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To:
Cc:
Subject: RE: Fact Draft

You have asked for our advice regarding certain transactions in which taxpayer purports to acquire solar energy equipment and lease it back to the seller. The seller has entered into service agreements with end users of the equipment. At or about the time these service agreements expire and some five years before the end of the leaseback term, the seller has the option of "repurchasing" the equipment. If seller does not exercise this option, it is required to secure replacement service agreements with end users or otherwise provide security for rent for the remaining five years of the leaseback term. We understand that irrespective of whether seller exercises the repurchase option, taxpayer will recover its investment in the equipment on a pre-tax basis, i.e., without regard to credits and depreciation deductions taken on the premise that it acquires ownership of the equipment. In other words, taxpayer will earn a pre-tax return either through the purchase option price or rent for the remainder of the leaseback term.

Under these facts, the transactions can be recharacterized as financings, with the result that credits and depreciation deductions are disallowed, and rent is recharacterized as the payment of principal and interest. Taxpayer lacks a key attribute of tax ownership, residual value risk. Compare Estate of Thomas v. CIR, 84 T.C. 412 (1985), and Swift Dodge v. CIR, 692 F.2d 651 (9th Cir. 1982). Residual value risk would be present if taxpayer's recovery of its investment depended on the value of the equipment at the end of the leaseback term. As noted, we understand that taxpayer will earn a pre-tax return either upon exercise of seller's purchase option or, in the event the option is not exercised, through rent paid over the remaining term of the leaseback.

While the Service has a basis for recharacterizing the transactions as financings, we would not characterize the transactions as SILOs. Here, the proceeds of the purported sale and leaseback transaction are used to retire pre-existing construction debt. The seller presumably made use of the construction loan proceeds, and the transactions represent a refinancing of the construction loans. SILOs, on the other hand, represent little more than a sale of tax benefits.

Thank you.