OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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

FROM: ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES

SUBJECT: LEASING TRANSACTION

This Field Service Advice responds to your memorandum dated November 8, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

A =
B =
C =
D =

E	=
F	=
G	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
$1	=
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#3	=
#4	=
#5	=
#6	=
Country A	=
Region A	=

ISSUES

1. Whether the transactions described below lack economic substance.
2. Alternatively, whether the transactions described below should be recharacterized as a financing.

CONCLUSION

1. The transactions described below lack economic substance and should not be respected.
2. Alternatively, the transactions described below should be recharacterized as a financing.

FACTS

On Date 1, (Closing Date), A purportedly sold certain property (Property) to a trust, B, treated by taxpayer, C, as a grantor trust, in return for the payment of $1. On the same date, C, B, and A entered into an agreement (Lease Agreement) by which C/B leased the Property back to A for approximately #1 years beginning in Date 2 , and ending on Date 3 (Basic Term). The Property is located and operated in Country A, by A, a public authority of Country A. Possession of the Property remained at all times with A.

The parties also entered into a participation agreement (Participation Agreement) under which the parties agreed to enter into various contracts, including the Lease Agreement and a loan agreement, in order to effectuate the transaction. The Participation Agreement further defined certain rights and responsibilities of the parties, such as warranties and security interests.

To fund the purported purchase of the Property, B borrowed $2 from D, which is #2 percent owned by A (Loan). D was granted a security interest in the Property. In addition, C transferred $3 to B as an initial investment (First Investment). B transferred these sums in the amount of $1 to A for the purported purchase of the Property on Date 1. On or about the same date, C also paid $4 in brokerage and advisory fees. On Date 2, C transferred to A through B an additional $5 as a second investment (Second Investment).

In addition to these financial arrangements, D and A entered into a swap agreement (Swap Agreement) under which fixed interest payment obligations were swapped for floating rate payment obligations. The amount of the swap, $2, equaled the amount of the loan to B. The amount due to A from D as a final swap payment, $6 also exactly equals the amount A must pay to B on Date 3 if the Purchase Option (discussed below) is elected. The stated purpose of the Swap Agreement is to “protect . . . against the currency exchange risk resulting from [the] obligation to make . . . payments in USD . . . .”

Under the Lease Agreement, C directed that all rental payments be paid directly to D. Under the terms of the Lease Agreement A is responsible for insurance premiums, maintenance expenses, and property taxes.

At the end of the Basic Term, A has the following options:

1. Purchase the Property for $7. (Purchase Option). The Purchase Option would be paid in installments. The first amount, $6, due on Date 3 , includes

the final rental payment. The next four installments of $8 are due Date 4 , Date 5, Date 6, and Date 7, respectively.

2. Locate a replacement lessee to enter into a replacement lease (Replacement Lease Option) to run from Date 3 until Date 8. The amount of the replacement lease rentals must be at least sufficient to pay in full the amounts of principal and interest scheduled to be payable under the terms of the Loan.
3. Return the Property to C/B and pay $9. (Return Option).

Under the Replacement Lease Option, the choice of replacement lessee is restricted. Pursuant to the Participation Agreement, A must use reasonable efforts to 1) obtain a replacement lessee that is a taxable entity and which will agree to use the Property in its own E business, or 2) enter into a service contract to provide services to one or more persons in their E businesses, or 3) enter into a sublease with a taxable entity, or 4) enter into a sublease of less than three years with sublessees that are tax exempt entities. However, if A cannot find such a replacement lessee, then A may find any other replacement lessee satisfying the definition of the term, as set forth in the Participation Agreement, provided that if A would have to make an inducement payment in order to obtain such a replacement lessee, then A is not required to find a replacement lessee who meets the above stated requirements.

The definition of replacement lessee further restricts A's choice. A replacement lessee must be a person listed on Schedule I of the Participation Agreement, (one of four Region A state F), or one that meets all of the following criteria: 1) has net worth greater than $500 million; 2) has a credit rating for long term unsecured debt obligations of Aa2 by Moody's or AA by S&P unless such Replacement lessee provides a credit enhancement or provides a guarantee of its obligations, satisfactory to C; 3) is a E or an operating lessor; 4) is not A or a related party to Lessee for purposes of section 168(i)(3)(A); 5) and will not violate C's credit restrictions or guidelines.

Further, if A elects the Replacement Lease Option, under the Lease Agreement, B may make a preemptive election to 1) require the return of the Property, and 2) pay all amounts due to D. If B exercises this preemptive option, A would not be required to make the payment required under the Return Option.

G conducted an appraisal (Appraisal) that concluded, inter alia:

1. The remaining life of the Property is #3 years at the Closing Date.
2. The Purchase Option price of $7 is #4 percent of the original cost of the Property to B, and the fair market value at the time the option can be exercised is $10, which is #5 percent of the original cost of the Property to B.
3. The rents that would be required under the Replacement Lease Option are equal to the anticipated fair market rental value of the Property during the

relevant period, and a replacement lessee meeting the criteria set forth in the Participation Agreement can be found.

Based on these conclusions, G further determined that it is reasonable that A will provide a replacement lessee rather than exercise the Purchase Option.

For federal tax purposes, C claimed interest expense deductions for its purported interest expense attributable to the loan and depreciation deductions on the Property. On its books, C treated the transaction as a financing.

LAW AND ANALYSIS

You have asked whether these transactions should be respected for federal tax purposes. For the reasons discussed below, we agree with your conclusion that the transactions lack economic substance.

1. Economic Substance

A. In General

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); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; 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.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation 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.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a 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 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.

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 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.

Moreover, claims of pre-tax profit are not dispositive. There has been some precedent that economic substance for a lease transaction will be satisfied if there is "some modicum" of economic substance, which may mean "some modicum" of pretax profit. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th cir.

1985); Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985). In Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990), the Fourth Circuit found that a leasing transaction was a sham. In doing so, it described a $17,000 profit potential as "minimal" on an eight-year investment of $130,000. The Fourth Circuit also found evidence of tax motivation in the offsetting obligations to pay rent and debt service. The transaction also involved the use of related parties to avoid section 465. Under these facts, the court found that "the tax tail began to wag the dog." Hines, 912 F.2d at 741. Thus, small profits on a lease transaction may be overlooked when tax considerations have taken over the transaction. See also Pacheco v. Commissioner, T.C. Memo. 1989-296.

B. Application to Sale-Leaseback Transactions

An equipment leasing transaction may be recognized for tax purposes even though it is motivated by some tax considerations. However, this does not mean such transactions cannot be challenged as shams. Friendship Dairies v. Commissioner, 90 T.C. 1054, 1067 (1988). Tax incentives provided by Congress for equipment leasing are designed to stimulate the formation of venture capital. Id., quoting Beck v. Commissioner, 85 T.C. 557, 579-80 (1985).

> Such incentives are not intended, however, to create a new economy consisting of paper transactions having no relationship to the real value of goods and services. Thus, the mere presence of a valid business enterprise at some levels of a transaction does not automatically entitle passive investors distant from day-to-day operations of the enterprise to the associated tax benefits.

Id.

It is clear that whether a sale-leaseback is characterized as such 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 held 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, a department store, had transferred legal title to three buildings to a bank and then leased them back. The Court found that the transaction was in reality a loan and allowed the taxpayer depreciation on the buildings even though legal title was held by the bank.

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 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 upholding the sale-leaseback in Frank Lyon, the Court rejected the Government's attempt to characterize it as a sham.

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 fully 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 15 years and at other points in the lease for the Company's investment plus compound interest at 6 percent. 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 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, in that the Company was only acting as a conduit to forward rent payments to pay the mortgage and was doing so for a guaranteed return.

The Government relied on Lazarus, but the Court distinguished Lazarus because it involved two rather than three parties. The third party was necessary to the transaction in Frank Lyon because of the restrictions on borrowing imposed on the Bank. The Court noted that other investors could have been substituted for the Company with much the same result and the ultimate solution was not dictated by majority shareholder's relationship to the Bank. The Court found it significant that the Bank could not legally own and finance its own building.

The Court also emphasized that there was no simple device to peel away the form of the transaction and reveal another substance. In this regard, it was important that the Company assumed recourse liability in the debt. Because of this, the Company, an ongoing enterprise, had been exposed to real and substantial risk and reduced its own borrowing ability. The Court also noted the Company's liability on the ground lease which could extend beyond the building lease.

In addition, the Court also pointed out that the government was likely to lose little revenue, if any, as a result of the shape given the transaction. That is, "[n]o deduction was created that is not either matched by an item of income or that would not have been available to one of the parties if the transaction had been arranged differently." Frank Lyon, 435 U.S. at 580.

The government had argued that the purchase options allowed the Bank to accumulate equity in the property over time. However, the Court rejected this contention resting its conclusion on the factual finding of the district court that 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.

The Court concluded 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.

Frank Lyon, 435 U.S. at 583-84.

The present case is clearly distinguishable from Frank Lyon. Initially, there is no legal barrier preventing A from owning the Property itself. In addition, because A is a tax-exempt foreign entity, the expenses claimed would not be otherwise claimed by a United States taxpayer. See also Sacks v. Commissioner, 69 F.3d 982, 988 (9th Cir. 1995), holding sale-leaseback was not a sham in part because the tax benefits would have existed for someone, and were shifted to the taxpayer rather than created out of thin air.

Further, the decision in Frank Lyon rested strongly upon the risks, including the recourse debt, incurred by the Company. Such risks gave the Company the significant attributes of a lessor. No similar risks were incurred in the present case. Here, the loans are subject to defeasance and the risks as well as the potential gains from the transaction have been carefully collared to limit both potential loss and profit by C.

Part of this restriction of risk is also the probability that the Purchase Option will be exercised by A and C will never come into possession of the property. That this will never happen is also underscored by the possible limited use of the property, that is, no one but A may have any commercially reasonable use for it. See Rev. Proc. 76-30, 1976-2 C.B. 752, modifying Rev. Proc 75-21, 1975-1 C.B. 715. Limited use property was not involved in Frank Lyon.

Rice's Toyota World, supra, is a pivotal case in defining sham transactions under the rationale of Frank Lyon. Significant to the present case, the Fourth Circuit affirmed that the Tax Court in finding an equipment sale-leaseback a sham. Under the test formulated, a transaction is a sham if (1) it is not motivated by any economic purpose outside of tax considerations, and (2) it is without economic substance because no real potential for profit exists.

In a sale-leaseback transaction, those claiming tax benefits must generally show that they entered into the transactions motivated by a business purpose sufficient to justify the form of transaction. Levy v. Commissioner, 91 T.C. 838, 854 (1988); Prager v. Commissioner, T.C. Memo. 1993-452.

In considering economic substance separately in a sale-leaseback case, Levy, 91 T.C. at 856, 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. at 204-207.

Thus, 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. More simply, that the taxpayer is willing to accept minimal returns in a transaction with no more profit potential demonstrates that the transaction was tax motivated. Thus, a minimal profit in an equipment leasing transaction will not prevent the finding 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.

C. Analysis

In the present case, the payments due during the Basic Term represent a circular cash flow. D and A entered into a Swap Agreement for $2. D then lent this exact amount to B. B, in turn, paid this amount plus the $3 First Investment to A as the purchase price for the Property. The debt service that B owed on the Loan from D is identical to the rental payments from A. C instructed A to pay these sums to D directly. D, moreover, has no possibility of profit on the Loan.

Thus, all such funds represent a circular cash flow. As a result, the offsetting and circular nature of the obligations eliminate any significant economic consequences of the transaction.

The different options at the end of the Basic Term do not present significant real economic risk to either party. In Date 3, A has three options. Under the Purchase Option, A must pay B $7. The first installment is $6. Also on that date, the amount of the swap payment that A is to receive from D is $6. The next four installments due from A could be funded by amounts drawn from the investment of C's First Investment of $3 and Second Investment of $5. Accordingly, A can elect the Purchase Option at no additional cost, merely by making book entries and turning over the proceeds from the First and Second Investment.

The Appraisal indicates that the Replacement Option is most likely because the Purchase Option price is $7 at a time when the Appraisal's estimation of the fair market value of the Property in Date 3 is $10. This conclusion, however, is predicated on the assumption that the Property could be rented for $11 per year. However, $11 is specified in the transaction documents as the rent under the Replacement Option, because that is the amount needed to discharge the remaining debt on the Property, if the Purchase Option is not elected. If $11 truly represents the fair market value of the rentals of the Property beginning in Date 3, then it also indicates that the Property is more valuable at that point than the Appraisal estimates. On the other hand, if this is excessive rent, then no truly independent Replacement lessee could be found at those rates. Moreover, the assertion that the Replacement Option is most likely depends upon the accuracy of the Appraisal and the assumption that C will not have a significant business incentive to retain possession of the Property which it uses. Thus exercising the Purchase Option would be the logical choice.

A, moreover, is limited in its choice of a replacement lessee. At a minimum, if the Replacement lessee is not one of the listed replacement lessees then the replacement lessee chosen must have a net worth of more than $500 million, an Aa2 or AA credit rating, or be able to provide a guarantee or credit enhancement, must be a railroad or an operating lessor, and must meet other requirements of C.

A also can pay B $9 and walk away from the property. This is $12 less than the Purchase Option, but also requires that A relinquish the Property. Even the Appraisal concludes that this option is unlikely. Therefore, this is not a realistic option.

Accordingly, the Purchase Option is the most likely choice. Under the Purchase Option, the circular flow of money is complete, and C's only real out of pocket expenses represent fees paid to the accomodating parties. We believe that we would prevail on the argument that deductions related to those circular payments should not be allowed. Even under the other options, C's economic consequences are limited to a de minimus range that does not have substance. Because the transactions lack the potential for any significant economic consequences, the transactions lack economic substance. Therefore, the depreciation deductions arising from the transaction should not be allowed.

2. Interest Deductions

Having concluded that the transactions lack economic substance, the next issue is the proper treatment of the interest deduction. The original loan of $2 was an integral part of the transaction. In general, an interest deduction that is part of a transaction that lacks economic substance may be disallowed, even if it arises on bona fide debt. See Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966). There are, however, circumstances where a loan that is part of a transaction that lacks economic substance is recognized. See Rice's Toyota World, Inc. v. Commissioner, supra. The difference between the two scenarios is whether the loans are an integral part of the transaction that lacks economic substance. It is our opinion that the loans under the present facts are an integral part of the transaction.

In Rice's Toyota World, Inc., the taxpayer purchased a used computer from a leasing company by issuing a recourse note and two nonrecourse notes to the leasing company. The taxpayer claimed accelerated depreciation deductions, based on its ownership of the computer, and interest deductions for the payments on the notes. The taxpayer paid off the recourse indebtedness, which was $250,000, in three years along with $30,000 of interest. The Tax Court found that the transaction lacked economic substance. In conjunction with this determination, the court found that, because the transaction could be disregarded, the taxpayer was not entitled to interest deductions.

The Fourth Circuit affirmed the Tax Court's finding that the transaction lacked economic substance. However, the Fourth Circuit reversed the Tax Court's finding that the interest on the recourse indebtedness was not deductible. "A sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded." Rice's Toyota World, Inc., 752 F.2d at 96, citing Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1243 (1981). The Fourth Circuit concludes that both the recourse indebtedness and the interest paid upon it were genuine. Rice's Toyota World, Inc., 752 F.2d at 96. Thus, section "163 does not limit the deductibility of . . . interest expense depending upon the item purchased by the taxpayer." Id; See also, Rose v. Commissioner, 88 T.C. 386, 423 (1987), aff'd, 868 F.2d 851 (6th Cir. 1989).

In addition, in Lieber v. Commissioner, T.C. Memo. 1993-424, the Commissioner challenged the taxpayers' deduction of interest on nonrecourse indebtedness incurred to enter a computer sale leaseback transaction. The Tax Court found that the taxpayers lacked a profit objective in regard to the transaction and disallowed the other deductions. However, the court went on to find the indebtedness incurred to purchase the computer was genuine and allowed the interest paid.

Other cases have recognized the distinction between borrowings that are separable from the sham transaction and those that are an integral part of the sham transaction. ACM Partnership, 157 F.3d at 262; Arrowhead Mountain Getaway, Ltd. v. Commissioner, T.C. Memo. 1995-54, 69 T.C.M. (CCH) 1805 (1995).

Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), however, is the primary precedent that disallows interest deductions in circumstances where there is no question that genuine loans were obtained. In Goldstein, the taxpayer had won the Irish Sweepstakes. To shelter her windfall, she borrowed money from banks to purchase Treasury securities that would yield a lower rate of interest than she would be paying to the banks. The transaction only benefitted her because of the tax savings on prepaid interest on the loans.

The Second Circuit found that the loans were genuine and recourse, but affirmed the disallowance of the interest expense. The opinion emphasizes the Tax Court's finding that the taxpayer's sole purpose for entering into the transaction was to obtain an interest deduction. 364 F.2d at 740-42. Goldstein holds that borrowing for such a purpose should not be recognized under section 163. Goldstein, Supra (citing Knetsch).

Following Goldstein, a number of cases have disallowed interest deductions where they are an integral part of a transaction found to lack economic substance. See Wexler v. United States, 31 F.3d 117, 125-26 (3d Cir. 1994), cert. denied, 115 S. Ct. 1251 (1995) (affirming the disallowance of an interest deduction in a "repo" transaction.); Sheldon v. Commissioner, 94 T.C. 738 (1990) (disallowing an interest deduction in a "repo" transaction.); Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (disallowing expenses and losses in a similar transaction to ACM Partnership); Seykota v. Commissioner, T.C. Memo. 1991-541 (distinguishing Rice's Toyota World and disallowing interest expense on a transaction which depended upon an up-front interest deduction for its tax benefits).

In disallowing the interest deduction in Lee v. Commissioner, T.C. Memo. 1997-172, aff'd 155 F.3d 584 (2d Cir. 1998), the Tax Court asserted that Goldstein "continues to apply to the narrower situation where a taxpayer enters into a borrowing transaction for no purpose other than to claim the deductions generated by that transaction itself." Lee, 73 T.C.M (CCH) at 2549. In affirming the disallowance of the interest deduction in Lee, the Second Circuit reasoned that:

> To adopt petitioners' reading would be to permit every shelter, no matter how transparently sham, to qualify for an interest expense deduction as long as the money used to finance the not-for-profit transactions involved were borrowed from a lender – any commercial bank would do -- that demanded repayment. That result, soundly criticized by the Third Circuit in . . . Wexler . . . is contrary to the longstanding jurisprudence of sham shelters from Knetsch on down.

Lee, 155 F.3d at 587; See also, Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999) (citing Lee in disallowing interest incurred in a leveraged corporate-owned life insurance program, which was found to lack economic substance).

The interest deductions at issue stem directly from the Loan taken out by C through B and cannot be separated from the purported sale transactions relating to the Property. As such, the Loan was an integral part of the transactions and a deduction for the interest on the Loan is not allowable under section 163.

3. Sale v. Financing

Alternatively, the transactions can be recast as a financing rather than as a sale of the Property. The term "sale" is given its ordinary meaning and is generally defined as a transfer of the ownership of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). Whether a transaction is a sale 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). A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). Courts have considered the following factors relevant in determining whether the benefits and burdens of ownership passed: (1) Whether the transaction was treated as a sale. United Surgical Steel Co., Inc. v. Commissioner, 54 T.C. 1215, 1229-30, 1231 (1970), acq., 1971-2 C.B. 3; (2) Whether the obligors on the notes were notified of the transfer of the notes. Id.; (3) Which party serviced the notes. Id.; Town & Country Food Co., Inc. v. Commissioner, 51 T.C. 1049, 1057 (1969); (4) Whether payments to the transferee corresponded to collections on the notes. United Surgical, 54 T.C. at 1229-30; Town & Country, 51 T.C. at 1057; (5) Whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship. United Surgical, 54 T.C. at 1230; Yancey Bros. Co. v. United States, 319 F. Supp. 441, 446 (N.D. Ga. 1970); (6) Which party had the power of disposition. American National Bank of Austin v. United States, 421 F.2d 442, 452 (5th Cir. 1970); cert. denied, 400 U.S. 827 (1970); (7) Which party bore the risk of loss. Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115, 118 (6th Cir. 1970), cert. denied, 400 U.S. 827 (1970); and (8) Which party had the potential for gain. United Surgical, 54 T.C. at 1229; Town & Country, 51 T.C. at 1057. 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).

In the sale-leaseback context, the Tax Court has also considered the following factors as being relevant to determining whether a sale has occurred: (1) the existence of a useful life of the property in excess of the leaseback term; (2) the existence of a purchase option at less than 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). Further the Tax Court has found the taxpayer's equity interest as a percent of the purchase price significant. Torres, supra.[1]

An analysis of the factors set forth above shows that D was a party to the transaction documents, therefore it had notification of the transfer of notes. Moreover, it does not appear that any restrictions were placed on A by C that would be inconsistent with a buyer-seller relationship. C had the power of disposition. At the Closing Date, the Property had a useful life of #3 years, and the Basic Term was approximately #1 years. Therefore, there is a useful life in excess of the Basic Term. Additionally, the Purchase Option is, purportedly, more than fair market value rather than less.

Other factors, including those the Tax Court has opined are most important, however, lead to the conclusion that, if these transactions are found not to lack economic substance, they are properly characterized as a financing. C treated the transaction on its books as a financing arrangement. The payments of rent correspond exactly to the collections on the note. The Renewal Rental rate is set at the amount needed to pay off the Loan rather than as an estimation of true market value. The First and Second Investments are the only portion of the funding for the transactions which does not stem from loan proceeds. As noted earlier, Under the Purchase Option, A must pay B $7. After the first installment of the Purchase Option, which has been pre-funded with the Swap Agreement, the next four installments due from A could be funded by amounts drawn from the investment of C's First Investment of $3 and Second Investment of $5. Therefore, C/B receives its First and Second Investments back in the circle of funding. Consequently, both the First and Second Investments lack economic substance

[1] Rev. Proc. 75-21, 1975 C.B. 715 provides guidelines for advance ruling purposes in determining whether certain transactions purporting to be leases of property are leases for Federal Income Tax purposes. Although the Tax Court has referred to these guidelines in determining whether the benefits and burdens of ownership has passed, (See Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1433 (1986)), they are not conclusive. Under Rev. Proc. 75-21 the minimum equity investment must be an equity investment equal to at least 20 percent of the cost of the property, and the investment must remain equal to at least 20 percent of the cost of the property throughout the lease term. The minimum investment includes only consideration paid and personal liability incurred by the lessor to purchase the property. Because First and Second Investment have no economic substance, C/B does not meet the requirements of Rev. Proc. 75-21 for minimum equity investment.

and do not represent the required minimum investment. Accordingly, C/B does not, in fact, have a true equity investment in the transaction.

Under the most likely option, the Purchase Option, C has invested $13 in order to receive $14 in four installments in Date 3. A present value calculation reveals that this is actually a loss of approximately $15 dollars. If A exercises the Purchase Option, C will not have an interest in the Property at the expiration of the Basic Term. Accordingly, it is not reasonably possible for C to recoup its investment in this transaction.

Because of these factors, we believe that, if the transactions do not lack economic substance, then under a benefits and burdens analysis, they would be recast as a financing. Under this recharacterization, all payments from C to A may be recast as a loan between C and A, secured by the Property.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

Please call if you have any further questions.

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