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

OFFICE OF
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September 7, 2001

Number: **200150011**
Release Date: 12/14/2001
CC:ITA:B5
TL-N-2319-00

UILC: 162.09-10

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL LM:MCT

FROM: J. Charles Strickland
Senior Technician Reviewer
CC:ITA:B5

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated May 30, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

X =

Y =

Z =

Date 1 =

Date 2 =

Date 3 =

Amount A =

Amount B =

Amount C =

Amount D =

Amount E =

Amount F =

Amount G =

Amount H =

Amount J =

Amount K =

Amount L =

Amount M =

Lender 1 =

Lender 2 =

Country M =

Year 1 =

ISSUES

1. Should the described LILO transaction be disregarded for federal income tax purposes because it lacks economic substance?

2. Should the transaction be recharacterized according to its substance, and, if so, how?

3. Should penalties be asserted?

CONCLUSIONS

1. The described LILO transaction should be disregarded because it lacks economic substance.

2. The transaction can be recharacterized as a loan by Taxpayer.

3. Penalties for negligence and substantial understatement of income tax may be asserted depending on the facts.

FACTS

In this lease-in, lease-out (LILO) transaction, a member of Taxpayer's affiliated group, X, enters into a 36-year headlease of railroad stock with Y.[1] The headlease calls for an advance rent payment of approximately Amount A and a deferred rent payment of approximately Amount B, which is due five years after expiration of the headlease.[2] The advance rent payment is allocated to the first four years of the headlease, while the deferred rent payment is allocated to the remainder of the headlease term and the following five years. X then leases the property back to Z, a Country M corporation. The term of the leaseback is 15 years, but there is a 13.8-year renewal term. Z assigns its rights to Y, the owner of the equipment and the lessor under the headlease.

X funds the advance rent payment with equity of approximately Amount D, a loan from Lender 1 of approximately Amount E, and a loan from Lender 2 of approximately Amount F. After payment of the advance rent to Y, the portion borrowed from Lender 1 is deposited in an account at Lender 1 bearing the same rate of interest as the loan. The portion borrowed from Lender 2 is deposited in an account at Lender 2's parent corporation. It earns a variable amount based on LIBOR, but Lender 2's parent enters into a swap transaction with Z that appears designed to eliminate the risk that interest will not be sufficient to satisfy the loan from Lender 2. The deposited amounts are used to make rent payments pursuant to the leaseback. X then uses the funds to service its debt. Of the equity portion of the advance rent payment, approximately Amount G is deposited in a custodian account and used to purchase various securities. The remainder of the equity portion, approximately Amount H, is retained by Y and other parties as transaction fees.

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[1] X engages in the transaction on Date 1, through a grantor trust. Apparently, the described transaction is only one of several LILOs engaged in by Taxpayer.

[2] The value of the equipment on the date of the transaction is approximately Amount C.

At the end of the initial leaseback term, Z has the option of buying X's headlease interest for approximately Amount J. If this option is not exercised, X can either compel the renewal term, lease the property to a third party for market rent then prevailing until Date 2, or obtain possession of the property. Assuming that either its headlease interest is purchased pursuant to the option or that it compels the renewal term, X will earn a pre-tax return of approximately Amount K percent on the transaction.

LAW AND ANALYSIS

In general, a transaction will be respected for tax purposes if it has "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." Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978); James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990). In assessing the economic substance of a transaction, a key factor is whether the transaction has any practical economic effect other than the creation of tax losses. Courts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer's beneficial interest except to reduce tax. The presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990).

In determining whether a transaction has sufficient economic substance to be respected for tax purposes, courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. For example, in Knetsch, the taxpayer purchased an annuity bond using nonrecourse financing. However, the taxpayer repeatedly borrowed against increases in the cash value of the 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, the Tax Court denied the taxpayer the purported 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 consequences of holding the Treasury bills were 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 at 769.

In ACM Partnership, 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 at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had a large tax effect resulting from the application of the installment sale rules to the sale. 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 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 Rev. Rul. 99-14, 1999-1 C.B. 835, the Service concluded that the LILO described in that ruling lacked economic substance because during the initial leaseback term there were no economic consequences to the U.S. taxpayer and after the initial leaseback term, the U.S. taxpayer's potential profit or loss due to fluctuations in the value of the residual interest were "collared" by cross-options (the foreign party's purchase option and the U.S. taxpayer's put renewal term option).

This transaction contains those same essential features and should likewise be disregarded for lack of economic substance. During the 15-year term of the leaseback to Z, X's right to use the property under its headlease is completely offset by its obligation to make the property available under the leaseback. Moreover, X's right to rent under the leaseback is completely offset by its obligation to make debt service payments to Lender 1 and Lender 2. That the rent and debt service will be paid is assured by the deposit arrangements. In short, during the 15-year term of the leaseback, the offsetting nature of the obligations eliminate any significant economic consequences to Taxpayer.[3]

Although there are potential economic consequences at the end of the initial leaseback term, these are very limited, as in Rev. Rul. 99-14. If Z exercises its purchase option due to the value of the property, Taxpayer is projected to realize a

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[3]The fact that the headlease is from Y while the leaseback is to Z does not provide a basis for distinguishing this case from Rev. Rul. 99-14. As in the ruling, the U.S. taxpayer does not acquire possession of the property during the leaseback term and the offsetting obligations eliminate cash flow.

pretax profit of approximately Amount K percent. If the property has depreciated so that exercise of the option is not attractive to Z, then Taxpayer can require a renewal leaseback term of 13.8 years, and the rents from the renewal leaseback also are projected to produce a pretax profit of approximately Amount K percent for Taxpayer.[4] Although a third possibility exists, a lease to a third party, this possibility seems unlikely in that if the property has retained enough value so that a lease to a third party will be more attractive to Taxpayer than the renewal leaseback to Z, Z will likely exercise its purchase option.[5] Thus, the transaction is structured to assure Taxpayer a pretax return of Amount K percent, without affording Taxpayer either the opportunity to earn significantly more than that or the risk of earning significantly less than that or of incurring a loss. This carefully limited exposure to economic consequences must be compared to the tax benefits promised by the transaction's promoters.

Nothing in United Parcel Service of America, Inc. v. Commissioner, 87 AFTR 2d ¶ 2001-1051 (11th Cir. 2001), requires a different result. In that case, the appellate court found that taxpayer's arrangement to have insurance premiums paid by its customers paid to an insurer (and then to a reinsurer) imposed real obligations on the taxpayer and the insurers. An economic substance inquiry is inherently factual. In this case, the facts show that Taxpayer's economic consequences from the transaction have been carefully and narrowly limited. Likewise, IES Industries, Inc. v. United States, 87 AFTR 2d ¶ 2001-1025 (8th Cir. 2001), is an economic substance case that turns on its specific facts. The appellate court concluded that taxpayer's purchase and sale of ADRs had economic substance because it earned the right to dividends on the ADRs and exposed itself to some risk that the dividends would not be paid and that it would not be able to resell the ADRs at the price contemplated.

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[4]We understand that X's obligation to make the deferred payment of approximately Amount B on Date 3 could be financed by Z's obligation to make a deferred payment of approximately Amount L at the end of its renewal leaseback term on Date 2. Thus, the existence of a renewal leaseback term would not obligate X to produce cash with which to make the deferred headlease rent payment.

[5]You have raised the point that this transaction presents a 7-year "tail" period, the interval of time between the end of the renewal leaseback term or lease to a third party and the end of the headlease term. We do not believe this imbues the transaction with substance. If the property were capable of generating significant rent during this period, it would be expected that Z would exercise its purchase option and acquire X's headlease interest. Under the parties' arrangement, Taxpayer's pretax profit is effectively capped at approximately Amount K percent.

Because the transaction lacks economic substance, it is to be disregarded for federal income tax purposes as it has been structured. Accordingly, Taxpayer is not entitled to deductions for rent or interest paid or incurred in connection with the headlease. Neither should Taxpayer have income as the result of receiving rent or purchase option payments. The economic substance doctrine has been applied to "give effect either to both the cost and the income functions [of a transaction], or to neither." ACM Partnership v. Commissioner, 157 F.3d at 261, citing Seykota v. Commissioner, 62 TCM (CCH) 1116.

You have asked whether any part of the transaction has economic substance that should be recognized for tax purposes. X is investing approximately Amount D with the expectation of receiving a return of approximately Amount K percent upon payment of the purchase option price or rent pursuant to the renewal leaseback. Thus, the transaction could be recast as a loan from X of Amount D, resulting in interest income to X. On the other hand, we do not believe X should be characterized as the owner of the securities held in the custodian account. Our understanding is that Z places approximately Amount G of the equity payment in this account, the funds are used to purchase municipal securities, and Z is entitled to approximately Amount M from the custodian in Year 1 regardless of the value of the account. Under these facts, X does not have the benefits and burdens of ownership of the securities – it neither benefits from their appreciation or earnings or suffers if they decline in value. See Angelus Funeral Home v. Commissioner, 407 F.2d 210 (9th Cir. 1969) (for federal income tax purposes taxpayer was owner of funds received in trust because funds inured to its benefit and were under its control).

You have asked whether penalties should be asserted. Code section 6662(a) imposes a penalty in an amount equal to 20 percent of the underpayment of tax attributable to one or more of the items set forth in section 6662(b). The items set forth in section 6662(b) include, as is relevant here, negligence and the substantial understatement of income tax.

"Negligence" includes a failure to make a reasonable attempt to comply with provisions of the internal revenue laws or failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See I.R.C. § 6662(c); Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), aff'g on this issue, 43 T.C. 168 (1964); Treas. Reg. § 1.6662-3(b)(1). A return position that has a reasonable basis is not attributable to negligence, but negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item "which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances[.]" Treas. Reg. § 1.6662-3(b)(1). The accuracy-related penalty does not apply with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion of an underpayment and that the taxpayer acted in good faith with respect to such portion. See I.R.C. § 6664(c)(1). The determination of whether the taxpayer acted with reasonable cause and in good faith depends upon the pertinent facts and circumstances. See Treas. Reg. § 1.6664-4(b)(1). The most important factor is the extent of the taxpayer's effort to assess the proper tax liability for the year. See Id. The negligence penalty can be applied to deficiencies resulting from the application of the economic substance doctrine. Compaq Computer Corp. v. Commissioner, 113 T.C. 214, 226-27 (1999).

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. I.R.C. § 6662(d)(1)(A). 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 an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. § 6662(d)(2)(B). However, those reductions do not apply to items of corporations attributable to tax shelters. I.R.C. § 6662(d)(2)(C)(ii). Tax shelter means, as is relevant here, any plan or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax. I.R.C. § 6662(d)(2)(C)(iii).

There is precedent for recovering the negligence penalty in an economic substance case so we would assert that penalty. Additionally, if the adjustments resulting from disregard of the LILO transaction result in a sufficiently large underpayment, we would assert the penalty for substantial underpayment of income tax.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call if you have any further questions.