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 NORTH -SOUTH CAROLINA DISTRICT COUNSEL
CC:SER:NCS:GBO

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Leveraged Lease Transaction

This Field Service Advice responds to your memorandum dated July 6, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND</u>:

Taxpayer =
B =
C =
D =

E =
F =
G =
H =
I =
J =

Period 1 =
Period 2 =
Period 3 =

Period 4	=
Period 5	=
Period 6	=
Period 7	=
Period 8	=
Period 9	=
Period 10	=
Date 1	=
Date 2	=
Date 3	=
Year V	=
Year W	=
Amount 1	= $
Amount 2	= $
Amount 3	= $
Amount 4	= $
Amount 5	= $
Amount 6	= $
Amount 7	= $
Amount 8	= $
Amount 9	= $
Amount 10	= $
Amount 11	= $
Amount 12	= $
Amount 13	= $
Amount 14	= $
Amount 15	= $
Amount 16	= $
Amount 17	= $
Amount 18	= $
Amount 19	= $
Amount 20	= $
Amount 21	= $
Amount 22	= $
Amount 23	= $
Amount 24	= $
Amount 25	= $
Percentage 1	=
Percentage 2	=

Percentage 3	=
Percentage 4	=
Percentage 5	=
Percentage 6	=
Percentage 7	=
Country	=
Notes 1	=
Notes 2	=
Number 1	=
Number 2	=
Number 3	=

This Field Service Advice responds to your request for coordination dated July 21, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUES:

1. Whether the leveraged lease transaction is a transaction lacking business purpose and economic substance.

2. Whether the purported sale and leaseback are properly characterized for federal income tax purposes.

3. Whether the indebtedness incurred by the taxpayer to purchase the rail cars should be respected for federal income tax purposes.

4. Whether section 482 should not be applied to this sale leaseback transaction to reallocate the ownership attributes between Taxpayer and D because we do not believe the control requirement of section 482 has been met.

CONCLUSIONS:

1. We believe a strong argument could be made that the sale lease-back transaction lacks economic substance and should not be respected according to its form. Moreover, even if the transaction were found to have some substance, it should not be respected according to its form because Taxpayer did not acquire the benefits and burdens of ownership of the rail cars and, therefore, should not be considered the owner of the rail cars for federal tax purposes. Additional factual

development is necessary before we can determine whether the Service should apply this theory.

2. We conclude that the transaction should not be respected as a sale and a lease-back for federal income tax purposes. The transaction may be viewed, at best, as a financing. The taxpayer's claim of depreciation deductions may be totally disallowed. Additional factual development is required to support these conclusions.

3. The indebtedness incurred by the taxpayer does not appear to be either genuine or to have economic substance. The indebtedness may be disregarded for federal income tax purposes, and can be disregarded for determining the taxpayer's basis in the rail cars. Any interest deductions taken pursuant to this indebtedness may be denied. Additionally, the taxpayer may only take depreciation deductions to the extent of its basis in the rail cars as discussed below.

4. We conclude that section 482 should not be applied to this sale leaseback transaction to reallocate the ownership attributes between Taxpayer and D because we do not believe the control requirement of section 482 has been met. Further, we do not recommend that the "acting in concert" doctrine that has been applied to lease stripping transactions should be pursued in this case because the parties in this transaction are unrelated and did not shift deductions separately from income in a manner that would raise a presumption of control by one party over the other.

FACTS:

B through its subsidiary Taxpayer entered into a type of transaction known as a "leveraged lease" transaction in Year V.

On Date 1, C acting as the Owner Trustee, agreed to purchase and hold Number 1 rail cars from D for the benefit of Taxpayer, for a purchase price of $Amount 1 pursuant to the terms of the Participation Agreement. D acquired Number 2 cars manufactured by E during Period 1 and initially placed the rail cars into service during Period 2. D initially acquired and placed into service Number 3 rail cars manufactured by F during Period 3. D purchased each of these cars for $Amount 2.

The purchase price of the rail equipment was comprised of the following amounts: the taxpayer paid $Amount 3 in cash to C; G, a Country bank, made a secured loan to C in the amount of $Amount 4 to pay D for the equipment and, in exchange, C issued the Notes 1 to G; and D made a purchase money loan to C in $Amount 5 and, in exchange, C issued the Notes 2 to D. Taxpayer agreed to make a capital contribution to H equal to a certain percentage of C's purchase price.

Although C was the promisor on the Notes 1 and Notes 2, C was acting for the benefit of Taxpayer. The Notes 1 and Notes 2 bear interest at an annual rate of Percentage 1. With respect to the Notes 2, no cash was exchanged; rather, the annual rent payments equaled the interest payments made by the Taxpayer pursuant to the Notes 2. D stated that the "[p]roceeds for the Notes 2 are an internal accounting circle, since D holds these notes." Questions Concerning Taxpayer Transactions, at 3.

The $Amount 4 loan principal that was disbursed by G to C (on behalf of D) was used to purchase a Certificate of Deposit ("CD") in that same amount with interest accruing at a rate of Percentage 1 annually. C purchased the CD on behalf of D from I. I then purchased a CD in the same amount from J. We understand that the CD with I has since been eliminated and D has deposited the cash with J in an interest bearing account. Questions Concerning Taxpayer Transactions, at 2.

Taxpayer disbursed $Amount 3 in cash to C, and C disbursed the money as follows: $Amount 6 to D; $Amount 7 was put into an Investment Account and used to purchase U.S. government securities; $Amount 8 to I, a subsidiary of B, as a deposit fee; and $Amount 9 as a fee to Promoter.

On Date 1, C (acting as trustee under the Owner Trust Agreement) leased the equipment back to D for a 20 year lease term pursuant to the terms of the Lease Agreement. D has agreed to pay approximately $Amount 10 in total rent over this 20 year period. Each rent payment is to be "in no event . . . less than the installment of principal and interest due and payable on the [Notes 1] Notes on such Rent Payment Date," pursuant to the Lease Agreement, ¶ 7.2. Upon an event of default (which includes failure to pay rent or to carry insurance on the rail cars), C has the right to demand payment of liquidated damages from D or D will have to deliver the rail cars to C. Lease Agreement, ¶ 12.1(b). In the event that C repossesses the rail cars or D otherwise sells the cars, the parties are required to comply with all requirements imposed on the sale by the Federal Transit Authority ("FTA"). Lease Agreement, ¶ 12.3. The lease is a net lease, and D is expected to maintain liability and loss value casualty insurance on the rail cars.

The money placed into the Investment Account was pledged to C to provide collateral security to C for D's obligations under the lease. The parties purchased one U.S. Treasury Bill and two U.S. Treasury Strips with a total face amount upon maturity of $Amount 11, and accruing a total amount of original issue discount ("OID") of approximately Amount 22 over a twenty year period. C had a first priority perfected security interest in the Treasury Bill and Strips, pursuant to the terms of the Investment Account Agreement and the Lease Agreement, ¶ 7.5(f). The OID will accrue to D; however, D is obligated to use the funds in the Investment Account, including the OID, to pay its rent for the rail cars to C.

D will have the choice of exercising either a Termination Option upon the expiration of the lease on Date 2, or a Purchase Option on Date 3, prior to the expiration of the lease. If D chooses to exercise the Termination Option, D will pay C $Amount 13. The Termination Option payment is Percentage 2 and Percentage 3 of the purchase price of the E and F cars, pursuant to the terms of Lease Supplement Number 1. Upon D's exercise of the Termination Option, C, as the lessor of the equipment, will be obligated to sell the equipment to the highest bidder and then pay a fraction of the amount received to D in the sale as a reimbursement for the Termination Option payment. Lease Agreement, ¶ 2.4. The taxpayer will be able to receive a refund equal to the lesser of either an amount equal to the discounted present value of the net proceeds of the equipment that exceeds Percentage 4 of the taxpayer's purchase price, or the Termination Option payment plus interest.

If D exercises the Purchase Option, D will pay a total amount of $Amount 14, stated to be Percentage 6 of the purchase price of the rail cars, pursuant to the terms of Lease Supplement Number 1. The Purchase Option amount that D is supposed to pay equals $Amount 15 for the residual value of the cars, and the outstanding interest and principal on the Notes 1 and Notes 2 . The Purchase Option is less than the Termination Option payment because it must be exercised one year earlier than the Termination Option payment.

C granted D a security interest in the leased rail cars and in the proceeds from the equipment and Bill of Sale, pursuant to the terms of the Lessee Security Agreement dated Date 1. Excluded from the collateral of the security interest is any right, title and interest of C in any lease with D, which includes any rent payments, profits or indemnity payments.

D granted C a security interest in the F Safe Harbor Equipment, that is, a Percentage 4 interest in the F cars pursuant to the terms of the Lessor Security Agreement dated Date 1.

G granted Taxpayer a continuing security interest in the Notes 1, pursuant to the terms of the Reimbursement and Security Agreement. Taxpayer has this security interest to secure G's obligation to reimburse Taxpayer for any payments that it is required to make that are not already funded by J. Reimbursement and Security Agreement, ¶2.

The parties calculated the residual value of the rail cars upon the expiration of the D lease in Year W to be Percentage 4 of the purchase price that Taxpayer paid in Year V, or $Amount 15.

Taxpayer is expected to receive from D either the Termination Option payment in the total amount of $Amount 13 or the Purchase Option payment in the total amount of $Amount 14. The taxpayer is expected to repay about $Amount 16 of indebtedness on the Notes 1 and 2, depending on whether D exercises either the Purchase Option or the Termination Option. Taxpayer expects to receive over $Amount 17 if D exercises the Purchase Option, for a return of approximately $Amount 18 in excess of its cash payment of $Amount 3. The facts indicate that Taxpayer may receive less if D exercises the Termination Option if Taxpayer does not receive significant salvage proceeds upon the sale of the rail cars.

Taxpayer is expected to take $Amount 19 in annual depreciation deductions over a Period 5 life pursuant to I.R.C. § 167 for a total of approximately $Amount 20 to $Amount 21. It is also expected that Taxpayer will take interest deductions in the amount of the interest paid on the Notes 1 and Notes 2 pursuant to section 163, but the exact amount is not clear from the facts.

If Taxpayer loses or is denied its interest deductions, depreciation deductions and amortization deductions, or if the taxpayer is required to recapture the depreciation deductions, then Taxpayer shall be entitled to an indemnification payment amount, pursuant to the terms of the Tax Indemnity Agreement, at ¶ 4.1. This indemnification amount is the “Make Whole Amount” and is equal to the economic return to which the taxpayer would otherwise be entitled, taking into account any additional taxes required to be paid on additional income. Tax Indemnity Agreement, at ¶ 5.1.

This type of domestic sale-leaseback transaction is discussed in Chapter 2 of a publication entitled published by the This publication provides guidance on how a transit system can meet the legal requirements that the receive “a proportional return of the value on disposal of transit assets” (i.e., rail cars). This publication states that, “since the transit system retains effective continuing control of the assets for transit service, regards this situation as meeting the requirements of the law. . . .” The concludes in this publication that “the requirement for effective continuing control does not require more than physical possession and the unquestioned right to use the asset in transit service, as agreed in the grant documents that enabled the asset’s initial purchase.” Additionally, “if the transit system defaults, then the lessor or owner of the assets has the right to take possession and resell the assets. However, the transit system has signed an agreement with pledging to maintain effective continuing control of the assets. The lessor would thus be in direct competition with the U.S. Government for control of the transit assets involved.” This publication notes that “the defeasance features of these leases tend to mitigate the risk associated with such defaults. Because the transit authority banks most of the proceeds of the sale of the assets, there is ample cushion from which to make the lease payments.”

We note that the endorsement and opinion as to the tax consequences are irrelevant to the analysis of this Field Service Advice.

ISSUE 1 - Economic Substance

Whether the lease transactions at issue lack business purpose and economic substance?

CONCLUSION

We believe a strong argument could be made that the sale lease-back transaction lacks economic substance and should not be respected according to its form. Moreover, even if the transaction were found to have some substance, it should not be respected according to its form because Taxpayer did not acquire the benefits and burdens of ownership of the rail cars and, therefore, should not be considered the owner of the rail cars for federal tax purposes. Additional factual development is necessary before we can determine whether the Service should apply this theory.

DISCUSSION

Where there is a genuine 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 transaction is valid and the Service should honor the allocation of rights and duties effectuated by the parties. To provide guidance in determining whether a transaction is for valid tax purposes, courts have looked to: (1) whether the taxpayer had a business purposes for engaging in the transaction other than tax avoidance; and (2) whether the transaction had economic substance beyond the creation of tax benefits. Thus, both the taxpayer’s subjective business motivation and the objective economic substance of the transactions are examined.

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is not valid and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752(1975); Rice's Toyota World v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985) Frank Lyon Co. v. United States, 435 U.S. 561 (1978). When a transaction is treated as invalid, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998) cert denied, 119 S.Ct. 1251 (U.S. 1999) the Service argued that the purchase and sale of debt instruments were prearranged and predetermined, devoid of economic substance and lacking in economic reality. See also, Compaq Computer v. Commissioner, 113 T.C. 17 (1999).

In its opinion, the Tax Court said that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The Tax Court also stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transaction lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts when viewed as a whole have no economic substance.

If the transaction is valid in this case, it would disallow income expenses and deductions from the sale-leaseback. The transaction at issue in this case involves a sale-leaseback that when taken as a whole have no business purpose independent of tax considerations. As in ACM Partnership, the Taxpayer entered into the transaction for the sole purposes of avoiding taxes.

The United States Supreme Court addressed the issue of whether a sale /leaseback transaction should be respected according to its form in Frank Lyon. In that case the taxpayer used third party financing to purchase a building from a bank and leased the building back to the bank. The Court sustained the taxpayer's position that it was the true owner of the building and therefore entitled to the corresponding tax benefits. According to the Court, the transaction was a genuine multi-party transaction with economic substance. The court noted that the taxpayer was liable for the recourse debt used to acquire the property and bore a risk of loss in the event it could not re-lease the property at the end of the lease term and the property was not repurchased pursuant to an option given to the bank. Additionally, the Frank Lyon Court emphasized that the transaction did not create deductions that would not otherwise exist. Respecting the transaction simply shifted those deductions from the bank to the taxpayer.

The present case differs significantly from that in Frank Lyon. Here, Taxpayer lacks any real liability for the transaction financing. Repayment of the financing from the is assured because of various deposits/investments, and satisfaction of the seller financing from D appears to be assured because of D's offsetting rent and end-of-year-lease term obligations to Taxpayer. There may be some possibility that if the rail cars fail to retain any residual value, Taxpayer will lose some portion of its $ Amount 15 investment. But this appears unlikely if District Counsel's factual conclusions are correct and, moreover, any such loss would appear to be nominal in relation to the size of the transaction. Thus, the taxpayer in Frank Lyon bore a burden of ownership, risk of loss from decline in market value, that Taxpayer does not bear in this case. A further basis for distinguishing Frank Lyon is that this transaction, if respected according to its form, does result in the creation of otherwise nonexistent deductions because D is unable to use the depreciation and other deductions available to the owner of the rail cars.

The lower courts, in numerous cases, have disallowed the tax benefits accompanying ownership of property when the transaction purporting to transfer ownership lacks economic substance. In Rice's Toyota World Inc., the court held that a sale/leaseback transaction did not have significant economic effect on the taxpayer insofar as risk of loss was negated by the use of nonrecourse financing and the opportunity for pre-tax profit was remote given that the leased property lacked any expected residual value. As already noted, this transaction is structured to substantially eliminate Taxpayer's risk of loss from depreciation of the rail cars. Taxpayer's opportunity to profit meanwhile is capped because D has the option of purchasing the rail cars at the end of the lease term and will exercise this option if the rail cars have a value of at least Percentage 4 of their purchase price. Even if D fails to exercise the option, makes the termination payment and transfers the rail cars to Taxpayer, any excess of the residual value of the rail cars over Percentage 4 of their purchase price inures to D's benefit because Taxpayer must sell the rail cars and pay D such excess. The limitations on Taxpayer's risk of loss and opportunity to profit deprive this transaction of meaningful economic substance.

District Counsel employs a present value analysis in concluding that the transaction fails to afford Taxpayer any opportunity for profit. Although there is some authority for not using the present value concept in evaluating the substance of a sale/leaseback transaction, we agree that the better view is to take into account the fact that the net payment expected to be received by Taxpayer will not be paid until Period 4 after Taxpayer makes its equity investment.

This was the approach adopted in ACM Partnership. Other cases have taken into account the time value of money. In Hines v. United States, 912 F.2d 736 (4th Cir. 1990), the court concluded that a sale and leaseback of computer equipment was invalid given that there was no reasonable expectation of profit apart from the tax benefits of the transaction.

There is contrary authority. Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n. 52 (1985). But in determining whether a transaction has more than a de minimis economic effect on a taxpayer, ignoring the present value concept flies in the face of reality.

Finally, regardless of whether this transaction is found to be valid, an argument can be made that Taxpayer is not entitled to depreciation and other deductions reserved to the owner of property because it never received the benefits and burdens of ownership of the rail cars. See Levy v. Commissioner, 91 T.C. 838

(1988); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981). A very important fact in determining whether a taxpayer is the tax owner of property is whether that taxpayer has the potential to realize a profit or loss from the sale or re-lease of the property. In this case, Taxpayer's ability to either profit or lose as a result of the residual value of the rail cars is circumscribed. It knows that it will receive a certain sum as a termination payment even if the rail cars lack any residual value and D fails to exercise its purchase option. It also knows that if the residual value of the rail cars exceeds Percentage 4 of their original cost, this excess will inure to D's benefit, either because D will exercise D will exercise its purchase option or because Taxpayer will have to sell the rail cars after they are transferred to it and remit the excess to D. Taxpayer lacks either the upside or downside that an owner of property normally possesses. Thus, even if the transaction were found to have substance as an investment by Taxpayer, or otherwise, it should not be respected as a valid sale and leaseback.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

ISSUE 2 Genuine Debt

Whether the purported sale and leaseback are properly characterized for federal income tax purposes.

CONCLUSION

We conclude that the transaction should not be respected as a sale and a leaseback for federal income tax purposes. The transaction may be viewed, at best, as a financing. The taxpayer's claim of depreciation deductions may be totally disallowed. Additional factual development is required to support these conclusions.

DISCUSSION

Whether the characterization of a sale and leaseback of the same asset should be respected for federal income tax purposes depends upon the substance of the transaction. Levy v. Commissioner, 91 T.C. 838 (1988). A transaction may be considered a sale for federal income tax purposes if the benefits and burdens of ownership passed to the purchaser of the assets. Levy, 91 T.C. at 859.

The petitioner in Levy entered into sale-leaseback transactions involving computer equipment. In determining that the petitioner's purchase of the equipment should be respected for federal income tax purposes, the court stated that the factors relevant to this determination are:

> (1) the purchaser's equity interest in the computer equipment as a percentage of the purchase price;
> (2) a useful life of the property that extends beyond the lease term;
> (3) lease renewal or purchase options at the end of the lease term based on fair market value of the equipment at that time;
> (4) whether the projected residual value of the equipment plus the cash flow generated by the rental of the equipment allows the investors to recoup at least their initial cash investment;
> (5) whether a turnaround point is reached at some point whereby depreciation and interest deduction are less than income received from the lease;
> (6) whether the net tax savings for the investors are less than their initial cash investment; and
> (7) the potential for realizing a profit or loss on the sale or release of the equipment.

Levy, 91 T.C. at 860. See also Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987), aff'd in part, rev'd in part, Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990) (determining that most of taxpayer's computer leasing sale and leaseback transactions were not motivated by a business purpose, were devoid of economic substance and were disregarded for federal income tax purposes, but also determined that taxpayer acquired the benefits and burdens of ownership).

Additional factors to consider include whether an equity interest was acquired in the property, whether the contract created a present obligation on the seller to execute and deliver a deed and on the purchaser to make payments, and whether the right of possession is vested in the purchaser. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

Factors that the Tax Court in Larsen deemed to be neutral in determining whether a taxpayer should be respected as the owner of the equipment include the following:

(1) the existence of a net lease;
(2) the absence of significant positive net cash flow during the leaseback term or rent geared to interest and mortgage amortization; and
(3) the use of nonrecourse liability.

Larsen, 89 T.C. at 1267, *citing* Estate of Thomas v. Commissioner, 84 T.C. 412 (1985). See also Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

Rev. Rul. 55-540, 1955-2 C.B. 39, established a guide for determining the federal income tax treatment of leases of equipment. The Service stated in this revenue ruling that, "In deciding whether a taxpayer is entitled to a deduction for any payments claimed to represent rentals under the provisions of the Code . . ., it is necessary to determine whether by virtue of the agreement the lessee has acquired, or will acquire, title to or an equity in the property. The determination of that question with respect to agreements of the type here involved will ordinarily depend upon whether the particular agreement should be treated, in reality, as a lease or a conditional sale contract." A transaction will not be treated as a lease or rental agreement if one or more of the following conditions is present:

(1) portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee;
(2) the lessee will acquire title upon payment of the required amount of rentals;
(3) the total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of title; see Truman Bowen v. Commissioner, 12 T.C. 446 (1949);
(4) the rental payments materially exceed the current fair rental value, as an indiction that the rental payments include an element other than compensation for the use of property;
(5) the property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, or is relatively small when compared with the total payments made; or

(6) some portion of the payments is designated as interest or recognizable as interest.

Rev. Rul. 55-541, 1955-2 C.B. 19, sets forth the proper treatment for federal income tax purposes of a lease of equipment. The Service determined that the purported lessee of the equipment, M, was transferred equitable ownership of the equipment and not a leasehold interest because M "enjoy[ed] all of the benefits of ownership for substantially the entire useful life of the property."

In Mapco Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977), the court upheld the trial court's determination that the assignment of future revenues by the plaintiff was not a bona fide sale, but was rather a loan-type of investment secured by the right to future revenue (a nonrecourse secured loan). The court looked to the fact that the assignee had the right to repayment, and this certainty was characteristic of a loan. Mapco, 556 F.2d at 1110. Additionally, the court determined that amounts deposited in the bank by the plaintiff indirectly guaranteed repayment, also characteristic of a loan.

If the transaction was not a sale, but rather a financing arrangement, then any amount that D received from Taxpayer would not be included in D's gross income. United States v. Centennial Savings Bank FSB, 499 U.S. 573, 582 (1991), 1991-2 C.B. 30. Furthermore, if the transaction is not a sale and a leaseback, the rental income to the Taxpayer would then be properly characterized as repayment of principal and would not be taxable as income.

Upon the application of the factors set forth in Levy and Grodt & McKay to the facts of this case, this sale and leaseback should not be respected for federal income tax purposes.

In the case at hand, Taxpayer paid $Amount 3 in cash which represented Percentage 5 of the $Amount 1 purchase price of the rail cars. Of the cash amount paid by the taxpayer, $Amount 6 was paid to D, and Amount 23 was paid for other expenses. The remaining $Amount 7 was placed in an Investment Account and was used to purchase U.S. Treasury securities. The Investment Account was created to provide collateral security to C (in substance to the taxpayer) for D's rental obligations under the lease. Although the money in the investment account is, in form, the property of D, D is not to receive the money unless all of its obligations to C under the lease have been discharged. Upon satisfaction of its obligations, D will be entitled to the proceeds.

Of the $Amount 1 purchase price paid by the taxpayer, $Amount 5 was financed by D as a purchase money loan. D has indicated that the "Notes 2 are an internal accounting circle since D holds the notes. They do not contemplate any future obligations to infuse any cash, since at the close of the transaction, the funds owed to D on the J deposit, the Notes 2 and the investment account should pay off all obligations of D." Questions Concerning Taxpayer Transaction, at 3. Thus, it appears that D never intended to contribute this amount of cash to the transaction, and the amount can be subtracted from the original purchase price of the rail cars. If the total amount of the Notes 2 is subtracted from the purchase price of the rail cars, then the purchase price of the rail cars was $Amount 24 and the cash paid by Taxpayer represents an equity investment of approximately Percentage 7 of the purchase price. This fact, when viewed alone, is neutral.

From the facts known by us, it is likely, but not certain, that the useful life of the property will extend beyond the Period 4 lease term. Both the E cars and the F cars may have a useful life of an additional Period 6. However, it appears to be likely that D will purchase and will continue to use the cars after the expiration of the leases.

Under the terms of the documents, if D elects the Termination Option, then D will have to acquire rail cars from another source. This will be beneficial to D if the residual value of these cars is inflated and if D can acquire rail cars more cheaply from another source. Additionally, if D elects the Termination Option and loses control and custody of the rail cars, then D will be required to repay the a fraction of the proceeds as D has agreed to do when it sells the rail cars (or loses custody and control over the rail cars).

D will be economically compelled to purchase the cars that it has leased if the cost to acquire cars from the marketplace is more expensive than keeping the cars that it has leased. D will be able to use the proceeds from the Investment Account to finance its acquisition of the rail cars, thereby avoiding any out-of-pocket expenses. Therefore, it appears that the Purchase Option will be economically beneficial to D. Upon D's exercise of the Purchase Option, D will then have been using the rail cars for their entire economic life, which would support the recharacterization as a financing transaction.

We do not know the whether the purchase price of the residuals in the Purchase Option reflects fair market value of the rail cars. We recommend additional factual development on this issue.

The taxpayer has projected its income in excess of its expenses to be approximately $Amount 3 if D exercises its Purchase Option, and can recoup at least their initial cash investment. It appears likely that D will exercise its Purchase Option. The taxpayer has also projected that it may lose money on the transaction if D exercises the Termination Option, but this is not as likely to occur. The fact that the taxpayer is indirectly guaranteed to recover its costs is indicative of a financing and, as discussed below, indicative of a lack of economic substance.

It does not appear that there will be a turnaround point when the deductions will be less than the income because the depreciation and interest deductions will exceed the taxpayer's rental income. The rental income is matched with the interest deductions on the Notes 1 and Notes 2 notes, indicating, if the transaction is to be respected at all, that it is a financing.

The taxpayer's initial cash investment of $Amount 3 (of which it will recover $Amount 7 plus accrued OID) is significantly less than the overall tax savings of $Amount 20 in depreciation deductions plus its additional interest deductions.

Under the form of the transaction, if D exercises the Purchase Option, then Taxpayer will receive $Amount 14 from D, which will include the $Amount 15 residual value of the equipment, the payment of the interest and principal due on the Notes 1 and Notes 2 . Thus, the $Amount 15 that D will pay Taxpayer will be in excess of both Taxpayer's total cash payment $Amount 3 and net cash payment of $Amount 25 ($Amount 6 to D and $Amount 8 and $Amount 9 in other fees). Because D expects to pay the residual value of the rail cars from the accrued OID on the U.S. government securities that it holds, the amount is predictable. It appears from the facts of this case that D will exercise the Purchase Option; therefore, Taxpayer's potential for realizing a "profit" (income in excess of its expenses) is locked in and a fixed amount, which is indicative of a financing transaction.

If the form of the transaction is respected, Taxpayer could lose money on the transaction if D exercises the Termination Option. If D exercises the Termination Option, Taxpayer will be forced to sell the rail cars on the open market. The sale of the rail cars will expose the taxpayer to the possibility that it will not recover its initial investment in the rail cars. As discussed previously, it appears unlikely that D will exercise the Termination Option. We recommend that you develop this issue as discussed below.

Under the documents, the beneficial ownership in the rail cars will not be vested in Taxpayer at any time during this transaction. Although Taxpayer will have the right to repossess the rail cars from D in the event that D defaults on its rental obligations, this is unlikely to happen because D has stated that the rents have already been provided for and that it is fully defeased. Questions Concerning Taxpayer Transactions, at 3. Taxpayer may possess the rail cars if D elects the Termination Obligation, but, as indicated above, this is also not likely to happen. Thus, these facts support characterizing the transaction as a financing.

Upon the application of Rev. Rul. 55-540 and Rev. Rul. 55-541 to this case, it appears that D was not a lessee of the rail cars because D has retained an equity interest in the rail cars. First, upon D's exercise of the Purchase Option and upon D's payment of the rents, D can acquire title to the rail cars without paying additional money. D will receive the accrued OID from the Investment Account upon its fulfillment of its obligation to pay rent. D has stated that it is fully defeased because it expects to use the $Amount 22 of accrued OID and the funds deposited in the CD with J to fund the Purchase Option without incurring any out-of-pocket expenses. Additionally, we note that if D does not exercise its Purchase Option, but rather exercises the Termination Option, and loses control over the rail cars, D will be obligated to pay the a certain fraction of the value of the rail cars. The is required to receive a portion of the value of the rail cars upon the disposal of the rail cars, pursuant to the legal requirements for the assistance that Taxpayer received.

Second, because D may reacquire the rail cars upon its exercise and payment of the Purchase Option, which requires no out-of-pocket payments by D, D will effectively acquire title to the rail cars upon its payment of all rent. D expects to pay for the residual value of the equipment from the OID that has accrued in the Investment Account to its benefit. Thus, D expects to pay none of its own funds to purchase the rail cars, an amount which is nominal in relation to the value of the equipment.

Third, it appears that D will enjoy the benefits of ownership for substantially the entire useful life of the property. As of Date 1, when the parties entered into this transaction, D had been using the E cars since Period 2, but D purchased the cars between Period 1. Although we do not know the age of the cars at the time that D put them in service, we do know that the E cars will have been used for between Period 7 upon the expiration of D’s lease. D had been using the F cars since Period 3. Although we do not know the age of the cars at the time that D put them in service, the F cars will have been used for between Period 8 upon the expiration of D’s lease. At best, some of the cars will be within Period 9 of their estimated Period 10 life. It appears likely that D will exercise its Purchase Option and will retain possession and control over the cars because of their continuous economic investment in the rail cars. Furthermore, in the ______________________________ published by the the requires rail systems like D to retain effective continuing control over the rail cars. The has stated that it will accept the purported sale-leaseback transaction. General Background Information on D Leases, at 5. Conversely, it appears that Taxpayer will never exercise physical control over the rail cars. These facts indicate that D has retained its equity interest in the rail cars, which supports characterizing the transaction as other than a lease.

Fourth, the total rental payments may materially exceed the total fair rental value of the rail cars. However, D’s actual annual rental payments will be far less than the annual fair rental value because the annual rental payments will equal the annual interest payments on the Notes 1 and Notes 2, and D will make one large balloon payment at the end of the lease. This will require an independent valuation of the fair market value of the rail cars and their rents. We recommend that you develop additional facts to support this argument, as discussed below.

Fifth, D was granted a security interest in the leased rail cars by C (the grantor), pursuant to the Lessee Security Agreement. This security interest may be viewed as an equity interest in the leased equipment. Although D's security interest in the rail cars is consistent with D's status as the seller of the rail cars and lender to the taxpayer, it is inconsistent with D's status as a lessee of the rail cars because, under Service position, a lessee may not have an equity interest in the equipment. In the event that C, the grantor, defaults upon its obligations, D, the secured party, may enforce its rights, including foreclosure of the rail cars. In the event of default by C, acting as the lessor of the equipment, D, as the lessee of the rail cars, would then have the right to terminate the lease. This leads to an absurd result because it would constitute a default by C, acting as the grantor, and D would retain its rights as a secured party, could terminate the lease, and could nevertheless foreclose upon the rail cars which have never left its possession. Because D has retained its equity interest in the rail cars, the transaction should not be respected as a sale and leaseback.

Upon the application of the factors set forth in Mapco, and assuming that the debt is bona fide, it appears that this transaction is a secured financing by D, and not a sale and leaseback of the rail cars. Thus, the funds ($Amount 7 and $Amount 4) that D will receive is simply a loan that it must repay. We exclude from this loan amount the Taxpayer's cash payment to D of $Amount 6 which D is not required to repay, and D's own purchase money loan of $Amount 5 because it is a loan to itself. D implicitly guaranteed repayment of the loan because D is to pay either the Purchase Option or the Termination Option with the amounts received on the loan from G, the accrued OID in the Investment Account and the purchase money loan that D made to Taxpayer (essentially repaying itself).

Upon recharacterizing this transaction as a financing, we must determine the ownership of the funds contributed to the Investment Account. Income is taxable to the recipient pursuant to section 61. When a taxpayer acquires funds, has control over the property, and derives readily realizable economic value from it, the taxpayer is regarded as having received income and is liable for tax on the income. James v. United States, 366 U.S. 213, 219 (1961).

A loan or an advance is not taxable income to the borrower. Sattelmaier v. Commissioner, T.C. Memo. 1991-597. In determining whether a loan is a bona fide loan, the Tax Court will consider the following factors: whether a note or other evidence of indebtedness exists; whether there is any written loan agreement; whether there is a fixed schedule for repayment; whether any security or collateral is requested; whether interest is charged; whether a demand for repayment has been made; whether the records reflect the transaction as a loan; whether any repayments have been made; and whether the borrower was solvent at the time of the loan. Id. The Tax Court stated in Reed v. Commissioner, T.C. Memo. 1994-611 that in determining whether a purported loan is bona fide, “the ultimate issue is the intent of the borrower to repay and the intent of the lender to enforce repayment.”

In this case, Taxpayer purportedly paid D $Amount 7 as part of the purchase price of the rail cars when it contributed $Amount 7 to C to contribute to the Investment Account in D’s name. In the event that D fails to pay rent for the rail cars, the funds in the Investment Account may be applied towards rent pursuant to the terms of the Investment Account Agreement. C, acting as trustee, has the first priority perfected security interest in the funds in the Investment Account. When asked how the securities in the Investment Account are going to be applied by D, D responded that these securities that it holds are restricted, and that it believes that “D cannot touch these securities.” Questions Concerning Taxpayer Transactions, at 2. D has said that it expects that it will not infuse any of its own cash into the transaction because it is “fully defeased” and “the funds owed to D on the J deposit, the Notes 2 and the investment account should pay off all obligations of D.” Questions Concerning Taxpayer Transactions, at 3. Furthermore, the parties specifically contemplated a situation in the Tax Indemnity Agreement, ¶ 4.2, where Taxpayer could receive additional income, possibly indicating that Taxpayer may be viewed as the owner of the Investment Account and the interest and OID accruals. These facts indicate that D intends to repay the money to Taxpayer, which supports characterization as a loan. Reed, T.C. Memo. 1994-611.

It appears that D has not had and will not have the control required to be considered to be the owner of the funds in the Investment Account for federal income tax purposes. James, 366 U.S. 213. Although not all of the indicia of bona fide indebtedness are present in this case, the most significant element of a loan, intent to repay, is present. It appears that the transaction resembles a loan. Accordingly, the interest and OID that will accrue in the Investment Account may be attributed to Taxpayer.

ISSUE 3 - GENUINE DEBT

Whether the indebtedness incurred by the taxpayer to purchase the rail cars should be respected for federal income tax purposes will depend on whether the debt is genuine and whether it has economic substance. If the debt used to purchase an asset is not genuine indebtedness, the debt is not properly included in the basis of the asset. Dean v. Commissioner, 83 T.C. 56, 78 (1984).

CONCLUSION

The indebtedness incurred by Taxpayer does not appear to be either genuine or to have economic substance. The indebtedness may be disregarded for federal income tax purposes, and can be disregarded for determining the taxpayer's basis in the rail cars. Any interest deductions taken pursuant to this indebtedness may be denied. Additionally, Taxpayer may only take depreciation deductions to the extent of its basis in the rail cars as discussed below.

DISCUSSION

Debt will not be recognized as genuine indebtedness if the purchaser acquires no equity in the property by making payments and has no economic incentive to pay off the note. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). In Estate of Franklin, Twenty-Fourth Property Associates, the purchasers, agreed to purchase real estate for $1,224,000. The sellers then leased back the property. The purchasers paid $75,000 in prepaid interest, issued a nonrecourse obligation to the sellers with a balloon payment in the final year of $975,000, and agreed to pay $9,045.36 in monthly principal and interest installments. The monthly principal and interest installments were designed to approximate the monthly lease payments. The appeals court determined that the taxpayers failed to demonstrate that the purchase price was at least approximately equivalent to the fair market value of the property. Estate of Franklin, 544 F.2d at 1048. The court stated that "[p]ayments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase." Estate of Franklin, 544 F.2d at 1048.

The court in Estate of Franklin determined that the taxpayers did not acquire an equity interest in the property because the purchase price did not approximate the fair market value. The taxpayer in the case at hand also did not acquire an equity interest in the rail cars that it purportedly purchased, although for reasons that are different from the taxpayers in Estate of Franklin. The taxpayer in the case at hand did not acquire an equity interest because D retained its equity interest in the rail cars, as discussed above. In addition, the purported debt was not used by the taxpayer and was secured by its own generation of interest. Therefore, the indebtedness incurred is not genuine. The purported purchaser, the taxpayer, can, therefore, lose no more than a chance to acquire an equity in the rail cars in the future. Under Estate of Franklin, the indebtedness will not be included in the taxpayer's basis in the rail cars.

The existence of debt will also be disregarded if the overall transaction is not valid, and therefore devoid of economic substance. Casebeer v. Commissioner, 909 F.2d 1360, 1366 (9th Cir. 1990); ACM v. Commissioner, 157 F.3d 231 (3d Cir. 1998). The taxpayer paid $Amount 3 in cash and financed the purported purchase of the rail cars by borrowing $Amount 4 from G (through C, acting as trustee), and by borrowing $Amount 5 from D. Upon close scrutiny of the loan from G and the loan from D, neither of these two loans possess any economic substance.

First, the loan from G for $Amount 4, for which the Notes 1 were issued, has no economic substance because the money was deposited in a CD (later deposited in an interest bearing account) ostensibly for the benefit of D. However, D has indicated that the funds held in the CD will be used to fund its future obligations to pay either the Termination Option or the Purchase Option to the taxpayer. Questions Concerning Taxpayer Transactions, at 3. The $Amount 4 will be moving in a circle without any economic substance.

Second, D's loan to C of $Amount 5 has no substance either because D has acknowledged that these funds, for which D received the Notes 2, "are an internal accounting circle" and for which cash was never going to be exchanged. Both of these two loans, therefore, can be excluded from Taxpayer's basis in the rail cars.

The funds deposited in the Investment Account may also be excluded from Taxpayer's basis because it appears that the funds in the Investment Account in substance belong to the taxpayer and not to D.

Interest payments are not deductible under section 163 if they arise from transactions that have no purpose, substance or utility apart from their anticipated tax consequences. <u>Lee v. Commissioner</u>, 155 F.3d 584, 586 (2d Cir. 1998); Rev. Rul. 99-14, I.R.B. 1999-13. The loans made pursuant to the Notes 1 and Notes 2 appear to have no purpose and substance apart from their tax consequences. Accordingly, Taxpayer's interest deductions taken pursuant to section 163 for interest paid on the Notes 1 and Notes 2 may be denied.

In summary, D has neither sold nor leased back its rail cars from Taxpayer. Taxpayer has no rights under the purported loan from G of $Amount 4 and under the purported loan from D amount of $Amount 5 because these purported loans are circular and possess no economic substance. If Taxpayer defaults on its obligations, it means that D failed to meet its obligation to pay rent. If Taxpayer fails to meet its obligation to pay rent, then D will have the right to repossess the rail cars. Thus, Taxpayer cannot at any time be the beneficial owner of the rail cars because D has retained its equity interest in the rail cars.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

The facts in this case support a recharacterization of the sale-leaseback and the economic substance argument. Although we are confident of our conclusion, we recommend that you develop additional facts in support of the recharacterization.

Such additional facts include the following:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

ISSUE 4 - INTERNATIONAL ISSUES

Whether section 482 should not be applied to this sale leaseback transaction to reallocate the ownership attributes between Taxpayer and D because we do not believe the control requirement of section 482 has been met.

CONCLUSION

We conclude that section 482 should not be applied to this sale leaseback transaction to reallocate the ownership attributes between Taxpayer and D because we do not believe the control requirement of section 482 has been met. Further, we do not recommend that the “acting in concert” doctrine that has been applied to lease stripping transactions should be pursued in this case because the parties in this transaction are unrelated and did not shift deductions separately from income in a manner that would raise a presumption of control by one party over the other.

If you have any further questions, please call the branch telephone number.

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