Office of Chief Counsel
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Memorandum

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subject: Sale-leaseback Transaction

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<u>LEGEND</u>

Taxpayer =
Equipment =
Counterparty =
A Lender =
A Lessor Lender =
B Lender =

B Lessor Lender =
Deposit Bank =
Closing Date =
Date 1 =
Date 2 =
Date 3 =
X years =
A dollars =
B dollars =
C dollars =

D dollars =
E dollars =
F dollars =
G dollars =
H dollars =
I dollars =
J dollars =
K dollars =
L dollars =
M dollars =
N dollars =
O dollars =
P dollars =
Q dollars =
A percent =
B percent =
C percent =

ISSUES

1. Whether deductions claimed by Taxpayer under § 168 for depreciation, § 163 for interest expense, and § 162 for amortized transaction costs, with respect to the sale-leaseback transaction, should be disallowed.

2. Whether Taxpayer's equity investment should be recharacterized as a loan, so that Taxpayer must report original issue discount ("OID") income resulting from the deemed loan.

CONCLUSIONS

1. Taxpayer is not entitled to depreciation deductions under § 168, interest expense deductions under § 163, or deductions for amortized transaction costs under § 162 as a result of entering into the sale-leaseback transaction. Taxpayer failed to acquire tax ownership of the Equipment. As it neither incurred personal liability for recourse debt nor acquired any property subject to nonrecourse debt, Taxpayer did not incur debt. And, under the circumstances, transaction costs were incurred in order to obtain tax benefits.

2. Because Taxpayer has some residual value risk and no right to compel a return of its entire equity investment, Taxpayer's equity investment cannot be recharacterized as a loan. Accordingly, Taxpayer does not have OID income.

FACTS

Financing of the Transaction

Taxpayer and Counterparty entered into a purported sale-leaseback transaction. Through this transaction, Counterparty intended to refinance its pre-existing lease financing of the Equipment. Taxpayer alleges that Counterparty sold the Equipment to Taxpayer, and Taxpayer immediately leased the Equipment to Counterparty. Numerous operative documents were simultaneously executed among various parties including Taxpayer, Counterparty, A Lender, B Lender, A Lessor Lender, B Lessor Lender, and Deposit Bank. These agreements were executed pursuant to a comprehensive participation agreement, which provides that the parties' rights and obligations under any of the agreements are not enforceable before the execution of all operative documents.

On the Closing Date, Counterparty sold the Equipment to Taxpayer for A dollars, and Taxpayer immediately leased the Equipment back to Counterparty for a period of X years. To fund this purchase price, Taxpayer injected B dollars of its own equity, and borrowed C dollars from A Lessor Lender ("A Lessor Loan") and D dollars from B Lessor Lender ("B Lessor Loan"). Both the A Lessor Loan and the B Lessor Loan are nonrecourse loans. Taxpayer paid the purchase price to Counterparty by transferring its equity investment and the proceeds of the two nonrecourse loans.

The nonrecourse loan from A Lessor Lender was funded by a loan from A Lender. A Lender made two nonrecourse loans to A Lessor Lender in the amount of C dollars and E dollars ("A1 Loan" and "A2 Loan," respectively). As explained above, A Lessor Lender transferred the proceeds of the A1 Loan to Taxpayer as the A Lessor Loan, and Taxpayer transferred these funds to Counterparty as a portion of the purchase price of the Equipment. A Lessor Lender deposited the A2 Loan with Deposit Bank in two accounts ("Deposit 1" and "Deposit 2").

Counterparty and A Lessor Lender entered into an agreement ("Agreement A") pursuant to the participation agreement. Agreement A provides that (1) Counterparty will transfer Taxpayer's equity portion of the purchase price, B dollars, to A Lessor Lender on the Closing Date; (2) Counterparty will transfer, F dollars, which corresponds to what is referred to as a deferred equity investment Taxpayer made on Date 1, to A Lessor Lender; (3) A Lessor Lender will deposit the funds that correspond to Taxpayer's equity investments received on the closing date and Date 3 with Deposit Bank ("Deposit 3"); and (4) A Lessor Lender will release specified amounts from Deposit 3 to Counterparty on scheduled dates.

The nonrecourse loan from B Lessor Lender was funded by B Lender. B Lender made a nonrecourse loan to B Lessor Lender in the amount of D dollars ("B Loan"), and B Lessor Lender transferred the proceeds to Taxpayer as the B Lessor Loan. Taxpayer transferred the B Lessor Loan to Counterparty as a portion of the purchase price of the Equipment.

Counterparty and B Lessor Lender entered into an agreement ("Agreement B") pursuant to the participation agreement. Agreement B provides that (1) starting on Date 2, Counterparty will semi-annually transfer a specified amount to B Lessor Lender (“Counterparty Payment”), and (2) starting on Date 1, B Lessor Lender will annually transfer a specified amount to Counterparty (“Company Payment”). Each Counterparty Payment equals a loan payment due from B Lessor Lender to B Lender. Each Company Payment funds most of the rent payment due from Counterparty to Taxpayer.

After the above transactions, Deposit Bank held Taxpayer’s equity investment and the proceeds of the A2 Loan, and Counterparty held the A Lessor Loan and the B Lessor Loan proceeds, which were funded by the A1 Loan and the B Loan, respectively. Counterparty used these funds to terminate the pre-existing lease financing arrangement.

Subsequent Cash Flows

Beginning on Date 1, matching payments were owed from Taxpayer to B Lessor Lender (i.e., B Lessor Loan payments), from B Lessor Lender to Counterparty (i.e., Company Payments), and from Counterparty to Taxpayer (i.e., rent payments). The matching payments were due annually on the same day. By the end of the lease term, the total amount of payments owed from Taxpayer to B Lessor Lender was G dollars, and the same amount was owed from B Lessor Lender to Counterparty.

Throughout the lease term, the total amount of rent payments owed from Counterparty to Taxpayer was H dollars. Because the Company Payment received by the Counterparty from B Lessor Lender was smaller than the rent owed by Counterparty to Taxpayer, Counterparty had to inject its own funds, of I dollars, to satisfy the rent payments. The amount injected by the Counterparty to pay the rent corresponds to the payments owed on the A Lessor Loan of J dollars, less the portion of the payments funded by the Taxpayer’s deferred equity contribution of F dollars. In addition, on Date 1, the Counterparty paid, from its own funds, F dollars to the A Lessor Lender as required by Agreement A, which the A Lessor Lender deposited with the Deposit Bank as an addition to Deposit 3.

From Date 2, A Lessor Lender began to withdraw funds semi-annually from Deposit 3, and transfer such funds to Counterparty. These amounts represent the accommodation fee paid to Counterparty for participating in this sale-leaseback transaction. In addition, A Lessor Lender began to withdraw funds from Deposit 1 and Deposit 2, and transfer them to A Lender to pay the interest due on the A2 Loan.

Starting on Date 2, using its own funds, Counterparty began to make the Counterparty Payments to B Lessor Lender pursuant to Agreement B. Using the Counterparty Payments, B Lessor Lender made payments to B Lender to repay the B Loan. The B Loan was fully repaid before the end of the lease term.

Termination of Transaction

At the end of the lease term, Counterparty has the right to exercise its option to purchase the Equipment from Taxpayer for the amount of K dollars. Most of the purchase option price would be satisfied by the total amount of Deposit 3 at the end of the lease term, L dollars, plus the Company Payment to be received from B Lessor Lender, M dollars. Counterparty would provide N dollars to satisfy the difference between the purchase option price and the funds to be received from A Lessor Lender and B Lessor Lender.

A Lessor Lender's funds would be provided by Deposit Bank. Under Agreement A, if the purchase option is exercised, A Lessor Lender would be obligated to withdraw Deposit 3 from Deposit Bank and release it to Counterparty. This amount would equal Taxpayer's equity investment and a predetermined after-tax rate of return. Further, if the purchase option is exercised, Taxpayer would be obligated to pay the outstanding balance on the B Lessor Loan to B Lessor Lender. Pursuant to Agreement B, B Lessor Lender would be obligated to transfer such amount to Counterparty as the Company Payment. The final matching transfer would be owed by Counterparty to Taxpayer in satisfaction of the purchase option price.

Upon receiving the purchase option price, Taxpayer would pay the outstanding balance on the A Lessor Loan to A Lessor Lender in the amount of N dollars. A Lessor Lender would then pay the outstanding balance on the A1 Loan to A Lender. Taxpayer would keep the remainder of the purchase option price, which represents Taxpayer's equity investment and a predetermined after-tax rate of return. The A2 Loan would be repaid by A Lessor Lender, who would withdraw Deposit 1 and Deposit 2 to pay the balance of the A2 Loan.

If Counterparty does not exercise the purchase option, Counterparty is required to find a third party to enter into a successor lease with Taxpayer. Rent under the successor lease is predetermined, and O dollars of the pre-determined rent represents Taxpayer's share, or return of equity. Taxpayer has the right to reject the proposed successor lease and take possession of the Equipment.

If a successor lease is accepted by Taxpayer, a successor lessee is required to provide a letter of credit for the benefit of Taxpayer. The amount that can be drawn under the letter of credit must equal the excess of a specified amount of damages ("Termination Value") over Taxpayer's entire loan balances. The Termination Value fluctuates over the successor lease term, but it is always sufficient to repay Taxpayer's entire loan balances, equity investment, and a predetermined after-tax rate of return.

At the end of the successor lease term, Taxpayer has the option to elect the sale option instead of taking possession of the Equipment. If this option is elected, Counterparty would be obligated to pay P dollars to Taxpayer, an amount sufficient to pay the balances of the A Lessor Loan and the B Lessor Loan. In addition, Counterparty would be obligated to sell the Equipment and distribute the sale proceeds in the following order: (1) Q dollars to Taxpayer; (2) P dollars to Counterparty; and (3) any excess to

Taxpayer. If Taxpayer receives at least Q dollars, Taxpayer would fully recover its equity investment and a reasonable return on its equity investment. On the Closing Date, it was estimated that the Equipment would be worth substantially more than Q dollars at the end of the successor lease term.

Throughout the lease term, Taxpayer has several remedies in the event of a default. Events of default include, but are not limited to, Counterparty's failure to make rent payments, carry full insurance coverage with respect to the Equipment, and make any debt payments. In the event of a default, Taxpayer has the right to take possession of the Equipment or cause Counterparty to pay Taxpayer the Termination Value.

LAW AND ANALYSIS

For federal income tax purposes, a transaction is taxed according to its substance, not its form. This principal was applied in the context of a sale and leaseback transaction in Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978), where the United States Supreme Court stated, "In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed."

Whether in substance a taxpayer has acquired ownership of property and is therefore entitled to deductions for its depreciation depends on whether the taxpayer has acquired the "benefits and burdens" of ownership; a taxpayer's acquisition of "title" is insufficient. According to Frank Lyon, the issue is whether the taxpayer who claims to have acquired ownership and leased the property "[has] retain[ed] significant and genuine attributes of the traditional lessor status." Id. at 584.

Among those lessor attributes, market risk is critical. In Frank Lyon, the Court relied on various factors in holding that the sale and leaseback transaction should be taxed according to its form. But the Court gave particular emphasis to the taxpayer's personal liability for recourse third-party debt and to the taxpayer's $500,000 equity deposit, which was at risk if the counterparty failed to exercise any of its purchase or lease renewal options. "[I]f Worthen chooses not to exercise its options, [the taxpayer] is gambling that the rental value of the building during the last 10 years of the ground lease, during which the ground rent is minimal, will be sufficient to recoup its investment before it must negotiate again with Worthen regarding the ground lease." Id. at 579.

Similarly, in Estate of Thomas v. Commissioner, 84 T.C. 412, 435 n. 40 (1985), the court stated, "[W]e believe that the [taxpayer's] assumption of the residual value risk here is of controlling significance on the facts currently before us." The court ruled that the taxpayer was the owner of the equipment because the taxpayer "bore the risk at the end of the leases that the residual value would not be sufficient to recoup [the taxpayer's] cash outlay." Id.

In the present case, Taxpayer lacks sufficient residual value risk to be considered the owner of the Equipment. In other words, the amount of its at-risk equity investment is insufficient to support its claim of ownership for federal income tax purposes. The represented facts indicate that Taxpayer's initial equity investment was B dollars (A percent of the Equipment's cost). However, the facts also indicate that Taxpayer is contractually entitled to return of at least O dollars of that investment. If the Counterparty exercises its purchase option at the end of the lease, Taxpayer fully recovers the investment. And should the Counterparty decide not to exercise the purchase option, the Counterparty is obligated to arrange a successor lease that provides fixed rent, of which O dollars represent Taxpayer's share. Thus, the amount of Taxpayer's equity investment subject to market risk is only B dollars less O dollars, which is approximately B percent of the Equipment's cost.[1]

We acknowledge that the 20-percent at-risk equity investment requirement found in the ruling guidelines is not to be used for audit purposes. Rev. Proc. 2001-28, 2001-1 C.B. 1156, §§ 3 and 4.01; Estate of Thomas, 84 T.C. at 440 n. 51; Frank Lyon, 435 U.S. at 577 n. 14. In Estate of Thomas, the court indicated that an investment of between 10 and 20 percent could suffice.[2] Id. But regardless of whether a 10-percent investment is sufficient, this case involves a much lower commitment of at-risk equity. And while Frank Lyon involved a six-percent equity investment, the Court emphasized taxpayer's liability for recourse debt, a relatively unique circumstance in leasing transactions, which makes that case distinguishable.

We are also aware of authorities that indicate minimal levels of equity investment will support a claim of tax ownership. E.g., Pearlstein v. Commissioner, T.C. Memo 1989-621 (at risk equity of less than two percent of purchase price); Emershaw v. Commissioner, 949 F.2d 841 (6th Cir. 1991), aff'g T.C. Memo 1990-246 (at risk equity of six percent). But allowing investments at those levels to support a claim of tax ownership would permit taxpayers to in effect "buy" tax ownership by incurring, in addition to transaction costs, what amounts to a contingent fee that would be incurred if and when the residual value of the property proved inadequate to provide a full return of capital.

Because Taxpayer lacks sufficient residual value risk, it should not be treated as the owner of the Equipment and is not entitled to depreciation deductions.

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[1] Even if what has been described as a deferred equity payment of F dollars is treated as part of Taxpayer's initial equity investment in the Equipment, rather than as simply a payment on a nonrecourse loan, the at-risk equity investment remains a relatively small portion of the cost of the Equipment (C percent).

[2] "The spirit of this 'safe haven' revenue procedure - attempting to ascertain 'true' ownership of the equipment - certainly has been met. The discrepancy between 10 plus percent equity here and the 20 percent required by the guideline does not justify respondent's position." Estate of Thomas, 84 T.C. at 440 n. 51.

It follows that Taxpayer should not be treated as the borrower of the funds constituting the debt portion of the Equipment's cost. Taxpayer has no liability for any of the loans; they are nonrecourse. Moreover, Taxpayer is not the owner of any property serving as collateral for the loans. Under these circumstances, Taxpayer should be treated as a conduit for loans from the lenders to the Counterparty, not as a borrower entitled to interest deductions. Jacobsen v. Commissioner, 4 T.C.M. (CCH) 333 ("A loan by one person cannot be transferred for tax purposes into a loan by another by using the latter as a conduit through which to pass the money loaned."), aff'd, 46-1 U.S. Tax Cas. (CCH) ¶9291 (7th Cir. 1946).

Regarding transaction costs incurred by Taxpayer, while the transaction differs from those described in Notice 2005-13, 2005-1 C.B. 630 (SILO Notice), in that the Counterparty uses the proceeds to refinance debt encumbering the Equipment, i.e., funds are put to purposive use, the funds Taxpayer provided are subject to a defeasance arrangement. Taxpayer's role in the refinancing appears limited to reaping tax benefits, and the transaction costs it incurred appear to be little more than payments for tax benefits. Under the circumstances, deduction of amortized transaction costs should not be allowed. See Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 294 (1999) (administrative fees disallowed as the product of a sham), aff'd, 254 F.3d 1313 (11th Cir. 2001).

Finally, because Taxpayer has some residual value risk and cannot compel a return of its entire investment, it is inappropriate to assert tax for OID income under § 1272 on the theory that Taxpayer has made a deemed loan. Commissioner v. Indianapolis Power and Light Co., 493 U.S. 203, 212 (1990).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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