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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL
CC:LM:MCT

FROM: Associate Chief Counsel (Passthroughs and Special Industries)
CC:PSI

SUBJECT: Lease In/Lease Out Transaction

This Chief Counsel Advice responds to your memorandum dated October 2, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

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.

LEGEND:

A

B

C

D

E

F

G

H

Equipment

Locality

Country

Date 1

Date 2

Date 3

Date 4

Date 5

Date 6

Date 7

Year 1

Year 2

Year 3

Year 4

Year 5

Year 6

Year 9

Year 13

Year 17

<u>a</u>

<u>b</u>

<u>c</u>

<u>d</u>

<u>e</u>

<u>f</u>

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<u>hh</u>

<u>ii</u>

<u>kk</u>

<u>mm</u>

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<u>oo</u>

<u>pp</u>

<u>qq</u>

<u>rr</u>

<u>ss</u>

<u>ISSUES</u>:

1. Whether the lease-in/lease-out transaction lacks economic substance.

2. What is the significance of the tail period, defined as the balance remaining on the headlease following the expiration of the renewal option period or the new sublease option period, if those options are chosen.

3. If the lease-in/lease-out transaction lacks economic substance, whether Exam should make adjustments a) disallowing the related rent and interest deductions claimed by A; b) eliminating the annual rental income from C under the sublease recognized by A; and c) disallowing any related deductions for fees paid by A to C, F, outside legal counsel, valuation experts, and others.

4. If the lease-in/lease-out transaction lacks economic substance, whether Exam should require A to accrue income annually in connection with the proceeds of the swap agreement with C which are to be paid in Year 2, Year 9, Year 13, and Year 17.

5. What should Exam consider in determining whether to assert penalties?

CONCLUSIONS:

1. Based upon the case development to date, we recommend that you pursue an economic substance argument.

2. Under economic substance principles, the tail period does not present a significant hazard.

3. Under an application of the economic substance doctrine, the following adjustments are appropriate: a) disallowance of the related rent and interest deductions claimed by A; b) elimination of the annual rental income from C under the sublease recognized by A; and c) disallowance of any related deductions for fees paid by A to C, F.

4. Even if the lease-in/lease-out transaction lacks economic substance, Exam should not require A to accrue income annually in connection with the proceeds of the swap agreement with C which are to be paid in Year 2, Year 9, Year 13, and Year 17.

5. In determining whether to assert penalties, the following factors should be considered: 1) how much of the underpayment is attributable to negligence or disregard of rules or regulations and 2) did taxpayer act with reasonable cause and in good faith.

FACTS:

A is a U.S. corporation and a wholly owned subsidiary of H. Pursuant to a trust agreement created on Date 1, B became the trustee of a grantor trust created by A. A is the sole beneficiary of the trust.

C is a municipal authority of Locality in Country. C owned Equipment as of Date 1.

On Date 1, A, B, C, D, E, and F entered into a Participation Agreement. In this agreement, (1) B agreed to lease Equipment from C, (2) C agreed to sublease Equipment from B, (3) D and E agreed to finance a portion of the lease payment to be made by B, (4) B, C, and F agreed to execute two agreements pursuant to which F will pay B the sublease payments to be made by C, and (5) the parties agreed to enter into other operative agreements with respect to the transaction.

Concurrent with the Participation Agreement, B and C entered into a lease agreement (the headlease) on Date 1. Under the lease agreement, B agreed to lease Equipment from C for a term of a years, ending on Date 6. The remaining useful life of Equipment was b years as of Date 1. Under the terms of the lease agreement, B was to make rent payments to C only twice. The advance lease payment in the amount of $c was due on Date 1 and the deferred lease payment in the amount of $d is due on Date 7, which is e years after the end of the lease term. The advance lease payment is to be allocated to the first f years of the lease term and the deferred lease payment is to be allocated to the rest of the lease term.

The advance lease payment in the amount of $c has three funding sources. A contributed $g and B borrowed $h from D and $i from E. On Date 1, B, D, and E entered into a loan agreement. Under the loan agreement, both loans are nonrecourse loans with an interest rate of k% and are to be paid back over m years, ending on Date 4. From the advance lease payment C received from B, C retained $n as a transaction fee.

Concurrent with the Participation Agreement, B and C entered into a sublease agreement on Date 1. Under the sublease agreement, C agreed to lease Equipment from B for a term of m years, ending on Date 4. At the end of the term, C has an option to purchase the balance of B's interest in the headlease by paying B $s. If this purchase option is exercised, then B is relieved of its obligation to pay the deferred lease payment in the amount of $d on Date 7 under the headlease.

If C does not exercise the option, then B must exercise one of the following three options. First, B can require C to continue leasing Equipment from B until Date 5 at substantially higher rents than the rents for the prior m years (the renewal option). Second, B can sublease Equipment to another entity for a term ending no earlier than Date 5 and no later than Date 6 (the new sublease option). Third, B can retain and operate Equipment (the retention option).

On Date 1, B, C, and F entered into two Payment Undertaking Agreements. Under the Payment Undertaking Agreements, F received from C $h and $i, which equaled the principal amounts of the loans B obtained from D and E, respectively, to pay the advance lease payment under the headlease. C paid F $o as a fee and F, in return, agreed to pay, on behalf of C, the annual rent payments due under the sublease agreement to B during the term of the sublease. A portion of the advance lease payment was used by C to pay the $o fee under the Payment Undertaking Agreements.

On Date 2, C and G entered into a swap agreement. Under the terms of the swap agreement, C paid G $p on Date 3 and G, in return, is to pay C $q on each January 1 of Year 2, Year 9, and Year 13, and $r in Year 17. A portion of the advance lease payment was used by C to pay G $p under the swap agreement.

In a given year during the term of the sublease, C's annual rent due under the sublease equals the sum of the payments from F under the Payment Undertaking Agreements and the payment from G under the swap agreement. The payments B receives under the Payment Undertaking Agreements exactly match the loan payments due by B to D and E under the loan agreement. In addition, under the terms of the Payment Undertaking Agreements, at the termination of the sublease on Date 4, F will pay B an amount equal to the total remaining principal of the two loans from D and E, effectively eliminating B's obligation under the loan agreement.

In Years 1 through 6, A would report the following income and expenses related to the lease-in/lease-out transaction:

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 |
|---|---|---|---|---|---|---|
| Rental Receipts | $aa | $ff | $ff | $ff | $ff | $ff |
| Expenses | | | | | | |
| Amortization - Lease Payment | $bb | $gg | $gg | $gg | $gg | $qq |
| Interest Expense on loans | $cc | $hh | $hh | $mm | $oo | $rr |
| Fee Amortization | $dd | $ii | $ii | $ii | $ii | $ii |
| Taxable Loss | $(ee) | $(kk) | $(kk) | $(nn) | $(pp) | $(ss) |

## LAW AND ANALYSIS

### 1. Economic Substance

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); 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); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985). 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 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 consequence 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 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.

It is the position of the Internal Revenue Service that certain lease-in/lease-out transactions lack economic substance. Rev. Rul. 99-14, 1999-11 C.B. 835. When the form of a transaction lacks economic substance, the form is disregarded and, consistent with the substance of the transaction, the proper tax treatment is determined. ACM Partnership, Id.

The payments due during the term of the sublease represent a circular cash flow. B is obligated to make two rent payments to C. B paid C the advance lease payment in the amount of $c, which was funded by a loan in the amount of $h from D, another loan in the amount of $i from E, and cash in the amount of $g from A. C is obligated to pay rent to B, who is in turn obligated to pay debt service to D and E. The annual rent payment from C to B under the sublease is to be funded with the sum of the annual payments under the Payment Undertaking Agreements and the swap agreement, all of which were funded with the advance lease payment C received from B. The payments to B under the Payment Undertaking Agreements exactly match B's payment obligation to D and E under the loan agreement. In sum, the majority of the funds B paid to C comes back to B. Thus, the movement of the 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.

Under the sublease agreement, at the end of the sublease term C has an option to purchase B's remaining interest in the headlease by paying B $s. If this purchase option is exercised, then B is relieved of its obligation to pay the deferred lease payment in the amount of $d on Date 7 under the headlease. When C exercises the purchase option, C will not incur any cost because C's option payment will be funded with the payments due on Date 4 under the Payment Undertaking Agreements and the payments due in Year 17 under the swap agreement. Thus, the movement of the funds related to the purchase option represents a circular cash flow. Therefore, the circular nature of the obligations eliminate any economic consequences to C's exercise of the purchase option. Moreover, because of C's historical use of the equipment, we believe there are compelling business reasons for C to exercise the purchase option.

If C does not exercise the purchase option at the end of the term of the sublease, B must exercise either the renewal option, the new sublease option, or the retention option.

Under the renewal option, B will require C to renew the sublease for another u years, ending on Date 5. During the renewed term of the sublease, C is obligated to pay annual rents that are substantially higher than the rents under the original sublease. The rents are so high that C will need to use its own funds, although at the beginning of the renewed sublease term C will have $r, the total amount of the distributions in Year 17 under the swap agreement, which was financed with a portion of the advance lease payment from B.

If the renewal option is exercised, then under the Participation Agreement, B is required to deposit a predetermined portion of the renewed sublease rents from C into a Lessee Deposit Account, the final balance of which will be used to fund the deferred lease payment payable by B to C on Date 7. The funding schedule for this account is based on the assumption that the account will earn a v% annual rate of return. In order to ensure that the Lessee Deposit Account will earn the predetermined annual rate of return, B and C are required to enter into an interest rate swap agreement under which B will pay C the annual interest it earns on the Lessee Deposit Account and C will pay B v% annual interest on a notional principal amount that matches the required balance in the Lessee Deposit Account on the annual payment date.

If C does not exercise the purchase option, it runs the risk of B choosing the renewal option. If the renewal option is chosen, then C will have to pay the rents with its own funds and, furthermore, C will have to absorb the interest rate risk under the interest rate swap with G. Although B will eventually pay C the deferred lease payment, it is questionable that C will be willing to spend a large amount of its own funds to pay the rents and will also be willing to absorb the interest rate risk only to get paid the deferred lease payment on Date 7, which is w years after the end of the renewed sublease. Moreover, even taxpayer’s own appraisal indicates that this option will not be chosen.

Under the new sublease option, B must find a new sublessee who is willing to pay at least as much as C would pay under the renewal option because B will remain liable to make the deferred lease payment in the amount of $d. A contends that if the purchase option is not exercised by C, B will select the new sublease option because A’s appraiser concluded that the estimated fair market value of the rent obtainable in year 17 will be higher than C’s rents under the renewal option. However, if rents on this type of Equipment are quite high at the end of the sublease, it is likely C will exercise the purchase option, since it would have to pay a similar high rental rate to replace the Equipment with other similar rented equipment.

Under the retention option, B will presumably operate Equipment. As under the new sublease option, B remains liable for the deferred lease payment under the retention option. However, B is not in the business of operating Equipment, making the retention option improbable.

Moreover, because it appears likely that C will exercise its purchase option and because 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). For this reason we believe economic substance principles may be applied in this case. In substance, A through B has invested $g in Year 1 to receive the payments under the swap agreement between C and G, i.e. $q in each of Year 2, Year 9, and Year 13, and $r in Year 17.

Taxpayer asserts that it is in the leasing business and will be earning a significant rate of return. 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. In support of your economic substance argument, we recommend that you not only verify the taxpayer's calculation of rates of return, but also the appraisals on which they are based. We recommend that you carefully scrutinize the pretax and post-tax returns using the relevant present value assumptions.

We strongly recommend you seek further assistance from the National Office as to alternative arguments including whether the transaction could be recharacterized on the basis that the leases should be collapsed during the original sublease term, with the prepayment regarded as a loan or a fee. The distinctive strength of this alternative argument is that even if the tail period results in some economic risk to the parties and thus cannot be dismissed as lacking in economic substance, the transactions during the coextensive lease term will not be recognized for federal tax purposes.

Further, 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). A's equity payment may be appropriately viewed as a loan with the unconditional obligation to repay a principal sum being the combination of the excess rent in the "shortfall years" and the purchase option payment. We may be able to require A to accrue income on a deemed loan from A to C based on a factual finding that the purchase option will be exercised. The amount by which the excess rent payments and the purchase option payment exceed the equity payment could be asserted to be original issue discount (OID) includable in A's income.

2. The Tail Period

Considering the nature of C's business and the nature of Equipment, it is unlikely that C will not exercise the purchase option and, consequently, let B determine who will use Equipment or force C to pay substantially higher rents and absorb the interest rate risk mentioned above. In addition, C has historically used Equipment and is highly likely to continue using Equipment. Furthermore, because the payment obligation under the purchase option is fully defeased, C will not need to draw on its own sources of capital to exercise the option. Based on the factual development to date, it appears likely that C will exercise the purchase option. Therefore, the possibility of the existence of a tail period does not present a significant hazard.

3. Adjustments

Under economic substance principles, the rent payments under the headlease are not deductible and the rental income from the sublease is not includible by A. In addition, no deductions for expenses arising out of the transaction are deductible under section 162. Furthermore, because the loans are an integral part of the transaction, a deduction for the interest on the loans is not allowable under section 163.

4. The Swap Agreement

The swap agreement is a contract that requires C to make a payment of $p in exchange for a total payment, by G, of $x, paid in eight installments. The swap agreement grants a security interest in C's rights under the contract to B and provides that payments due C be paid directly to B. C funds its payment using a portion of the advance lease payment of $c. The advance lease payment includes A's equity payment of $g. Although A's funds may have been used to pay C's payment under the swap agreement, the agreement does not require that C use A's funds to make its payment.

Based on the cash flows alone, an argument could be made that, in substance, A entered into the swap agreement and should accrue income in connection with the contract, notwithstanding that A is not a party to the contract. However, we do not recommend making such an argument. First, as mentioned above, the contract does not require A's funds to be used to make C's payment, so A has not made a payment in exchange for the payments it will ultimately receive from G. Furthermore, the payments made by G to A have not been assigned to A. Instead, C has directed that the payments due C be paid to A.

5. Penalties

In determining whether to assert penalties, Exam should consider 1) how much of the underpayment is attributable to, among other things, negligence or disregard of rules or regulations and 2) whether the taxpayer acted with reasonable cause and with good faith.

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 the taxpayer acted in good faith. Section 6664(c)(1).

a. Negligence

Pursuant to sections 6662(c) and 1.6662-3(b)(1), 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 reasonably and ordinarily 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. The Tax Court 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 ($10,000 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. Section 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 (more likely than not standard). Section 1.6664-4(e)(2)(i).

The regulations provide that 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).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

Please call if you have any further questions.

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