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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL

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

SUBJECT: Lease-in/Lease-out Transaction

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LEGEND

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F=
G=
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K=
X=
Y=
Trust=

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ISSUES

1. Whether the Lease-in/Lease-out (LILO) transaction described below has economic substance.

2. Whether the LILO transaction qualifies for nonrecognition treatment under section 1031 of the Internal Revenue Code.

3. Whether A is required to include in income original issue discount .

4. Whether A's participation in the LILO transaction subjects it to the accuracy-related penalty for negligence and substantial understatement pursuant to section 6662.

CONCLUSIONS

1. The LILO transaction described below lacks economic substance and should not be respected for federal income tax purposes.

2. The LILO transaction does not qualify for nonrecognition treatment under section 1031. The replacement property acquired by A appears to constitute a partnership interest which under section 1031(a)(2)(D) does not qualify for nonrecognition treatment. Even if the replacement property does not constitute a

partnership interest, section 1031 nonrecognition treatment will be unavailable because the transaction lacks economic substance.

3. A must include OID in income.

4. A is liable for the accuracy-related penalty because of its participation in a transaction lacking in economic substance.

FACTS

1. A's Sale of X

On Date 1, A, acting through an intermediary, sold its ownership interest in X, a culm-fired cogeneration plant, for $a. At the time of sale, A held its interest in X with an adjusted basis of $b. Accordingly, the sale of X caused A to realize a gain of $c.

To defer the gain realized from the X sale, A entered into a LILO transaction with B. A treated the transaction as a sale and leaseback and accounted for it as a purchase, claiming like-kind exchange treatment under section 1031 of the Internal Revenue Code.

2. Lease Terms

On Date 2, all of the parties to the transaction described below entered into a Participation Agreement generally describing the LILO transaction through which A would lease Y from B. A created a grantor trust, Trust, to act on its behalf in the transaction. C, a Delaware corporation was appointed as trustee, and executed all of the LILO transaction documents as trustee for A.

Prior to the transaction, B, a tax-exempt entity, was a% owner of Y, an electric generating facility located in State. D, an unrelated tax-exempt entity, owned the remaining b% of the facility. B agreed to lease a c% undivided interest in the facility to Trust for a term of d years beginning Date 2 and ending on Date 3 (Head Lease). Trust agreed to lease the same interest back to B for a term of e years, beginning Date 2 and ending Date 4 (Operating Lease). C and B agreed that B's transfer of the undivided interest in the facility would be treated as a sale of that interest by B and the rent received by B would be treated as the purchase price.

Trust owed rent of $a to B under the Head Lease. To fund this rental payment, A invested $d and borrowed $e in non-recourse loans from E. The borrowed $e was divided into a Series A loan for $f and a Series B loan for $g. The Series B loan was immediately sold to F. A transferred the entire $a to Trust which prepaid the $a rent to B in full payment of the Head Lease.

Pursuant to an Investment Agreement, B transferred the prepaid rent to three accounts. First, B deposited $g with G. The Investment Agreement required G to invest the money in U.S. Treasury Strips. B pledged the deposit with G to Trust for its obligations under the Operating Lease. Trust in turn pledged this interest to F, the lender of the Series B loan, as collateral for the Series B loan. B also purchased a surety bond from F for $h guaranteeing the payments owed to Trust under the Operating Lease, with an additional fee of $i paid to F. B agreed to reimburse F for any payments made pursuant to the surety bond. Second, B deposited an amount equal to the Series A loan with H. The interest rate on the Series A loan to A equaled the interest rate paid on the amount deposited with H, and H is an affiliate of E, the Series A lender. Third, B transferred approximately $j to I. This money was used to purchase U.S. Treasury Strips. The maturity dates and amounts of the Treasury Strips would allow B to use the proceeds to fund the purchase option granted to B. The remainder of the prepayment, approximately $k was retained by B as its fee for participating in the transaction.

Pursuant to the Operating Lease, Trust leased the undivided interest in Y back to B for a term beginning Date 2 and ending on Date 4. The rent due to Trust under the Operating Lease was paid from the three accounts described above and equaled the amounts due by A under the Series A loan and Series B loan. Trust used the rental payments to make payments on the Series A loan and Series B loan.

B holds the following options for the end of the Operating Lease term. First, B can purchase Y from Trust for a fixed price of $l. This amount exceeds the estimated appraisal value of Y at that point by $m. If B exercises this purchase option, B must pay an immediate installment of $n on Date 4, and four subsequent installments of $o each on Date 5, Date 6, Date 7, and Date 8.

If B fails to exercise the purchase option, D will have the opportunity to purchase Y from Trust under the same conditions offered to B. If neither B nor D exercises its respective purchase option, then A can terminate the Operating Lease and purchase Y for $p. If A also chooses not to exercise its purchase option, the Operating Lease grants B the option of arranging for service contracts. This option requires B to locate potential purchasers of power and to persuade those purchasers to enter into a Power Sales Agreement with Trust.

To fund either the purchase option or the service contract option, B would use its remaining deposits with G, H, and the matured Treasury Strips. If B elects the purchase option, Trust would use the initial option payment to pay off the Series A loan and Series B loan. The four installment payments would be transferred to A.

The LILO transaction allows A to defer approximately $c in capital gains for a e year period.

LAW AND ANALYSIS

You have asked whether this LILO transaction should be respected for federal tax purposes. For the reasons discussed below, we agree with your conclusion that the 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); 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.

In other leasing transactions, leases have been respected as valid despite the presence of credit support for their payment, such as third-party rent guarantees. See Torres v. Commissioner, 88 T.C. 702 (1987); Cooper v. Commissioner, 88 T.C. 84 (1987); Gefen v. Commissioner, 87 T.C. 1471 (1986). On the other hand, a fully defeased lease arguably is not "compelled or encouraged by business and regulatory realities" as required by Frank Lyon v. Commissioner, 435 U.S. 561, 583 (1978).

Moreover, claims of pre-tax profit are not dispositive. There is 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 pre-tax profit. See Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 203 n.17 (1983), aff'd in part and rev'd in part on other grounds, 752 F.2d 89 (4th Cir. 1985).

See 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.

2. Application to LILO Transaction

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).

A sale leaseback transaction is distinct from a LILO transaction. A LILO involves a lease from one entity to another, with a generally coextensive lease back to the first entity. 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. Similarly, an analysis of the benefits and burdens factors, as would be utilized in analyzing a sale leaseback, would be inappropriate under the present facts.

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.

As in Rev. Rul. 99-14, the cash flows in the LILO transaction described above are completely circular in nature. The proceeds of the Series A loan are transferred to B through Trust, and are then immediately deposited with H, an affiliate of the Series A lender. The deposit with H earns an interest rate equal to that paid on the Series A loan. H will use the deposit plus interest to pay B's rent obligation under the Operating Lease, as well as a portion of B's initial installment of the purchase option.

Likewise, the proceeds from the Series B loan are transferred to B who immediately deposits them with G. The interest rate paid on the Series B loan to F is f%, compared with g% paid on B's deposit with G. These funds were also used to pay

B's rent obligations under the Operating Lease and a portion of the initial installment of the purchase option.

As described above, all of the payments due under the Operating Lease are fully defeased as of the closing date of the LILO transaction. Documents obtained from B consistently refer to the transaction as fully defeased. Moreover, with the exception of the minimal risk associated with the Series B loan, A has eliminated all potential risks which may result from the transaction.

In addition, the various options at the end of the Operating Lease term present insignificant, if any, economic risk to either B or A. Although A obtained an appraisal showing the fair market value of the property at the end of the sublease term to be far less than the purchase option amount, such appraisal is unreliable because it assumes a major turbine failure in the final year of the Operating Lease. Furthermore, the appraiser, concludes that B would have no incentive to exercise its purchase option at the close of the Operating Lease term. However, this conclusion apparently ignores B's interest in retaining ownership of Y. Documents obtained from B show that ownership and control of Y were of paramount concern to B, and if B failed to exercise its purchase option, either D or A could accede to B's ownership interest. Journal entries made by B on Date 9 reflect a debit to "Restricted Investment - Lease Termination Fund" and a credit to "Lease Termination Obligation", both in the amount of $q, the amount used for the purchase of the Treasury Strips and for funding the purchase option. The notation to this journal entry reads, "to record the investment of the equity deposit received for the fixed option and the obligation to exercise this option (terminate the lease) in e years."

Additionally, although the appraisal evaluates the service contract option, it fails to recognize the remoteness of this option, as it is only available if the purchase option is not exercised by either B or D, and A does not exercise its preemptive election.

The above facts, combined with the full prepayment of the purchase option price at the start of the transaction, indicate that exercise of the purchase option is the most likely choice for B. The purchase option thus acts as an "economic collar" which, when exercised, completes the circular flow of funds.

In addition, the net present value of A's equity investment of $d equals approximately $r absent any tax benefits - an approximate h% rate of annual return. However, when tax benefits are included, the present value of the investment for the same period increases to approximately $s - an approximate i% rate of annual return.

Based on the above, the circular flow of funds, the minimal risk associated with the LILO transaction, and B's incentive to purchase the property as set forth above, we believe the transaction lacks economic substance and should be disregarded for federal income tax purposes. Accordingly, A should be required to immediately recognize the gain it realized on the sale of X, and should be denied any deductions associated with the transaction.

3. Like-Kind Exchange

To defer gain recognition of $c on the disposition of X, A structured a deferred like-kind exchange under section 1031. A, acting through Trust, acquired a c% interest in Y through a LILO transaction. The term of the Head Lease from B in the LILO is d years, and the term of the Operating Lease back to B is e years. The remaining useful life of Y is estimated to be j years.

Section 1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(c) of the regulations includes as examples of a "like kind" exchange that qualifies for deferral of gain under section 1031(a)(1) the exchange of city real estate by a taxpayer who is not a dealer in real estate for a ranch or farm, or the exchange of a leasehold of a fee with 30 years or more to run for real estate, or the exchange of improved real estate for unimproved real estate.

Section 1031(a)(2)(D) provides that section 1031(a)(1) shall not apply to any exchange of interests in a partnership. The flush language in that provision indicates that for purposes of section 1031, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of the partnership and not as an interest in the partnership. See also §1.1031(a)-1, which provides in part that section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are limited or general.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and is not a corporation, or a trust or estate. Section 761(a) allows a qualifying joint venture to elect out of subchapter K if "it is availed of for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted." Section 1.761-2(a)(3) sets forth the following three-prong test to determine whether a joint venture will qualify to make a 761 election:

1. The participants own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights, and
2. The participants reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and
3. The participants do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year.

In this case, certain documents characterize the relationship of B and D as joint venturers in the ownership and operation of Y. We note that the undivided interest in Y that A claims it acquired for purposes of effectuating the like kind exchange was acquired from only one of the parties -- B. It was not acquired by virtue of either a long term lease or sale of such interest from both parties, as joint venturers. As a joint venture, B's and D's ownership interests in Y would be partnership interests for federal tax purposes, unless the owners elected out of subchapter K under section 761(a).

In applying the three-part test of section 1.761-2(a)(3) to Y, the owners appear to satisfy the first two prongs. The Y Ownership Agreement executed by B and D states that B and D own Y as tenants in common and that each participant reserves the right to take in kind or dispose of their shares of power produced. However, the Ownership Agreement also states that excess power not needed by B or D shall be pooled and offered for sale, with each owner credited a proportionate share of the revenue from the sale. This provision likely violates the requirement under section 1.761-2(a)(3) that the co-owners do not jointly sell the property produced. Thus, regardless of whether or not B and D actually elected out of subchapter K, it seems unlikely that they were eligible to do so.

Assuming your office determines that the facts indicate that B and D own and operate Y as a partnership, and thus the property acquired by the A from B amounts to a partnership interest, section 1031(a)(2)(D) of the Code precludes A from using section 1031 to defer its gain on the disposition of its interest in the culm-fired cogeneration plant.

In the event that the interest acquired by A does not constitute a partnership interest, then under the section 1031 regulations, Y must be actually acquired by Trust. This acquisition can be accomplished either by purchase or through a lease with a term of at least 30 years. If the LILO transaction lacks economic substance, and thus Y was not actually acquired by Trust, the section 1031 nonrecognition of gain is not available to A on the disposition of X.

4. Original Issue Discount

If the LILO transaction lacks economic substance, then A can be imputed original issue discount (OID) income under two alternative arguments. First, the $d equity investment by A could be characterized as a loan from A to B. To the extent that the purchase option price exceeds the equity investment, that amount should be included in A's income as OID income. In the alternative, the transaction could be recharacterized as A's purchase of $j of Treasury Strips. Funds paid by A to B were used to buy the Treasury Strips, which are pledged to C and the payments upon maturity of the Treasury Strips are used to satisfy B's obligations to A. These facts indicate that A is the owner of the Treasury Strips, and therefore, the OID on the Treasury Strips must be included in A's income.

5. Penalties

Section 6662 imposes an accuracy-related penalty equal to twenty percent of the portion of the underpayment attributable to, among other things, negligence or disregard of rules or regulations, and any substantial understatement of income tax. Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components and, thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is twenty percent. The accuracy-related penalty does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. Section 6664(c)(1).

1. *Negligence*

Pursuant to sections 6662(c) and 1.6662-3(b)(1), negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of the tax return. Negligence has been defined as the failure to what a reasonably and ordinarily prudent person would do under the circumstances. Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967); Neely v. Commissioner, 85 T.C. 934, 947 (1985). Section 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable person to be "too good to be true" under the circumstances.

In Compaq v. Commissioner, 113 T.C. 214 (1999), the Service argued that Compaq was liable for the accuracy-related penalty because Compaq disregarded the economic substance of the transaction. The Tax Court agreed with the Service's position and upheld the Service's assertion of the negligence penalty because Compaq "failed to investigate the details of the transaction, the entity it was investing in, the parties it was doing business with, or the cash-flow implications of the transaction."

Similarly in United Parcel Services of America, Inc. v. Commissioner, T.C. Memo. 1999-268, reversed, 87 AFTR2d ¶ 2001-1051 (11^{th} Cir. 2001), the Tax Court sustained the Service's determination of the negligence penalty against United Parcel Service (UPS) because UPS was a sophisticated taxpayer engaged in an ongoing sham transaction devoid of economic substance for the year at issue.

The Tax Court likewise sustained the application of the negligence penalty in Sheldon v. Commissioner, 94 T.C. 738 (1990), stating that the taxpayer intentionally entered into loss-producing repurchase agreements to generate and claim tax benefits.

b. *Substantial Understatement*

Pursuant to section 6662(d)(1), a substantial understatement of income tax exists for a taxable year if the amount of the understatement exceeds the greater of ten percent of the tax required to be shown on the return or $5,000 ($10,0000 in the case of corporations other than S corporations or personal holding companies). Section 6662(d)(2)(B) provides that understatements are generally reduced by the portion of the understatement attributable to: 1) the tax treatment of items for which there was substantial authority for such treatment, and 2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or a statement attached to the return, and there is a reasonable basis for the taxpayer's tax treatment of the item. These exceptions, however, do not apply to tax shelter items of corporate taxpayers. Section 6662(d)(2)(C)(ii). Thus, if a corporate taxpayer has a substantial understatement attributable to a tax shelter item, the accuracy-related penalty applies to the understatement unless the reasonable cause exception applies. Section 1.6664-4(e), discussed below contains special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation. However, section 6662(d)(2)(C)(iii) which is applicable to the years at issue, defines a tax shelter, among other things, as a plan or arrangement the principal purpose of which is tax avoidance or evasion.

c. *Reasonable Cause*

Section 1.6664-4(b)(1) provides that the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, generally taking into account all pertinent facts and circumstances. The most important factor is generally the extent of the taxpayer's effort to assess its proper tax liability. Reliance on professional advice may constitute reasonable cause and good faith if, under all the circumstances, such reliance was reasonable. See United States v. Boyle, 469 U.S. 241 (1985). The advice must also be based upon all pertinent facts and circumstances and the law relating to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purpose) for entering into a transaction and for structuring a transaction in a particular manner.

With respect to reasonable cause for the substantial understatement penalty attributable to a corporation's tax shelter items, a corporation is deemed to have acted with reasonable cause and in good faith if the corporation had substantial authority, as that term is defined in section 1.6662-4(d), for its treatment of the tax shelter item, and if at the time of filing the return, the corporation reasonably believed such treatment was more likely than not the proper treatment (more likely than not standard). Section 1.6664-4(e)(2)(i).

The regulations provide that the more likely than not standard can be met by the corporation's good faith and reasonable reliance upon the opinion of a tax advisor if the opinion is based on the advisor's analysis of the pertinent facts and authorities in the manner described in section 1.6662-4(d)(3)(ii), and the opinion unambiguously states the advisor's conclusion that there is a greater than fifty percent likelihood the tax treatment of the item will withstand a challenge by the Service. Section 1.6664-4(e)(2)(i)(B)(2).

In this case, it is likely A will claim it had reasonable cause for the LILO transaction because it had a valid business purpose. Although a review of X's operating profit and net income for the years Date 10 through Date 11 appears to give some merit to this claim, A has provided nothing to show that Y would be a better investment than X. As with the taxpayers in Compaq and United Parcel Service, A is a sophisticated taxpayer who would not have blindly ventured into this investment. Yet nothing has been provided to date to show that A considered investing in any other power plants, and if it did so, how those power plants compared with Y. The information gathered by the Internal Revenue Service shows B, acting through J, was in the market for an investor in its power plant. J then apparently brought this to the attention of K, and after considering several alternatives relating to the amount of the investment, the transaction was consummated as a LILO in the amount of $a. None of the information gathered shows that A either performed an in-depth analysis of Y or considered other investments as like property to exchange.

In addition, when considering the present value and internal rate of return analysis mentioned above, arguably no prudent business person would enter into the transaction. Absent the tax benefits, the net present value of A's $d investment utilizing a rate of k% (weighted average of the rate paid on the Series A and Series B deposits) produces a loss of approximately $t. Similarly, A's investment, without the tax benefits, produces an internal rate of return of approximately h%. A most conservative investment in the lowest rated T-bills would have yielded a return rate of at least I%.

Based on the circular cash flows, the rate of return, and the lack of a valid business purpose, it is evident that A's involvement in the LILO transaction was solely due or primarily motivated by the tax benefits, and thus is totally devoid of economic substance. Therefore, based on the facts presented, assertion of the section 6662 accuracy-related penalty is appropriate in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

Please call Craig Gerson at (202) 622-3050 if you have any further questions.

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