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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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

FROM: ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES CC:PSI

SUBJECT: Leasing Transaction

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LEGEND

A=
B=
C=
D=
F=

G=
H=
J=
K=
L=
M=
N=

Country A=
Country B=
Country C=
Country D=

Region A=

#1=
#2=
#3=
#4=
#5=
#6=
#7=

$1=
$2=
$3=
$4=
$5=
$6=
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$15=
$16=
$17=
$18=

Date 1=
Date 2=
Date 3=
Date 4=

Date 5=
Date 6=

ISSUE

Whether the transactions described below lack economic substance.

CONCLUSION

The transactions described below lack economic substance and should not be respected.

FACTS

A sold certain property (Property) to a Country A entity and leased the Property back for a period of approximately #1 years beginning in Date 1. The Property is located in Region A, Country B. B owns #2 percent of A. B is a Region A, Country B state authority that owns C. C was granted an option to purchase the Property after #3 years.

On Date 3, A and C purportedly assigned all of their rights and interests in the Property, including the purchase option, to a trust, D, treated by taxpayer, F, as a grantor trust, in return for the payment of $1 to A and $2 to C.

To fund the purported purchase of the Property, D borrowed $3 from G and $5 from J. In addition F transferred $10 to D. D transferred these sums in the amount of $11 to A for the purported purchase of the Property on Date 5. On that same day A pre-paid $12 to K as rent under the sublease described below. A retained the difference. K deposited these funds in three places: $3 with G; $5 with L; and a portion of F's purported initial investment (Initial Investment), $13, with J. J used this amount to purchase $13 in U.S. Treasury Strips.

Also on Date 3, D leased the Property to K, a Country C company owned by N and formed on Date 2 with $4 capital. The lease agreement (Lease) between D and K provided that the basic term (Basic Term) of the lease was #4 years with a replacement term (Replacement Term) of #5 years. K agreed that it (or any sublessee) will operate the Property only in Country B. (Because the Basic Term exceeds the term of A's original lease with the Country A entity, it appears certain that the option to purchase the Property from the Country A entity will be exercised.) Under the Lease, D granted a security interest in the Property to its lenders, G and J.

Also on Date 3, K, as sublessor (Sublessor), and A, as sublessee (Sublessee), entered into a sublease (Sublease). The terms of the Lease and the Sublease were coextensive and the rents were identical. The Sublease stated that A is bound by the terms of the Lease (not the Sublease) in regard to maintenance, modifications, insurance, and inspection. Under the documents, A, as primary obligor, guaranteed all payments under the agreements.

Under the coordination agreement (Coordination Agreement) entered into by G, K, B, and A, B underwrote the obligations of G, and was subrogated to the rights of K. In a separate agreement, G directed K to pay $3 into B's account. Any variation in payment direction required the prior written consent of A and B. The dates and payment amounts coincided with the amounts D needed to pay off the loan. Thus, this portion of the rents actually by-passed D and paid off the $3 loan from G, which was underwritten by B. Similarly, L directed K to deposit $5 with D. D, in turn, used these amounts to pay off its $5 loan from J.

On Date 3, K and J entered into a swap agreement (Swap Agreement) under which fixed interest payment obligations were swapped for floating rate payment obligations. The Swap Agreement was set to end on the date the Purchase Option may be exercised.

On the expiration of the Sublease, A has the option of purchasing the Property (A's Purchase Option) or returning the Property and paying a return amount (A's Return Option). The price for A's Purchase Option and A's Return Option are identical to the price of K's Purchase Option and K's Return Option under the Lease.

F, through D, also made a deferred investment (Deferred Investment) of $14 on Date 6. This amount was deposited with J and was used to buy U.S Treasury Strips. Along with F's original $13 Initial Investment in U.S. Treasury Strips, these U.S. Treasury Strips will mature into amounts that equal amounts due as installments under the Purchase Option.

At the end of the Basic Term, K also has three options:

1. K can pay the purchase option price of $6 with the first installment of $7 coming due on Date 4 (Purchase Option). K would then owe four more installments totaling $8.
2. K can elect to return the Property and pay a deficiency payment of $9 to D (Return Option).
3. K may procure a replacement lessee (Replacement Lessee) who will enter into a replacement lease, and arrange for the continuation of the loans or arrange for replacement loans (Replacement Lease Option). The Replacement Lessee must pay rent sufficient to pay the amounts of principal and interest payable under the loans.

For federal tax purposes, F claimed deductions on its purported interest expense and depreciation deductions on the Property. F has not included in income any interest on the U.S. Treasury Strips.

LAW AND ANALYSIS

You have asked whether this transaction should be respected for federal tax purposes. For the reasons discussed below, we agree with your conclusion that the entire transaction lacks economic substance.

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); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998). Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic substance because the economic consequence of holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 T.C. at 769.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership, 157 F.3d at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

Moreover, claims of pre-tax profit are not dispositive. There has been some precedent that economic substance for a lease transaction will be satisfied if there is "some modicum" of economic substance, which may mean "some modicum" of pretax profit. See Rice's Toyota World, Inc. v. Commissioner, supra; Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985). In Hines v. Commissioner, 912 F.2d 736 (4th Cir. 1990), the Fourth Circuit found that a leasing transaction was a sham. In doing so, it described a $17,000 profit potential as "minimal" on an eight-year investment of $130,000. The Fourth Circuit also found evidence of tax motivation in the offsetting obligations to pay rent and debt service. The transaction also involved the use of related parties to avoid section 465. Under these facts, the court found that "the tax tail began to wag the dog." Hines, 912 F.2d at 741. Thus, small profits on a lease transaction may be overlooked when tax considerations have taken over the transaction. See also Pacheco v. Commissioner, T.C. Memo. 1989-296.

Because this transaction contains both a lease-in, lease-out transaction (LILO) between A and F and a purported sale of the Property from A to F, it is necessary to scrutinize both parts of the transaction in order to determine whether the transaction as a whole lacks economic substance.

2. Application to LILO Transaction

A LILO is a lease from one entity to another with a generally coextensive lease back to the first entity. It is the position of the Internal Revenue Service that certain LILO transactions lack economic substance. Rev. Rul. 99-14, 1999-13 I.R.B. 3. 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, supra; Compaq Computer v. Commissioner, 113 T.C. 17 (1999).

Viewed as a whole, the objective facts of the above-described LILO transaction indicate that the transaction lacks the potential for any significant economic consequences other than the creation of tax benefits; therefore, the transaction lacks economic substance.

The payments due during the term of the Sublease represent a circular cash flow. The Sublease rent paid by A through K to D matches the loan payments due from D to G and J. In addition, after the close of the Sublease term on Date 4, the required cash flows for the Purchase Option are also circular. All of the payments required for the first installment of the Purchase Option are prefunded by the loan. The sum of the payment by K to D on the first installment of the Purchase Option of $7 plus the final payment of rent exactly equals the amount due from D to the lenders. By exercising the Purchase Option, A can make its initial purchase payment by making book entries. The remaining installments of the Purchase Option are covered by the maturing U.S. Treasury Strips.

F also provided $10 in an Initial Investment plus $14 in a Deferred Investment. This amount is partially defeased by the requirement that J purchase U.S. Treasury Strips in the amount of $13, and later in the amount of $14. The difference between the original amount of the Initial Investment and the amount used to buy U.S. Treasury Strips is retained by A and represents A's return on the transaction.

Although there is a spread between the rates of interest on the Swap Agreement with J, this spread is paid to J, as a fee for keeping the loan proceeds on deposit. It would appear to make no economic difference whether an amount was paid as interest or as a fee. In sum, the amount of the rent obligation is equal to the amount of the debt service. Thus, all such funds represent a circular cash flow. As a result, the offsetting and circular nature of the obligations eliminate any significant economic consequences of the transaction.

The different options at the end of the Sublease term do not present significant real economic risk to either party. F relies on an appraisal (Appraisal) that indicates that the Replacement Option is most likely because the Purchase Option exceeds the

Appraisal's estimation of the fair market value of the Property on Date 4. The Appraisal states that as of the end of the Sublease term the Property will have an estimated fair market value of $15 to $16. The amount of the Purchase Option is $6 with the first installment of $7 coming due on Date 4. K would then owe four more installments totaling $8. In reality, K (or A) need only make book entries in order to exercise the Purchase Option. Moreover, this assertion depends upon the accuracy of the Appraisal and the assumption that A will not have a significant business incentive to retain possession of the Property which it uses. The Appraisal states that a primary user of similar Property operates them for an average of #6 years and that it is most likely that a secondary user will be able to operate the Property for an average of #7 more years. The Appraisal further states that because M is purchased to perform a particular function, it is rarely if ever sold to a secondary user until it has fulfilled its primary life. In fact, the Appraisal states that it is not possible to identify sales of M which are only a few years old. This supports the theory that A would be unwilling to part with its Property after only #4 years.

A also can exercise A's Return Option and pay a deficiency payment of $9 to D. Because A has prepaid the Purchase Option of $7, A would have to come up with the difference between the deficiency payment and the Purchase Option and give up the use of the Property; an unlikely scenario given A's ongoing use of the Property.

These first two options are available to both A and K. In addition, K has a third option, the Replacement Option, but since A, through B, is subrogated to K's rights, we will address this option in terms of the likelihood of A's election. The minimum rents, ($17 a year for #5 years, a total of $18), that would be required of a replacement lessee, far exceed the total rentals for the Basic Term. The rent must be increased in order to fully discharge the principal balances of the loans (which would not have been discharged since the Purchase Option was not exercised). If $18 truly represents the fair market value of the rentals of the Property beginning in Date 4, then it also indicates that the Property are more valuable at that point than the Appraisal estimates. Thus exercising the Purchase Option would be the logical choice. On the other hand, if this is excessive rent, then no truly independent Replacement Lessee could be found at those rates.

Accordingly, the Purchase Option is the most likely choice. Because the Purchase Option will be exercised, the circular flow of money is complete, and F's only real out of pocket expenses represent fees paid to the accomodating parties. We believe that we would prevail on the argument that deductions related to those circular payments should not be allowed. Because the transaction lacks the potential for any significant economic consequences, the LILO transaction lacks economic substance. Therefore, the depreciation deductions arising from the transaction should not be allowed.

Further, if case development reveals that F is found to be the owner of the U.S. Treasury Strips for tax purposes and F's ownership is separate from the principal tax benefit sought in the transaction, F should be required to include in income the original issue discount (OID) accruing with respect to the U.S. Treasury Strips. Under the facts provided, it appears that the OID income associated with the U.S. Treasury Strips may be both economically substantive and separable from the sham aspects of the underlying transaction. The "centerpiece" or "principal tax benefit" of the LILO transaction is to create artificial rent and interest deductions that have no economic basis due to the offsetting circular cash flows. See ACM Partnership, 157 F.3d at 262; compare Salina Partnership v. Commissioner, T.C. Memo. 2000-352 (refusing to classify transitory partnership as a sham but upholding the Commissioner's determination on alternate grounds). Thus, if F is found to be the owner of the U.S. Treasury Strips, the OID income that accrued on the Strips will have an economically substantive impact on F's net financial position. Under these circumstances, recognition of the income attributable to the U.S. Treasury Strips accurately reflects the economic realities of the transaction. 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).

3. Purported Sale of the Property from A and F

Arguments directed toward recharacterizing a sale leaseback are generally unavailing in LILO transactions. A sale leaseback transaction is distinct from a LILO transaction. While a LILO is analogous to a lease from one entity to another with a generally coextensive lease back, a sale leaseback involves a disposition for tax purposes. Rev. Proc. 75-21, 1975-1 C.B. 715, provides safe harbors and ruling guidelines for determining whether a transaction is a lease or a sale. Because a sale leaseback is distinct from a LILO transaction, Rev. Proc. 75-21 does not apply to LILO transactions. Notwithstanding this distinction, because a purported sale has been layered on top of the LILO, a benefits and burdens analysis is warranted as to that portion of this transaction.

The term "sale" is given its ordinary meaning and is generally defined as a transfer of the ownership of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). Whether a transaction is a sale is a question of fact which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9th Cir. 1956). A transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). Courts have considered the following factors relevant in determining whether the benefits and burdens of ownership passed: (1.) Whether the transaction was treated as a sale. United Surgical Steel

Co., Inc. v. Commissioner, 54 T.C. 1215, 1229-30, 1231 (1970), acq., 1971-2 C.B. 3; (2) Whether the obligors on the notes were notified of the transfer of the notes. Id.; (3) Which party serviced the notes. Id.; Town & Country Food Co., Inc. v. Commissioner, 51 T.C. 1049, 1057 (1969); (4) Whether payments to the transferee corresponded to collections on the notes. United Surgical, 54 T.C. at 1229-30; Town & Country, 51 T.C. at 1057; (5) Whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship. United Surgical, 54 T.C. at 1230; Yancey Bros. Co. v. United States, 319 F. Supp. 441, 446 (N.D. Ga. 1970); (6) Which party had the power of disposition. American National Bank of Austin v. United States, 421 F.2d 442, 452 (5th Cir. 1970); cert. denied, 400 U.S. 827 (1970); (7) Which party bore the risk of loss. Union Planters Nat'l Bank of Memphis v. United States, 426 F.2d 115, 118 (6th Cir. 1970), cert. denied, 400 U.S. 827 (1970); and (8) Which party had the potential for gain. United Surgical, 54 T.C. at 1229; Town & Country, 51 T.C. at 1057. Although the potential for gain and amount of risk have been deemed the pivotal factors, the overall concentration should lie on the economic substance of the transaction. Mapco, Inc. v. United States, 556 F.2d 1107, 1111 (Ct. Cl. 1977).

In order to apply the above factors to the purported sale of the Property between A and F, it is necessary to ascertain which party possesses the benefits and burdens of owning the Property.

Legal title to the Property does not pass to F at the inception of the transaction because A does not own the Property. Instead A and C assign their right, which includes the right to purchase the Property, to F. Thus legal title cannot pass to F until the option is exercised. Even though legal title appears to pass to F when, and if, F exercises its right to buy the Property, if the Purchase Option is exercised, it will pass back to A at the end of the Basic Term.

On its books, F treated the transaction as a leveraged lease financing arrangement. It is not clear from the facts presented how B treated the transaction on its books. Nor is it clear if the Country A entities were notified of the transfer.

F never had possession of the Property as they were being operated by A in Region A, Country B. Although F could gain possession of the Property under certain circumstances, this possibility was remote, given the options available to A.

F's investment in the transaction was partially defeased by the Initial Investment of the $13 and the Deferred Investment of $14 in U.S. Treasury Strips. The rest of F's Initial Investment was in the nature of a fee. The proceeds of the loans to F circle around and are ultimately used to repay G and J. Thus, F's investment is best characterized as an investment in the U.S. Treasury Strips, and not in the Property. Moreover, because of the Purchase Option, F has not retained any potential for appreciation in the Property. A, however, had the potential to profit both from the operation of the Property and from the ultimate disposition of the Property.

Because the Purchase Option is the most likely option, F is at little risk in the transaction. F insulated itself against loss due to the potential decrease in fair market value. From the inception of the lease, F specified certain lease termination payments that were required should the Lessee, or Sublessee, terminate the lease early. These payments would ensure that F would not suffer any economic loss due to a decrease in the fair market value of the Property. In addition, both the Lease and Sublease were net leases requiring A to pay all insurance premiums, maintenance expenses and property taxes.

Accordingly, the purported sale of the Property from A to F is merely a vehicle for passing the funds further along the circle. Viewed as a whole, the objective facts of the purported transaction indicate that the transaction lacks the potential for any significant economic consequences to F other than the creation of tax benefits; the transaction lacks economic substance.

4. Treatment of Interest Expense

Having concluded that the transaction lacks economic substance, the next issue is the proper treatment of the interest deduction. The original loans of $3 and $5 were an integral part of the LILO transaction. In general, an interest deduction that is part of a transaction that lacks economic substance may be disallowed, even if it arises on bona fide debt. See Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966). There are, however, circumstances where a loan that is part of a transaction that lacks economic substance is recognized. See Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985). The difference between the two scenarios is whether the loans are an integral part of the transaction that lacks economic substance. It is our opinion that the loans under the present facts are an integral part of the transaction.

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

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

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

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

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

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

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

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

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

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

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

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call if you have any further questions.

ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES
By: MATTHEW LAY
ASSISTANT TO THE BRANCH CHIEF
OFFICE OF THE ASSOCIATE CHIEF COUNSEL
(PASSTHROUGHS & SPECIAL INDUSTRIES)