration or termination of X Years term of Agreement.

Taxpayer is responsible for performing maintenance and repair of Capability. Taxpayer provides scheduled maintenance at a certain cost to User, which is to be paid based on a specific formula. The total fee for scheduled maintenance is capped, but subject to an inflation adjustment. Taxpayer is liable for any costs in excess of this capped rate. Taxpayer is responsible (up to a specific set amount) for repairs arising from certain unscheduled maintenance, and emergency and non-emergency situations with respect to certain potential service affecting events. Amounts above the set amount are allocated among Interest Holders. The costs of unscheduled maintenance to repair or replace Product will be borne proportionately by the Interest Holders in the affected Product based on the ratio that the number of each Interest Holders' affected Product bears to the total number of affected Product. Taxpayer's obligation to perform maintenance expires on Date B. Thereafter, Taxpayer is entitled to participate in the process by which the Interest Holders will choose a new provider of the maintenance.

The Agreement provides that Taxpayer and User must procure and maintain insurance meeting certain specifications. Taxpayer still carries insurance in connection with each segment and Product. The Agreement also requires that Taxpayer pay

taxes, fees and other governmental impositions, to the extent they cannot be separately assessed, and that User will reimburse Taxpayer for its proportionate share of such tax, based on the methodology used to impose the tax, e.g., relative property interests or projected revenue.

For approximately W Years, User cannot transfer a whole and discrete interest in the x Product to a third party without the Taxpayer's consent, which may be withheld at Taxpayer's sole discretion. This restriction does not apply to User's acquisition of Product in excess of the original x Product, provided the transferee participates as an Interest Holder in the Agreement. Except for transfers such as those involving collateral for a loan, a transfer to a parent or affiliate or to an entity in control of User or acquiring all User's assets, all transfers are subject to Taxpayer's consent. This consent, however, is not to be unreasonably withheld or delayed. User, however, is in no way restricted in its right to create A volume in its Product and selling or otherwise permitting third parties to utilize such volume.

Taxpayer retains legal title to the entire Capability. However, the Agreement expressly states that the grant of exploitation to User is to be treated for federal, state, and local tax purposes and for accounting purposes as the sale and purchase of Product and a corresponding interest in Taxpayer's rights in the Related Assets.

Taxpayer's Capability has been developed along certain property interests in B Industry, which involved numerous other property agreements between Taxpayer and participants in B Industry. Your office states that a sample of such an agreement has a primary term of Y Years, with options to extend the term to a maximum of Z Years.

LAW AND ANALYSIS

Your office acknowledges that Taxpayer is treating the transfer to User of the x Product and Related Assets as sales for federal income tax purposes. In addition, the Agreement contains the above provision expressly stating that Taxpayer and User understand and agree that the transaction is to be treated for federal income tax purposes as a sale to User of x Product and Related Assets and to file their respective tax returns accordingly. Your office also concludes that, based on the case law and Service rulings, the Agreement results in sales for federal income tax purposes of x Product and, except perhaps for certain real property interests, an undivided interest in the Related Assets equal to that portion represented by the number of x Product to the total number of Product. Therefore, except for certain real property interests in the Related Assets (or Other Assets), there does not appear to be any dispute or issue between your office and Taxpayer concerning the character of this transaction as a sale. Nevertheless, you have requested Field Service Advice concerning whether the

transfer of the x Product and the corresponding Related Assets under the respective exclusive and nonexclusive terms and conditions of the Agreement is a sale.

The general characterization of a transaction for tax purposes is a question of law. Frank Lyon Co. v. United States, 435 U.S. 561, 581 n. 16 (1978). The economic substance of a transaction rather than its form controls for federal tax purposes. See Gregory v. Helvering, 293 U.S. 465 (1935). The fact that the documents contain labels that the transaction is, or is not, a sale is not determinative of the actual character. The issue of ownership is governed by the substance of the agreement, not labels used in the agreement. See Tomerlin Trust v. Commissioner, 87 T.C. 876 (1986).

The term "sale" is given its ordinary meaning for federal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). The key to deciding if a transaction is a sale is to determine if the benefits and burdens of ownership have passed to the purported buyer. Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987). This is a question of fact which must be ascertained from the intention 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).

Closely associated with the benefits and burdens of ownership is a long line of precedent holding that an agreement for the transfer or use of property will be considered a sale regardless of its labels if the period of use or term of the agreement results in the return of the property to the owner with little or no residual value remaining. Consequently, the transfer of property for substantially all of its useful or economic life will be considered a sale of the property, even where the user must return the property at the end of the agreement. See Rev. Rul. 55-541, 1955-2 C.B. 19. The fact that the transaction does or does not make any provision for the transfer of title will not prevent the transaction from being considered a sale. See section 4.02 of Rev. Rul. 55-540, 1955-2 C.B. 39; Leahy v. Commissioner, 87 T.C. 56, 66 (1986) (transfer of the benefits and burdens of ownership govern for Federal tax purposes, rather than the technical requirements of passage of title under State law). .

In Sprint Corporation v. Commissioner, 108 T.C. 384 (1997), petitioner bought from Northern Telecom, Inc. (NTI) central office equipment, including digital switches, for use in its business of providing telephone services. Petitioner claimed investment tax credits and depreciation deductions with respect to the total cost of each digital switch, which included the cost of the custom computer software load necessary to make each switch operable. The Tax Court distinguished between ownership of software loads related to the digital switches and ownership of the underlying copyright to such software loads. In so doing, the court examined the substance of the sales agreements and found that petitioner had acquired from NTI magnetic tapes containing

copies of the computer software necessary to make the digital switch operable (i.e., the software load) but did not acquire any of the underlying, exclusive, intangible intellectual property rights. The court further found that petitioner had acquired all the significant benefits and burdens of ownership with respect to the magnetic tapes to be considered the owner of the software load. NTI, the court concluded, simply did not retain a residuary interest in the software load commensurate with an interest typically retained by a lessor of property. The most important rationale for this conclusion is that petitioner had acquired exclusive use of the NTI software load for the useful life of the digital switch, which was tantamount to acquiring the perpetual right to use that particular load because of the interrelationship between the switch hardware and the software. In addition, petitioner had the right to transfer the software load in conjunction with a transfer of the digital switch. The court thus held the taxpayer had tax ownership of the software load and that the amounts paid by the taxpayer for the digital switches that were allocable to the software used in the switches qualified for the investment tax credit.

In the instant case, the term of the Agreement is defined as extending from acceptance by User to the end of the economically useful life of the Product, as reasonably determined by User. The term will run for at least X Years. Your office asserts, and we have no reason to doubt, that the economically useful life of the x Product and the corresponding Related Assets will not exceed X Years, and in essence will most likely become technologically obsolete before then. Thus, the User received exclusive exploitation of x Product for its full economic or useful life. Therefore, x Product will in essence have no residual value when it is returned by User to the Taxpayer. Under such circumstances and pursuant to the revenue rulings and the Sprint case cited above, the transfer of the x Product under the Agreement must be considered a sale to the User.

No factual distinction has been made between the useful life of Product and that of Related Assets. Moreover, exploitation of Related Assets is intertwined with, and integral to, exploitation of x Product. In order to exploit and benefit from x Product, User therefore contracted for the non-exclusive exploitation of Related Assets. We note that the nature of Capability requires that User share Related Assets with Taxpayer and other Interest Holders of Product in the Taxpayer's Capability. Thus, by acquiring exploitation of only x Product out of y Product, the rights acquired by User with respect to Related Assets necessarily had to be nonexclusive in order to give practical force and effect to the exploitation of the remaining Product by other Interest Holders. Under the terms of the Agreement, User essentially obtained, except perhaps for certain real property interests, exploitation for its full economic or useful life of what represents an undivided interest or share in the Related Assets commensurate to a proportion equal to that of the x Product to the total Product. Accordingly, the above legal analysis also would apply to User's rights to Related Assets. In our view, except

for certain real property interests, this legal analysis supports treating the transfer of nonexclusive exploitation of an undivided interest or share of the Related Assets as a sale such undivided interest or share to User equal to proportion of x Product to total Product.[3] Rev. Rul. 55-541, 1955-2 C.B. 19.

The above analysis is further supported by the transfer to User of certain other burdens and benefits of ownership to x Product and Related Assets. Additional factors examined by the Tax Court include: (1) Whether legal title passed; (2) Whether the parties treated the transaction as a sale; (3) Whether the alleged purchaser acquired an equity in the property; (4) Whether the contract of sale creates a present obligation on the seller to execute and deliver a deed and present obligation on the purchaser to make payments; (5) Whether the purchaser is vested with the right of possession; (6) Whether the purchaser pays property taxes following the transaction; (7) Whether the purchaser bears the risk of loss or damage to the property; and (8) Whether the purchaser receives the profits from the operation and sale of the property. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981).

No one of the above factors is dispositive of the issue of whether a sale has taken place. As noted above, the Tax Court does place emphasis on whether the property retains some significant residual value when it returns to the lessor:

> ...[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

[3] We understand that the Taxpayer maintains that the Agreement operated as a sale of the entire Related Assets to User rather than an undivided interest or share equal to the proportion that the x Product bears to the total amount of Product. Apparently, for federal income taxes, Taxpayer accounted for, or reported, this transaction accordingly. We further understand that Taxpayer's accounting is the subject of another request for national office review. Accordingly, we will not opine on whether Taxpayer reported or accounted for this part of the transaction correctly. Our only observation is that following the Agreement with User, a significant number of Product and a corresponding amount of Related Assets remained available for exploitation by Taxpayer or for transfer by it to other Users under agreements with terms and conditions similar to those in Agreement here.

> the lease so as to give the purchaser a meaningful possessory right to the property.

Torres v. Commissioner, 88 T.C. 702, 721 (1987). See also Estate of Thomas v. Commissioner, 84 T.C. 412, 436 (1985)(factors relevant to the determination of ownership include the existence of useful life of the property in excess of the lease term).

Therefore, the provisions in Agreement governing the maintenance and repair of the x Product and Related Assets are of lesser importance in this case. Those provisions governing insurance, payment of property and other local taxes and fees, and whether or not title passes to the User are also not compelling factors.

Instead, the most significant feature here is the fact that the User has obtained exploitation of x Product and its share or undivided interest in Related Assets (except for certain real property interests) for the full economic or useful life of such property, leaving little or no residual interest for the Taxpayer upon the termination or expiration of the Agreement. This factor is compelling because it enables User to essentially profit from the operation, retention, and after a short period of time, the possible "resale" to third parties of the x Property and its interest in the Related Assets for the full life of such properties. Therefore, User could benefit from appreciation of the Product during their economic life by exploiting Product itself or by selling Product after the restrictions on such transfers expire. Such rights support sales treatment and are integral to the tax ownership of property.

In addition, the intent of the parties as reflected in their agreement and the surrounding facts and circumstances is important in determining the character of a transaction. See Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955). Even though the Service is not bound by the tax treatment of a transaction by the parties, whether the parties did treat the transaction as a sale is nevertheless an important factor in determining if the burdens and benefits of ownership to property have been transferred because it sheds light on that intent. As stated above, the Agreement expressly provided that Taxpayer and User understand and will treat the transaction as a sale for federal income tax purposes. Moreover, the parties here did treat the transaction as a sale for Federal income tax purposes.

Another factor is whether User acquired an equity interest in the property. Equity is generally the difference between the fair market value of the property and the outstanding balance of any loans on the property. Equity is the amount of the purchaser's investment at risk in the property. In this case, we have no reason to challenge the position of your office that User did acquire an equity interest in x Product and an equity interest in a proportionate undivided share of the Related Assets

(except perhaps certain real property interests) transferred under the Agreement. Your office has provided several illustrations, which include sums of money invested by User, in support for this position. These sums are clearly at risk. This factor weighs on the side of a sales treatment.

Consequently, even though x Product and Related Assets technically revert back to Taxpayer, they do so at the end of their economic or useful lives, or after X Years in the event of non-exploitation by User. Accordingly, we conclude that the Agreement results in a sale from the Taxpayer to User of x Product and, except for certain real property interests, an undivided interest or share of the Related Assets equal to the proportionate share that the x Product bears to the total number of Product.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

First, we do have some concern about whether certain Other Assets involving interests in real property that may be considered included in Associated Rights (e.g., rights of way, easements and sub-easements) should be considered the subject of a sale especially since land and certain interests in real property do not have an economic or useful life. Therefore, many of the above tests and factors that are significant for equipment or other personal property are not as appropriate for real estate. Also, certain land interests such as leases or easements have a life determined by the time period or term of the agreement. For instance, we note that certain easements in real property in this case have a term of Y Years that can be extended or renewed by the Taxpayer for a term up to Z Years. Since the term of the Agreement is essentially X Years, which is substantially less than Y or Z Years, we think a substantial residual value or reversion in these easements remains in the hands of the Taxpayer. This factor suggests that these real property interests are not the subject of a sale. In addition, the role of local law and the passage of title are far more important in determining whether an interest in real property has been sold to another party. [redacted]

[redacted]

Third, we acknowledge that the Agreement is not a standard separate category of interest that has been recognized at law. Thus, claiming that a particular Agreement results in a sale is dependent on the specific terms of that particular agreement, including the term/length of the agreement; who benefits from an increase in system capacity; participation in proceeds received on disposal of the system; participation in management of system; ability to inspect the books of the legal owners; the exclusive use of capacity in the system; any compensation in the event of system breakdown; liability to pay a portion of costs incurred on disposal of the system; whether it can be freely assigned or transferred; who bears the risk; and who gains the upside in any increase in capacity. As noted in the footnote in the main text, our conclusion reflects only the specific transaction discussed in the text and should be limited to that one transaction. It should not be used for, or treated as, a determination with respect to any other transaction. Thus, the above result could change with respect to transactions based on other Agreements with different terms, provisions, conditions or length of use, even if the terms and conditions are exclusive in nature.
Accordingly, a conclusion that this particular Agreement results in a sale should not be viewed as a position of our office that all Agreements result in sales.

[redacted]

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.

Heather Maloy
ASSOCIATE CHIEF COUNSEL
(INCOME TAX & ACCOUNTING)

By: _____
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